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Bankruptcy Appellate Panel Upholds Municipality's Eligibility for Chapter 9 Bankruptcy Protection: *In re City of Vallejo, California*

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Introduction

On 26 June 2009, the Bankruptcy Appellate Panel of the Ninth Circuit (the 'BAP')¹ affirmed the ruling of the United States Bankruptcy Court of the Eastern District of California (the 'Bankruptcy Court') and held that the City of Vallejo, California ('Vallejo') had satisfied the eligibility requirements of chapter 9 of title 11, United States Code (the 'Bankruptcy Code') and thus was eligible to utilise the Bankruptcy Code to restructure its financial obligations.² Vallejo's eligibility under chapter 9 had been challenged by a number of Unions³ representing a majority of the city's work force. In upholding the Bankruptcy Court ruling, the BAP concluded that Vallejo had satisfied the requirements of Bankruptcy Code section 109, in that the municipality had established that it (i) was insolvent upon commencement of the case, (ii) desired to implement a restructuring plan and (iii) was unable to negotiate with creditors because such negotiations were impracticable. The BAP determined that the Bankruptcy Court had erred in concluding that Vallejo had engaged in good faith negotiations with creditors regarding the terms of a restructuring plan – based on the fact that Vallejo had failed to negotiate the terms of a *specific* plan – but found that such error was harmless since Vallejo had been able to establish the alternative requirement of showing creditor negotiation to have been impracticable. As a result, Vallejo will be able to proceed with its financial restructuring under Bankruptcy Court protection.

Background

As reported in *International Corporate Rescue*, Volume 5, Number 5, on 23 May 2008 (the 'Petition Date'), Vallejo filed a petition under Bankruptcy Code section 109, thereby becoming the largest city in California history to seek bankruptcy protection. Despite concerted efforts to achieve a balanced budget, Vallejo faced a substantial budget deficit, due to excessive labour costs and pension obligations, coupled with declining revenues tied to a depressed real estate market. Negotiations with creditors, including the Unions, proved unsuccessful, leaving Vallejo no viable option other than a bankruptcy filing.

Approximately one month after the Petition Date, the Unions filed an objection to Vallejo's chapter 9 petition and statement of qualifications under Bankruptcy Code section 109(c), asserting therein that (i) Vallejo did not satisfy chapter 9's eligibility requirements and (ii) Vallejo had filed the case in bad faith. After a protracted evidentiary hearing, the Bankruptcy Court denied the motion to dismiss and held that Vallejo was eligible for chapter 9 relief. The Unions filed a timely notice of appeal and the matter was assigned to the BAP.

On appeal, the Unions asserted numerous grounds for error,⁴ which the BAP distilled as raising the following issues on appeal:

- A. Whether the bankruptcy court erred in finding Vallejo was insolvent under § 109(c)(3).
- B. Whether the bankruptcy court erred in finding that Vallejo desired to effect a plan to adjust its debts under § 109(c)(4).

Notes

- 1 Appeals from United States Bankruptcy Courts may be heard by United States District Court or by a Bankruptcy Appellate Panel, if the appellate panel program is in effect in the district in question. Currently, the First, Sixth, Eighth, Ninth and Tenth Circuits utilise bankruptcy appellate panels.
- 2 See Opinion, dated 26 June 2009, BAP No. EC-08-1244-JuMkMo. References herein to the Opinion are references to the version published on Westlaw as: 2009 WL 1841693 (9th Cir. BAP (Cal.)).
- 3 As used herein, the term 'Unions' refers to the Vallejo Police Officers Association, the International Association of Firefighters, the International Brotherhood of Electrical Workers and the Confidential, Administrative, Managerial and Professional Employees Association of Vallejo.
- 4 See Appellant's Notice of Filing Designation of Record and Issues, filed November 18, 2008.

