

Dubious Distinctions: A Cautionary Tale of Stockton's Bankruptcy Firsts

By JOSHUA LEVIN-EPSTEIN

The city of Stockton, California has the dubious distinction of being the largest U.S. city ever to file for bankruptcy¹ and the first California city to seek Chapter 9 relief following the enactment of state laws expressly designed to curtail such access. The tepid economic recovery forced Stockton officials to file for bankruptcy in late June 2012, when dwindling tax revenues made obligations to bondholders, retirees, and employees unaffordable (24 BBLR 890, 7/12/12). While municipal bankruptcies are rare, a discussion of the Stockton bankruptcy case offers an instructive cautionary tale and a perspective on the Court's recent thinking. Bondholders and holders of public employee pension plans, in particular, should be closely following the restructuring of Stockton's unfunded pension plans, pension obligation bonds, and general obligation bonds.

Retired employees and bondholders have a lot at stake in these cases. For example, Stockton's retired employees' health benefits may be severely reduced. Moreover, the contemplated reductions would cost certain retirees nearly all of their annual incomes to replace.² According to the Association of Retired Employees of the City of Stockton, "it is not an exaggeration to say . . . that the City's plan has placed [retiree's] very

lives in imminent danger."³ Stockton's bondholders, who constitute six of the ten largest unsecured creditors⁴, are also in an unenviable position. Stockton's economic situation is so poor that the City defaulted on bond payments for the first time in its 150-year history.⁵

The Reasons for the Bankruptcy

The housing boom in the early 2000s transformed Stockton. Between 2000 and 2007, Stockton's population increased by 17%,⁶ which provided a boon to the City's treasury: Property tax revenues increased by more than 100%;⁷ sales and use taxes increased by 65%.⁸ Surging tax revenues enabled Stockton to sustain its generous benefits programs and fund expensive projects. City officials launched ambitious plans for a new City Hall, an event center, a marina, parking garages, and a slew of other capital-intensive projects.⁹ To fund its ambitious urban renewal plans, however, the City incurred significant debt.

The City banked on the housing market's continued growth to generate enough tax revenue to service an array of bonds and loans.¹⁰ For example, undergirding California's largest redevelopment project was approximately \$166 million in bond issuances, \$11 million in loans, and \$13 million in certificates of participation. Stockton's debt obligations were not its only problem.¹¹

Even before the housing boom, the City made onerous retiree health insurance commitments that were excessive in comparison to comparable cities' retiree obligations.¹² The City provided uncapped benefits without

¹ Steven Church and Alison Vekshin, *Stockton, California, Seeks Bankruptcy After Talks Fail*, BLOOMBERG.COM, June 29, 2012, <http://www.bloomberg.com/news/2012-06-29/stockton-california-files-for-bankruptcy-protection.html>

² Assoc. of Retired Employees of the City of Stockton's Complaint for Declaratory and Injunctive Relief, July 10, 2012, at p. 2 ¶ 4, ECF No. 305.

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³ *Id.*

⁴ List of Creditors Holding 20 Largest Unsecured Claims, July 28, 2012, ECF No. 20.

⁵ City of Stockton's Memorandum of Fact and Law in Support of its Statement of Qualifications Under Section 109(C) of the United States Bankruptcy Code, at p. 6 ¶¶ 27-28, July 29, 2012, ECF No. 19 (explaining that "Just to remain cash-solvent for the remaining months of 2011-12, the City defaulted on payments to capital markets creditors . . .").

⁶ *Id.* at p. 9 lns. 1-2.

⁷ *Id.* at p. 9 lns. 3-4.

⁸ *Id.* at p. 9 lns. 4-5.

⁹ *Id.* at p. 38 lns. 3-16.

¹⁰ *Id.* at p. 9 lns. 8-9.

¹¹ *Id.* at p. 38 lns. 8-16.

¹² *Id.* at p. 39 lns. 22-23.

any minimum service requirements¹³ whereas comparable cities provided no retiree benefits or only limited benefits. In a jarring example of Stockton's largesse, a Stockton employee who worked only one month was eligible for lifetime uncapped health benefits. To make matters worse, the City did not fund its retiree obligation on an "actuarially sound basis".

