

VIII. In re Stockton, California: Current Issues Surrounding the Landmark Municipal Bankruptcy

A. Introduction

On June 28, 2012, Stockton, California, a central valley city of 292,000, filed the largest Chapter 9 bankruptcy in U.S. history.¹ Though Detroit has since stolen that “title” from Stockton,² the Stockton bankruptcy has become a two-year legal battle that is setting up to be the case study for a string of municipalities across the nation that are on the brink of Chapter 9 filings.³ How Stockton handles the reorganization may dictate a new chapter in bankruptcy law.⁴

This Article will outline Stockton’s path to bankruptcy, the current status of the bankruptcy proceedings, and the potential future consequences of Stockton’s landmark municipal reorganization. Part B highlights issues surrounding Chapter 9 bankruptcy filings and California’s state bankruptcy laws. Part C gives reasons why Stockton became insolvent and filed for bankruptcy protection. Next, Part D briefly outlines the debate between bondholders and pensioners in Stockton’s bankruptcy proceedings. Part E analyses the recent bankruptcy court decisions concerning Stockton’s bankruptcy. Finally, Part F analyzes the arguments on both sides of the pension debate.

B. Background: Chapter 9 of the U.S. Bankruptcy Code

Chapter 9 of the U.S. Bankruptcy Code allows a municipality to file for bankruptcy protection while it works out its debts.⁵ Filing for Chapter 9 allows the municipality to cease payments to creditors while

¹ Billy Hamilton, *The Ask’: What’s at Stake in Stockton’s Bankruptcy?*, 65 ST. TAX NOTES 343, 343 (July 30, 2012).

² See Joe Guillen, *Bankruptcy Scorecard: Detroit’s Exit Plan Approved*, DETROIT FREE PRESS (Nov. 8, 2014, 2:23 AM), <http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/07/bankruptcy-scorecard-ruling/18673485/>, archived at <http://perma.cc/2KNL--57GV>.

³ See Robin Respaut, *Holdout Creditor Files Appeal to Stockton, Calif., Exit from Bankruptcy*, REUTERS (Nov. 14, 2014, 7:07 PM), <http://www.reuters.com/article/2014/11/15/usa-stockton-idUSL2NOT42W220141115>, archived at <http://perma.cc/3XLL-8QYZ>.

⁴ *Id.*

⁵ 11 U.S.C. § 109(c)(1) (2012).

under bankruptcy protection.⁶ While similar to other forms of bankruptcy in that respect, Chapter 9 differs in that it does not require the municipality to ask the court for permission to pay bills it had pre-filing.⁷ Chapter 9 also does not allow creditors to submit their own reorganization plans, leaving the municipality in control of its workout plan.⁸

While governed by Chapter 9 in all respects, California differs from other states in that its state law, under Assembly Bill 506 (“A.B. 506”), requires municipalities to file a pre-bankruptcy workout to ensure that the municipality exhausts all viable options prior to filing for bankruptcy.⁹ This pre-bankruptcy workout is intended to help municipalities avoid Chapter 9 filings altogether, and to cut down on litigation and administrative costs once the city is in bankruptcy.¹⁰ California lawmakers adopted A.B. 506 “after the city of Vallejo went bankrupt in 2008 and then slogged through a three-year bankruptcy battle that racked up a reported \$10 million in attorney fees.”¹¹ Stockton was one of the first cities to use A.B. 506, but the new legislation did little to prevent Stockton from requiring bankruptcy protection.¹² A 2014 report estimates that Stockton’s legal fees have accrued to over \$13.9 million since the bankruptcy proceedings began.¹³

⁶ 11 U.S.C. § 922(a) (mandating an automatic stay of creditors’ enforcement claims against the debtor).

⁷ Hamilton, *supra* note 1, at 346.

⁸ *Id.*

⁹ CAL. GOV’T CODE § 53760 (West 2013); *In re City of Stockton, Cal.*, 475 B.R. 720, 724, 727 (Bankr. E.D. Cal. 2012); Hamilton, *supra* note 1, at 344 (“California is the only state with a mediation requirement, and Stockton is the first city to use it.”).

¹⁰ See Max Stendahl, *Stockton, Calif., Takes Historic Plunge Into Bankruptcy*, LAW360 (June 27, 2012, 10:56 AM), <https://www.law360.com/articles/353762/stockton-calif-takes-historic-plunge-into-bankruptcy>.

¹¹ Hamilton, *supra* note 1, at 344.

¹² Erin Coe, *Stockton, Calif., Empowers City Manager to Seek Bankruptcy*, LAW360 (June 5, 2012, 12:00 AM), <http://www.law360.com/articles/346613/stockton-calif-empowers-city-manager-to-seek-bankruptcy>.