- C. Whether the bankruptcy court erred in finding that Vallejo negotiated with its creditors in good faith under § 109(c)(5)(B).
- D. Whether the bankruptcy court erred in finding that Vallejo was unable to negotiate with its creditors because to do so was impracticable under § 109(c)(5)(C).
- E. Whether [certain bank creditors of Vallejo] have standing as appellees.⁵

The BAP heard oral argument on 19 February 2009, and subsequently requested supplemental briefs. In an opinion dated 26 June 2009, the BAP affirmed the Bankruptcy Court's ruling and held that Vallejo had satisfied the eligibility requirements of chapter 9.

Standard of appellate review

Before turning to the substantive arguments, the BAP first set forth the applicable standards for appellate review. The BAP explained that questions of law, such as issues of statutory interpretation, are reviewed *de novo*,⁶ while questions of fact, such as whether Vallejo was insolvent, are reviewed for clear error. The BAP explained that '[i]f the bankruptcy court's account of the evidence is plausible in light of the record viewed in its entirety, we may not reverse it even though convinced that we might have weighed the evidence differently.'⁷

The Bankruptcy Appellate Panel's ruling

The BAP began its discussion by reciting the requirements for debtor eligibility under chapter 9 of the Bankruptcy Code. The requirements are set forth in Bankruptcy Code section 109(c), which provides:

'(c) An entity may be a debtor under chapter 9 of this title if and only if such entity –

- (1) is a municipality;
- (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law

to authorize such entity to be a debtor under such chapter;

- (3) is insolvent;
- (4) desires to effect a plan to adjust such debts; and
- (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
- (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;
- (C) is unable to negotiate with creditors because such negotiation is impracticable; or
- (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.'⁸

The BAP explained that '[c]hapter 9 petitioners must meet the mandatory provisions of § 109(c)(1)-(4) and one of the requirements under § 109(c)(5) to be eligible for an order for relief.'⁹ The BAP noted that the debtor bears the burden of proof with respect to the issue of eligibility, and that pursuant to Bankruptcy Code section 921(c), if the debtor has not carried this burden, the court may dismiss the petition. The BAP further noted that although the language of section 921 is permissive, some courts have interpreted the provision as mandating dismissal. Nonetheless, the BAP cited competing authorities that suggest that courts should construe section 109(c) broadly 'to provide access to relief in furtherance of the Code's underlying policies.'¹⁰

A. Insolvency

With the first two elements of section 109(c) not at issue,¹¹ the BAP addressed the 'insolvency' requirement under section 109(c)(3), and stated that '[a] municipality is insolvent if it is not paying its debts as they come due or is unable to do so'.¹² Solvency, the BAP

Notes

- 5 Opinion at *4. Union Bank of California, N.A. and Wells Fargo Bank, N.A. (together, the 'bank creditors') sought to participate in the appeal as additional appellees. The BAP agreed provisionally to accept the appellate briefs filed by the bank creditors, pending resolution of the issue of standing.
- 6 In undertaking *de novo* review, the appellate court (or panel) considers questions of law anew and accords no deference to the lower court's ruling.
- 7 Opinion, at *4.
- 8 11 USC § 109(c).
- 9 Opinion at *4.
- 10 Opinion at *5 (internal quotations omitted).
- 11 There was no dispute that Vallejo was a 'municipality' or that the city had taken appropriate steps to authorise the filing of its chapter 9 petition.
- 12 Opinion at *5 (citing Bankruptcy Code section 101(32)(C)(i) and (ii)).

explained, 'is determined on a cash flow basis'; Vallejo thus had the burden of establishing its inability to pay its debts as they came due during the coming year.¹³ On this point, the Unions asserted that (i) Vallejo had sufficient cash to continue operations, without altering its budget, based on their view that Vallejo's Comprehensive Annual Financial Report ('CAFR') showed that the city had sufficient unrestricted funds, (ii) Vallejo had failed to offer admissible evidence to support the assertion that certain funds were restricted, and (iii) Vallejo could have avoided deficits by making additional budget cuts, adjusting projections and accepting certain modifications to collective bargaining agreements that the Unions had offered.