The City's labor contracts were also an albatross because the City approved contracts that were "neither transparent nor sustainable." In yet another example of imprudence, the City tethered automatic salary increases to other cities that were unreasonable comparisons and neglected to include "additional pays" that masked the trust cost of the contracts. Taken together, the City's "poor decisions",¹⁴ "lax management",¹⁵ "shoddy management and accounting practices"¹⁶ and misfortune,¹⁷ put the City in an economically precarious position. As long as the housing market grew, the City was able to collect developer fees and taxes to service its mushrooming obligations.

The Great Recession "hit Stockton hard."¹⁸ Since 2008, median home prices lost nearly one-third of their value from their peak in 2006¹⁹; sales and use taxes are expected to be 17% below peak year level;²⁰ unemployment has soared to over 20%²¹; and more than half of Stockton's homes are "underwater."²² Quality of life has also experienced a significant decline: Stockton has the highest crime rate for a large City in California²³, serious crimes are rising;²⁴ police department personnel have been reduced by 22%,²⁵ fire companies have closed;²⁶ police departments have been cut; virtually all government programs have been dramatically reduced; the city reduced its total full-time workforce by nearly 25%. By any measure, Stockton was in serious trouble.

All the "belt-tightening", fiscal "surgery", or any other drastic budget cutting colloquialism, could not stave off bankruptcy.²⁷ As a practical matter, the City could not raise taxes without voter approval because state law prohibited tax increases in situations where the City's expenditures exceeded revenues.²⁸ The City

also could not tap other City funds due to state and federal use restrictions. Faced with a budget crisis, the City defaulted on bond payments, initiated layoffs, and slashed funding for almost all programs. The City's austerity plan was not enough to shore up an operating shortfall of almost \$26 million for fiscal year 2012-2013.

The Advent of Cal. Govt. Code § 53760 to Curb

Municipal Bankruptcies

Stockton's financial crisis coincided with the enactment of legislation designed to limit access to Chapter 9. As the economy worsened, and states required voter approval of any tax increases, California legislators feared a tsunami of municipal bankruptcies. To limit access to Chapter 9, the State passed Assembly Bill 506 that conditioned a municipalities' filing of a bankruptcy on whether:

(a) The local public entity has participated in a neutral evaluation process . . . [or]

(b) The local public entity declares a fiscal emergency and adopts a resolution by a majority vote of the governing board . . .²⁹

The enactment of Assembly Bill 506 marked a change in policy that had for decades allowed municipalities' unfettered access to Chapter 9.

The City initiated the neutral evaluation process following a public hearing in February 2012 at which the Stockton City Council determined that the City was or was likely to become insolvent. For ninety days, under the auspices of the retired Honorable Ralph Mabey, the City negotiated with creditors, including the indenture trustees of its public debt issuances and bond insurers.³⁰ Unable to reach an out-of-court restructuring, the City filed for Chapter 9 on June 28, 2012 (24 BBLR 890, 7/12/12).

An Issue of First Impression:

The Interplay between Federal Law and California's State Law's

Confidentiality Requirement to Protect the AB 506 Mediation

Upon Stockton's bankruptcy, the City requested the Court's authority to submit confidential information about the AB 506 mediation to support the City's eligibility to be a Chapter 9 debtor. Under the Bankruptcy Code, the City must show that it meets Chapter 9's eli-

Qualifications Under Section 109(C) of the United States Bankruptcy Code, at p. 31 lns. 27-28, p. 31 lns. 1-3, July 29, 2012, ECF No. 19.

²⁹ Cal. Govt. Code § 53760.

³⁰ City of Stockton's Memorandum of Fact and Law in Support of its Statement of Qualifications Under Section 109(C) of the United States Bankruptcy Code, at p. 23 lns. 19-28, July 29, 2012, ECF No. 19.

¹³ *Id.* at p. 39 ln. 34, p. 40 lns. 1-2, 15-19.