¹³ Chriss W. Street, *Stockton Retirees Could Lose 99% of Health Care Claim in Bankruptcy*, BREITBART (June 10, 2014), <http://www.breitbart.com/Breitbart-California/2014/06/09/Stockton-Retirees-Lose-99-of-Healthcare-Claim-in-Bankruptcy>, archived at <http://perma.cc/QQC3-JNHQ>.

C. How Stockton Got Here

The road to Chapter 9 bankruptcy was long for Stockton, but not unexpected once you examine the events that played out.¹⁴ In general, Stockton's financial problems came from decades of mismanagement, poor planning by city leaders, and the real estate market collapse.¹⁵ In the 1990s, city officials saw a cheap, yet shortsighted, solution to the firefighters' labor negotiations—simply guarantee the firefighters full healthcare benefits in retirement.¹⁶ Soon the police and other public safety workers demanded the same benefits.¹⁷ During the real estate bubble years that followed, few questioned this far away cost, but as healthcare costs skyrocketed, the city was left with an enormous liability on its balance sheet.¹⁸

On top of the mismanagement of expenses, Stockton was one of the hardest hit areas during the real estate market crash of the 2000s.¹⁹ The city's home prices "skyrocketed from a median of \$110,000 in 2000 to nearly \$400,000 in 2006."²⁰ Over this same time period, property tax collections increased by almost \$50 million.²¹ The city's revenue was artificially propped up by inflated home values, but the real estate crisis caused Stockton's tax base to plummet.²² Property taxes typically accounted for 30% of Stockton's revenue, and during the real estate crisis this tax base fell by 22%.²³ Stockton's unemployment rate skyrocketed,²⁴ and in 2007, as a last ditch effort, the city issued an additional \$125 million in municipal bonds to fund its

¹⁴ See Rex Sinuefield, *Stockton, CA: One Of America's Most Miserable Cities Just Got More Miserable*, FORBES (April 5, 2013, 8:00 AM), <http://www.forbes.com/sites/rexsinuefield/2013/04/05/stockton-ca-americas-most-miserable-city-just-got-a-lot-more-miserable>, archived at <http://perma.cc/H4VQ-WZ3L>.

¹⁵ See Hamilton, *supra* note 1, at 343.

¹⁶ *Id.* at 344.

¹⁷ *Id.*

¹⁸ See *id.*

¹⁹ See Katy Stech, *Stockton, Calif., Bankruptcy Plan Faces March Trial*, WALL ST. J. (Nov. 18, 2013, 7:47 PM), <http://online.wsj.com/news/articles/SB10001424052702304439804579206552204276582>.

²⁰ Hamilton, *supra* note 1, at 344.

²¹ *Id.*

²² *Id.* at 344–45.

²³ *Id.* at 344.

²⁴ *Id.*

mounting pension obligations.²⁵ Stockton was unable to rebound from its property tax deficit, because a California law called Proposition 13 limits property taxes on homes to one percent of the full cash value of the home.²⁶ Proposition 13 effectively prevented Stockton from simply increasing property tax rates to raise additional revenue.²⁷

On its Chapter 9 filing date in 2012, Stockton was in dire straits.²⁸ It faced a \$26 million budget gap for the fiscal year, despite reducing its budget by \$90 million over the past three years by firing city employees, slashing city services, and cutting all feasible operating costs.²⁹ The city claimed to be at a “crisis point,” where any further cuts to public services would be dangerous to its citizens.³⁰ With about \$240 million in general obligation debt outstanding, and roughly \$900 million due to its pension fund, Stockton had cut everything it could feasibly cut, and still had more bills to pay.³¹ Without the protection of bankruptcy, city officials projected that their budget deficit would “grow to \$40 million per year within three years.”³²

D. Bondholders Versus Pensioners

One of the key legal issues with the Stockton bankruptcy is how the city plans to deal with its outstanding pension liabilities.³³ Stockton owes considerable sums to both general obligation debt-

²⁵ *See id.*

²⁶ *Id.* at 344–45.

²⁷ *Id.*

²⁸ *See* Stendahl, *supra* note 10.

²⁹ *Id.*

³⁰ Hamilton, *supra* note 1, at 345; *see also* Letter from Ann Johnston, Mayor, City of Stockton, to the Community of Stockton (July 24, 2012), *available at* http://www.stocktongov.com/files/OpenLetterCommunity_Approved_2012_7_24.pdf (“The City has reduced Police officers by 25%, Fire department staffing by 30% and all other City employees by 43%. These reductions occurred in a city that has one of the highest crime rates and some of the busiest fire stations in the country.”), *archived at* <http://perma.cc/X7NU-NJ5J>.