The BAP rejected each of the Union's arguments relating to insolvency. First, the BAP stated that the Union's reliance on the CAFR was misplaced. Although the report listed assets held by various agencies within the city, it did not provide details regarding those assets, nor did it list the associated liabilities. Moreover, the CAFR provided a snapshot of Vallejo's financial position as of June 2007, nearly a full year prior to the Petition Date; intervening events had rendered the report unreliable, and the BAP held that the CAFR alone was insufficient to establish that Vallejo was solvent.¹⁴

Next, the BAP repudiated the contention that Vallejo had failed to offer sufficient admissible evidence that many of the city's funds were restricted. At trial Vallejo had offered declarations of the city's Assistant Finance Director, Susan Mayer ('Mayer'), to establish this point. The Unions had objected, contending, among other things, that Mayer's testimony constituted an inadmissible lay opinion and reached legal conclusions that were the province of the Bankruptcy Court. Noting first that legal conclusions generally are inadmissible under the Federal Rules of Evidence, the BAP explained that under certain circumstances, such testimony 'is helpful to the jury, and thus admissible'.¹⁵ Mayer's testimony, the BAP explained, was helpful, due to the complexity of the laws creating and restricting municipal funds, as well as various modifications to those restrictions that had been enacted over a 30-year period. In light of these complexities, the BAP found that '[t]he most concise manner for Vallejo to prove that many of its funds were restricted was through Mayer's testimony'.¹⁶ The BAP observed that the Unions had an opportunity to

challenge Mayer's testimony on cross examination and through presentation of their own evidence. Accordingly, the BAP held that under these circumstances, the admission of Mayer's testimony did not constitute an abuse of the Bankruptcy Court's discretion.¹⁷

The BAP next addressed the Union's assertions regarding Vallejo's fiscal prudence. The BAP flatly rejected the contention that Vallejo could have reallocated funds to the city's general fund to close the budget deficit. The Union's expert witness, the BAP explained, had failed to identify a single fund the city could have used to ameliorate its financial crisis. The BAP thus concluded that 'raiding funds for short-term needs would simply cripple Vallejo more'.¹⁸ Similarly, the BAP rejected the Union's contentions that (i) Vallejo could have avoided bankruptcy by accepting the Union's final offer regarding modifications to the collective bargaining agreements, (ii) that the city's budget was based on flawed staffing assumptions, and (iii) that Vallejo could have reduced discretionary spending. The BAP found no error in the Bankruptcy Court rulings rejecting these contentions, as the evidence at trial supported the conclusion that Vallejo could not have closed its budget deficit. Accordingly, the BAP found that as of the Petition Date, Vallejo was unable to pay its debts as they came due, and thus was insolvent within the meaning of Bankruptcy Code section 109(c)(3).¹⁹

B. Desire to effect a plan to adjust debts

Having determined that Vallejo was insolvent, the BAP next considered whether Vallejo had established that it desired to implement a plan of adjustment as required by Bankruptcy Code section 109(c)(4). After noting that the few published decisions on this issue offered no bright-line test, the BAP concluded that the record before it offered ample evidence to support the Bankruptcy Court's conclusion that Vallejo desired to effectuate a plan. In particular, the city had submitted its Statement of Qualifications, certified under oath by the city manager, which expressly stated that the city 'desires to effect a plan to adjust its debts'.²⁰ In addition, the BAP found the city's postpetition action to implement a 'pendency plan', involving spending cuts, wage freezes and modifications of work rules and staffing

Notes

13 Opinion at *5.

14 Opinion at *6.

15 Opinion at *6 (citing 4 Jack B. Weinstein & Margaret A. Berger, *Weinstein's Federal Evidence* § 704.04[2][a] (2d ed.1990)).

16 Opinion at *7.

17 The BAP also noted that the Unions had failed to object to a chart summarising the city's various funds and the restrictions applicable to each that Vallejo had moved into evidence. The BAP found this to provide further support for its conclusion that the Bankruptcy Court did not err in admitting Mayer's testimony. Opinion at *7.