¹⁴ *Id.* at p. 11 lns. 1-2.

¹⁵ *Id.* at p. 8 ln. 23.

¹⁶ *Id.* at p. 11 ln. 2.

¹⁷ *Id.*

¹⁸ City of Stockton's Memorandum of Fact and Law in Support of its Statement of Qualifications Under Section 109(C) of the United States Bankruptcy Code, at p. 8 ln. 20, July 29, 2012, ECF No. 19.

¹⁹ *Id.* at p. 9 lns. 18-19.

²⁰ *Id.* at p. 33 ln. 18.

²¹ *Id.* at p. 6 ln. 17.

²² *Id.* at p. 9 lns. 15-16.

²³ *Id.* at p. 6 lns. 22-23.

²⁴ *Id.* at p. 6 ln. 24.

²⁵ *Id.* at p. 6 lns. 23-24.

²⁶ *Id.* at p. 18 ln. 6.

²⁷ *Id.* at p. 7 lns. 5-6, p. 9 ln. 22.

²⁸ Cal. Const., art. XVI, § 18; see also City of Stockton's Memorandum of Fact and Law in Support of its Statement of

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gibility requirements set forth in Sections 109(c) and 921 of the Bankruptcy Code. The City requested the Court's authorization to submit confidential evidence about the mediation to support its petition without violating the confidentiality provisions of the mediation.³¹ Several creditors, including banks and financial institutions, objected to Stockton's request.

Chief Bankruptcy Judge Christopher M. Klein explained that Stockton's bankruptcy case "function[ed] as the maiden voyage"³² for evaluating the interplay between federal law and state law with respect to the confidentiality requirements of Calif. Gov. Code § 53760.

The Bankruptcy Court framed the issue as:

the extent to which the California confidentiality provision applies in the conduct of this chapter 9 case and, to the extent it does not apply, how to deal with matters warranting confidentiality³³

While Calif. Gov. Code § 53760.3(q) permits "lift[ing] the shroud of confidentiality" from the AB 506 mediation for the purpose of establishing eligibility under Chapter 9, federal law preempts state law in bankruptcy court. The Bankruptcy Court, was therefore tasked with deciding the extent to which Calif. Gov. Code § 53760.3(q) applied.

In a thorough, twenty-four page opinion, Judge Klein explained the longstanding principle that federal law

preempts state law unless an issue is governed by state law. Therefore, with respect to the City's Chapter 9 eligibility, the state's confidentiality provision only applied to Bankruptcy Code Section 109(c)(2), which provides that state law must authorize a City to be a Chapter 9 debtor.³⁴ To establish eligibility under Section 109(c)(2) of the Bankruptcy Code, the City desired to submit information about the number and length of meetings between the City and its creditors, the identity of the participants at such meetings, and the types of issues discussed. The Court denied the City's request because the evidence necessary to establish the City's eligibility under Section 109(c)(2) of the Bankruptcy Code was not confidential under California state law.³⁵

Conclusion

Despite the recent filing of several high-profile municipal bankruptcies, municipal bond analysts still consider municipal debt a safe investment and a nationwide wave of municipal bankruptcies unlikely.³⁶ Stockton's bankruptcy has not spooked the marketplace for municipal bonds as interest rates on the highest-quality 30-year bonds municipal bonds' yields are still low and do not reflect a substantial risk premium. For these reasons, the Stockton bankruptcy is best viewed as a cautionary tale rather than an indicator of things to come.

³⁴ *Id.* at 729.

³⁵ *Id.* at 730-31.

³⁶ Mary Williams Walsh, *Bankruptcy in California Isn't Seen as a Trend*, N.Y. TIMES, July 20, 2012, <http://www.nytimes.com/2012/07/13/business/bankruptcy-in-california-isnt-seen-as-a-trend.html>

³¹ *In re City of Stockton*, 475 B.R. 720, 724 (Bankr. E.D. Cal. July 13, 2012).

³² *Id.* at 727.

³³ *Id.* at 728.