³¹ Jeff Sistrunk, *Holdout Creditor Blasts Treatment in Stockton Ch. 9 Plan*, LAW360 (Sept. 5, 2014, 4:49 PM), <http://www.law360.com/articles/574370/holdout-creditor-blasts-treatment-in-stockton-ch-9-plan>.

³² Stendahl, *supra* note 10.

³³ *See, e.g.*, Gary M. Kaplan, *In Practice: New Chapter in Municipal Bankruptcy*, RECORDER (May 2, 2013), <http://www.therecorder.com/id=1202597410133/In-Practice-New-Chapter-in-Municipal-Bankruptcy>.

holders and to the city's pensioners.³⁴ Stockton's current plan of adjustment in bankruptcy promises full payment of its pension liabilities and makes severe cuts to its bondholder payments.³⁵ While Stockton and other cities have been loath to cut their pension payments in bankruptcy, which would effectively leave many of the city's public employees with no retirement plan, the alternative that the city faces is to stiff its general obligation debtors.³⁶

E. The Bankruptcy Court Speaks

In October 2014, Judge Christopher Klein, Chief Judge of the U.S. Bankruptcy Court for the Eastern District of California handed down two key rulings concerning Stockton's proposed payments to pensioners and bondholders.³⁷

First, on October 1, 2014, Judge Klein held that, pursuant to the U.S. bankruptcy code, Stockton could impair its pension obligations in bankruptcy.³⁸ Judge Klein proclaimed that California state law, which purports to prevent Stockton from impairing its pension obligations in bankruptcy, is "simply invalid in the face of the supremacy clause of the United States Constitution."³⁹ This decision shocked many observers, who thought that California law prevented Stockton from slashing the pension payments.⁴⁰

Second, on October 30, 2014, Judge Klein considered whether to approve Stockton's plan of adjustment, which proposes making full payment to pensioners and heavily cutting payments to bondholders.⁴¹ Judge Klein, to the delight of Stockton's weary pensioners, approved Stockton's plan of adjustment.⁴² This crucial ruling "allow[s] the city to

³⁴ *Id.*

³⁵ Mary Williams Walsh, *Judge Spares Pensions in Stockton, Calif., Bankruptcy*, N.Y. TIMES, Oct. 31, 2014, at B4.

³⁶ See Kaplan, *supra* note 33.

³⁷ See Dale Kasler, *Appeal Threatens Stockton Bankruptcy Ruling on Pensions*, SACRAMENTO BEE (Nov. 4, 2014, 9:17 PM), <http://www.sacbee.com/news/business/article3932965.html>, archived at <http://perma.cc/75YQ-AA2C>.

³⁸ Chris Megerian & Melody Petersen, *Stockton Bankruptcy Ruling a Blow to Pensions*, L.A. TIMES (Oct. 1, 2014, 8:59 PM), <http://www.latimes.com/business/la-fi-stockton-bankruptcy-20141002-story.html>, archived at <http://perma.cc/8DXG-UBLB>.

³⁹ *Id.*

⁴⁰ See Kasler, *supra* note 39.

⁴¹ See *id.*

⁴² *Id.*

exit bankruptcy, more than two years after it filed for Chapter 9⁷ protection, and provides for full payment of all of the city's pension obligations.⁴³

However, the pensioners are not out of the woods yet. Shortly after Judge Klein handed down his October 30th decision, Franklin Templeton Investments ("Franklin"), who purchased around \$35 million in bonds from Stockton, filed a notice of appeal.⁴⁴

F. Bondholders Versus Pensioners: A Closer Look

1. The Bondholders' Arguments

Franklin, as one of Stockton's biggest bondholders, has fought for a bigger payout to bondholders throughout Stockton's bankruptcy proceedings.⁴⁵ Stockton previously offered Franklin—a \$35 million bondholder—\$350,000 or approximately one cent on the dollar for their bond debt.⁴⁶ Franklin feverishly rejected the city's offer of less than a penny on the dollar, noting that other unsecured creditors will walk away from the negotiation table fully compensated.⁴⁷ Franklin's attorney, James Johnston, argues that "[t]his isn't a case of inability to pay; it's [a case of] unwillingness to pay."⁴⁸ Franklin urged the court to reject the plan of adjustment and compel Stockton to slash their pension liability to free up more money for the bondholders.⁴⁹

Bondholders, like Franklin, further argue that cutting payment on bonds will likely have a crippling effect on the city's ability to raise capital through the bond market in the future.⁵⁰ General obligation creditors are issued bonds based on the general creditworthiness of the city, and while these bonds are not secured by assets like many traditional forms of lending, general obligation bonds from

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See Dale Kasler, *Judge Approves Stockton's Plan to Repay Creditors, Leaving Pensions Intact*, SACRAMENTO BEE (Oct. 30, 2014, 9:20 PM), <http://www.sacbee.com/news/business/article3474893.html>, archived at <http://perma.cc/J9C2-XVNV>.