18 Opinion at *8.

19 Opinion at *9.

20 Opinion at *10.

requirements, provided further evidence of Vallejo's desire to effect a plan. Finally, the BAP rejected the assertion that section 109(c)(4) contained a good faith component, noting that where Congress intended to add a good faith requirement – such as in section 109(c)(5)(B) – it did so. Because the terms of the statute did not include a good faith requirement, the BAP resisted injecting one where Congress had declined to do so.²¹

C. Good faith negotiation with creditors

The Unions next asserted that the Bankruptcy Court erred in concluding that Vallejo had satisfied section 109(c)(5)(B), which required the city to establish that it 'has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of all the claims of each class that [Vallejo] intends to impair under a plan'.²² Specifically, the Unions averred that the prepetition negotiations focused on resolving labour issues did not satisfy the statutory requirements because they did not involve discussions of the terms of a potential plan. Noting that the plain language of section 109(c)(5)(B) did not expressly require negotiations concerning a proposed plan, the BAP stated that the complete text of the statute provides interpretive guidance. The BAP explained that the statute references obtaining approval of creditors holding at least a majority of claims in each class proposed to be impaired under a plan. Stating that 'it would be difficult for a municipality to prove that it negotiated in good faith with creditors it intends to impair unless the municipality had a plan of adjustment drawn or at least outlined when it negotiated with the creditors', the BAP held that 'the plain language of § 109(c)(5)(B) requires negotiations with creditors revolving around a proposed plan, at least in concept'.²³ Because Vallejo had not engaged in negotiations with the Unions regarding the specific terms of a proposed plan, the BAP ruled that the Bankruptcy Court had erred in concluding that Vallejo had satisfied the requirements of section 109(c)(5)(B). However, the BAP concluded that this error was harmless since Vallejo had satisfied the alternative requirement of Bankruptcy Code section 109(c)(5)(C) (involving impracticability of negotiating with creditors).²⁴

D. Impracticability of creditor negotiations

The BAP rejected the Union's assertion that the Bankruptcy Court erred in finding Vallejo had satisfied the alternative requirement of showing that creditor negotiations were impracticable under section 109(c)(5)(C). The BAP explained that satisfaction of this requirement turns on the particular circumstances of the case. Here, Vallejo was unable to prepare reliable long term financial plans, due to the uncertainties regarding future labour costs. Because labour costs were the largest component of the city's budget, and labour negotiations had reached an impasse, the BAP concluded that Vallejo was unable to engage in meaningful discussions with its primary bank creditor, and that it would have been futile for Vallejo to undertake negotiations with other creditors. The BAP thus found that the Bankruptcy Court correctly concluded that negotiation by Vallejo with creditors was impracticable.²⁵

E. Bank creditor standing on appeal

The final issue addressed by the BAP was whether Vallejo's bank creditors had standing as appellees to participate in the appeal. The BAP remarked that although the banks undeniably were creditors of Vallejo, they did not qualify as 'persons aggrieved' by the order for relief and thus lacked standing. Specifically, the banks' claims against Vallejo were not impaired or foreclosed by the order for relief, and their pecuniary interests thus were not adversely affected. In closing, the BAP noted that a contrary ruling that failed to limit appellate standing, would raise the prospect of bankruptcy litigation becoming 'mired in endless appeals brought by the myriad parties who are indirectly affected by every bankruptcy court order'.²⁶

Discussion

In *City of Vallejo*, the BAP affirmed the primarily fact-driven Bankruptcy Court ruling and held that Vallejo was eligible for chapter 9 protection. One aspect of the ruling that initially may seem questionable is the BAP's determination that to satisfy the 'negotiations with creditors' prong of section 109(c)(5)(B), the debtor must show that negotiations addressed actual terms of a bankruptcy plan, rather than vague or uncertain restructuring possibilities. The plain language of the

