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Patricia A. Redmond, Chair

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Legislative Update

Judith Greenstone Miller
Jaffe, Raitt, Heuer & Weiss, P.C.
Chair, Legislation Subcommittee

My Chi To
Debevoise & Plimpton LLP
Vice Chair, Legislation Subcommittee

Henry C. Kevane
Pachulski Stang Ziehl & Jones LLP
Contributing Author

California Assembly Bill No. 506

Effective January 1, 2012, California amended its statutory authorization for its local public entities to commence a municipal bankruptcy filing under Chapter 9 of the Bankruptcy Code. Previously, California's local public entities were freely authorized to file a Chapter 9 case (one of only 11 states that permitted such filings without conditions or pre-approval). Under the new law, a local public entity must now engage in a pre-filing, multi-party neutral evaluation (*i.e.*, mediation) or, alternatively, declare a fiscal emergency by majority vote at a public hearing. Moreover, under the new law, school districts in California are now excluded from the local public entities that may commence a Chapter 9 case. The new statute is enacted at Sections 53760 – 53760.7 of the California Government Code. Extensive legislative history accompanies the underlying Assembly Bill No. 506, sponsored by Assembly member Bob Wieckowski.

A state's statutory permission for its municipalities to seek federal bankruptcy relief is a key component of Chapter 9. The limitations on the eligibility of a municipality to file a Chapter 9 case arise because of the tension between two constitutional imperatives. On the one hand, as instrumentalities of a state, Chapter 9 municipal debtors enjoy substantial freedom from federal interference. This freedom derives from the Tenth Amendment to the Constitution which provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." On the other hand, only federal law can overcome the constitutional prohibition on the impairment by states of the obligation of contracts or otherwise override contrary state law. U.S. CONST., art. I, § 10, cl. 1 (Contracts Clause); art. I, § 8, cl. 4 (Uniform Bankruptcy Laws); art. VI, cl. 2 (Supremacy Clause).

The constitutional compromise manifests itself in the stringent eligibility test under the Bankruptcy Code for a Chapter 9 debtor. A potential debtor under Chapter 9 must, among other requirements, be "specifically authorized" by state law to file. The state authorization prong of the eligibility test is where many municipalities often find that their path to Chapter 9 relief is shut. Congress amended the Bankruptcy Code in 1994 to require that municipalities be "specifically authorized" under state law to file a petition under Chapter 9. 11 U.S.C. § 109(c)(2). Previously, a municipality was eligible if it was "generally authorized" to file. Although many states currently permit Chapter 9 cases, some with detailed pre-conditions or prior consent, almost half the states either prohibit or do not expressly permit the bankruptcy option. Various states currently use a gatekeeper to regulate entry to Chapter 9 (for instance, Connecticut, New Jersey, Kentucky and Louisiana require the prior approval of a petition or a proposed plan by certain state officers).

California's new eligibility statute imposes two conditions to filing a petition under Chapter 9: (a) participation in a neutral evaluation process pursuant to Gov't Code § 53760.3, or (b) declaration of a fiscal emergency pursuant to Gov't Code § 53760.5. Notably, even though the State has now imposed certain requirements to permit local entities to file a bankruptcy case, the State has disclaimed any liability or responsibility arising from a local public entity's actions under, or violations of, the new statute or the conduct of its Chapter 9 case. *See* Gov't Code § 53760.7. This "immunity from liability" disclaimer appears to be derived from earlier concerns following the Orange County bankruptcy case when California considered requiring express State approval for any Chapter 9 filings. Governor Pete Wilson vetoed this legislation in 1996 partly on the grounds that it "could raise questions of the liability of the state to creditors of the public agency if eligibility for bankruptcy is denied."

Governor Jerry Brown's signing statement accompanying AB506 stated that the bill "does not prevent a municipality from declaring bankruptcy or even throw roadblocks in its path. It simply requires local government to do either of the following: declare a fiscal emergency or negotiate with creditors before filing bankruptcy." The first option, codified at Gov't Code § 53760.5, requires the adoption of a resolution declaring a fiscal emergency by a majority vote of the local entity's governing body at a noticed public hearing. The resolution must include findings that (i) the financial state of the entity jeopardizes the health, safety or well-being of its residents, and (ii) the entity is or will be unable to pay its obligations within the next 60 days.

One of the elements of the federal eligibility test for Chapter 9 under section 109(c) of the Bankruptcy Code for Chapter 9 relief is that the municipality "must be insolvent." Hence, satisfying California's requirement of a fiscal emergency should not necessarily impose an additional obstacle to a distressed public entity. Nevertheless, the 60-day requirement is at odds with the typically long-term nature of municipal bond, pension and retirement liabilities. In the City of Vallejo Chapter 9 case, the unions claimed that, through a combination of budget cuts, wage compromises and contract modifications, the city could have operated for at least another year or possibly longer and, hence, was not definitively insolvent as of the petition date. The Bankruptcy Court and the appellate panel each rejected this "stopgap" approach to solvency under Chapter 9, taking a prospective, long-term view that a municipality is not required to literally run out of funds and actually default before it is deemed insolvent. *In re City of Vallejo*, 408 B.R. 280 (B.A.P. 9th Cir. 2009). California's new requirement shifts the focus from a

municipality's future inability to pay to its more immediate financial condition on the petition date.

The second option, pre-filing mediation, requires a distressed entity to initiate a neutral evaluation by providing notice to all "interested parties." These include trustees or indenture trustees, creditors' committees, creditors holding non-contingent claims greater than $5 million (or greater than 5% of the entity's total debt or obligations), pension funds, unions (that are party to collective bargaining agreements with the entity), and retiree representatives. The local entity and the interested parties must then agree on a mediator (failing which, the local entity can select the mediator from a slate of five nominees that is subject to veto by the interested parties). The mediator must have ADR experience and must also have at least 10 years experience as a U.S. bankruptcy judge or otherwise have professional experience in municipal finance.

Once commenced, the mediation process is deemed confidential and the mediator must, among other matters, advise all parties of the "provisions of Chapter 9 relative to other chapters of the bankruptcy code" and shall also "highlight the limited authority of United States bankruptcy judges in Chapter 9." Further, the new statute requires that all participants negotiate in "good faith," a term which is itself defined at Gov't Code § 53760.1(d). Last, the local public entity is responsible for 50% of the costs of the mediation, and creditors (not the more expansive group of "interested parties") are responsible for the balance, unless otherwise agreed.

The goal of the mediation is to reach a settlement among the local entity and all interested parties. If so, the mediator may then assist the parties in preparing a pre-packaged plan of adjustment in connection with a Chapter 9 filing. Alternatively, the settlement may lead to a consensual out-of-court restructuring. Under the new law, the mediation session cannot last for more than (i) 60 days unless the local entity ***or*** a majority of the interested parties agrees to a 30-day extension, or (ii) 90 days unless the local entity ***and*** a majority of the interested parties agree to a further extension.

The mediation process is deemed to end once the parties reach a settlement, or if the mediation process exceeds the maximum time limit, or if no interested party responds to the local entity's invitation to convene a mediation within the statutory deadline to respond (*i.e.*, 10 business days following the date of receipt of notice by certified mail). If the mediation is thus concluded, the local entity may then proceed to commence a Chapter 9 case (without meeting the stricter standard of a fiscal emergency). At any time during the mediation process, however, if the entity's financial condition deteriorates, it may declare a fiscal emergency and revert to the alternative means for authorization to file a Chapter 9 case.