⁴⁶ Dan Fitzpatrick, *Big-Name Investors Clash Over Pensions*, WALL ST. J., July 8, 2014, at C1.

⁴⁷ *See id.*

⁴⁸ Street, *supra* note 13.

⁴⁹ Sistrunk, *supra* note 31.

⁵⁰ *See* Kaplan, *supra* note 33.

municipalities are traditionally considered to be a safe investment.⁵¹ This form of borrowing is one of the most common ways for a city to make up the gap between income from tax collection and their liabilities.⁵² If Stockton were to reduce the payout on these bonds, the interest rate on Stockton's bonds would skyrocket and the city would have a difficult time accessing the bond market in the future.⁵³ Some have said that they could even be left out of the bond market entirely.⁵⁴

2. The Pensioners' Arguments

Stockton first argues that the city's retirees have already agreed to take a ninety-nine percent haircut on their lifetime health care benefits, by accepting a \$5 million payout in lieu of the \$544 million obligation the city promised them in retirement.⁵⁵ A reduction to their pension benefits would leave the city's retirees with substantially less income as well as a loss of health care benefits.⁵⁶ While Franklin calls the city's pensions "lavish," the average retiree receives only around \$24,000 per year in pension payments.⁵⁷ Traditionally, elderly persons have a harder time finding new jobs, which would compound the effects of reduced pension payments.⁵⁸

Stockton further argues that if they are forced to cut pensions they will see a migration of suitable employees from Stockton.⁵⁹ In essence, Stockton argues that employees will flock to the private sector if they perceive public sector pensions to be vulnerable.⁶⁰ However, this argument might not hold up because total compensation in the public sector is actually greater than in the private sector in California.⁶¹ A

⁵¹ See Peter Molk, Note, *Broadening the Use of Municipal Mortgages*, 27 YALE J. ON REG. 397, 399 (2010).

⁵² See *id.* at 397-99.

⁵³ Kaplan, *supra* note 33.

⁵⁴ See *id.*

⁵⁵ Street, *supra* note 13.

⁵⁶ *Id.*

⁵⁷ Michael Hiltzik, *In Stockton Bankruptcy Case, The Target is the Working Class*, L.A. TIMES (Oct. 2, 2014, 11:13 AM), <http://www.latimes.com/business/hiltzik/la-fi-mh-in-stockton-bankruptcy-case-20141002-column.html#page=1>, archived at <http://perma.cc/UWX5-4PBR>.

⁵⁸ See Alina Tugend, *Unemployed and Older, and Facing a Jobless Future*, N.Y. TIMES, July 27, 2013, at B4.

⁵⁹ Kaplan, *supra* note 33.

⁶⁰ See *id.*

⁶¹ Andrew G. Biggs & Jason Richwine, *Overpaid or Underpaid? A State-by-*

study of public employee compensation against the private sector for all fifty states finds that California compensates its public sector employees more generously than almost any other state.⁶² While public sector employees make less in traditional wages, states like California promise guaranteed benefits to their public sector employees in retirement, which can constitute up to half of their total compensation.⁶³ Because California tends to “overpay” their public sector employees in total compensation, it is easier for Franklin to argue that the court should force a cut in pension payments.⁶⁴

G. Conclusion

The outcome of *In re Stockton* will not end the debate between municipal bondholders and pensioners in bankruptcy.⁶⁵ With not enough money to go around, Stockton had to make difficult choices in bankruptcy.⁶⁶ Unfunded pensions remain an issue across the nation, as some of the largest cities in the country like Chicago and Los Angeles are underwater on their vested pension obligations.⁶⁷ Judge Klein and the City of Stockton will pave the way for many more municipal bankruptcies that are likely to follow.

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State Ranking of Public-Employee Compensation 9 (Am. Enterprise Inst. for Pub. Policy Research, Working Paper No. 2014-04, 2014), available at <http://www.aei.org/papers/economics/overpaid-or-underpaid-a-state-by-state-ranking-of-public-employee-compensation/>, archived at <http://perma.cc/USX8-67T2>.

⁶² See *id.* at 42.

⁶³ *Id.* at 9.

⁶⁴ See *id.* at 42.

⁶⁵ See Hamilton, *supra* note 1, at 343.

⁶⁶ See *supra* text accompanying notes 34–37.

⁶⁷ See Brian Chappatta & Tim Jones, *Chicago Cut to 3 Levels Above Junk by Moody's on Pensions*, BLOOMBERG (Mar. 5, 2014, 11:02 AM), <http://www.bloomberg.com/news/2014-03-05/chicago-cut-to-3-levels-above-junk-by-moody-s-on-pensions.html>.

⁶⁸ Student, Boston University School of Law (J.D. 2016).