Notes

- 21 Opinion at *10.
- 22 Opinion at *10.
- 23 Opinion at *12.
- 24 Opinion at *12.
- 25 Opinion at *13.
- 26 Opinion at *13.

statute does not appear to dictate this result, but, as discussed in greater detail below, when the entire provision is considered in context, this interpretation gains force. As a result, potential chapter 9 debtors wishing to safeguard their chapter 9 eligibility will be advised to bifurcate their dialogue with creditors. Although the primary focus of these negotiations may be an out-of-court solution that will permit the municipality to avoid a bankruptcy filing altogether, the municipality should also undertake discussions regarding the terms of a potential restructuring plan that will be implemented through bankruptcy proceedings, to satisfy the statutory language of section 109(c)(5)(B).

The BAP's interpretation of Bankruptcy Code section 109(c)(5)(B) is supported by a careful parsing of the terms of the statute. Under this provision, a municipality may be eligible for chapter 9 protection if it '(B) has negotiated in good faith with creditors *and* has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter ...'.²⁷ This provision arguably contains two separate and independent components, separated by the word 'and': first, the requirement that the municipality has negotiated in good faith with creditors (the 'Good Faith Component'), and second, that the municipality has failed to obtain the agreement of a majority of creditors of each class that the debtor intends to impair under a plan (the 'Consent Component'). Viewed in isolation, the Good Faith Component speaks only to negotiations in good faith, without tying those negotiations to the terms of a plan. Moreover, because the Consent Component is expressed in the negative (i.e., the requirement is satisfied if the debtor has 'failed to obtain the agreement of creditors'), the Consent Component arguably could be satisfied by a municipality's mere failure to take any action – an outcome that some may view as absurd. These factors thus militate in favor of a holistic reading of the statute.

Additionally, reading the two components of section 109(c)(5)(B) as independent of each other would result in the Consent Component being rendered meaningless surplusage. By way of illustration, if a debtor had negotiated with creditors in good faith, there would be two possible outcomes with respect to the Consent

Component: either the requisite creditors consented, or they did not. The scenario where requisite creditors have consented is already governed by section 109(c)(5)(A).²⁸ Thus, in all situations where the requisite creditors have not consented to the terms of a proposed plan, as long as the 'Good Faith Component' has been satisfied, the municipality would be eligible for chapter 9 protection, regardless of whether the municipality had obtained – or even sought – consent of impaired creditors. Under this approach, the language establishing the Consent Component would be surplusage, a result disfavoured under traditional principals of statutory construction. To avoid this result, the Consent Component cannot be isolated from the Good Faith Component. Reading the provision holistically, the better interpretation is that the 'good faith negotiations' element requires negotiations with creditors regarding the terms of a chapter 9 plan of reorganisation. Although the statutory language certainly could have been drafted more clearly to achieve this result, in *City of Vallejo*, the BAP nonetheless managed to navigate the statute to reach the correct outcome.

Conclusion

As described above, the Unions have, for many months, been engaged in a fierce battle with the City of Vallejo, with the fate of the Unions' collective bargaining agreements – and the fate of thousands of workers – at stake. Although the Unions initially challenged the BAP ruling by filing a notice of appeal, that notice was subsequently withdrawn. Perhaps accepting that the fact-driven ruling of the Bankruptcy Court, having been affirmed once, was unlikely to be found to be clearly erroneous, the Unions may have elected to refocus their energies on other aspects of the case. One worthwhile pursuit would be seeking to negotiate revised labour agreements on terms palatable to both Vallejo and the Unions, to avoid wholesale rejection of collective bargaining agreements and the resulting disruption and economic losses. Resolving these key labour issues – whether through negotiation or litigation – will be a critical first step in Vallejo's efforts to emerge from bankruptcy protection.

Notes

27 11 USC § 109(c)(5)(B) (emphasis added).

28 11 USC § 109(c)(5)(A).

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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