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California Restricts Access of Municipalities to Chapter 9 of the Bankruptcy Code

CRAIG A. BARBAROSH, KAREN B. DINE, AND BRANDON R. JOHNSON

The authors review the key sections of a new California law that will affect the ability of local governments to enter bankruptcy.

Numerous municipalities in California and elsewhere are struggling financially. Indeed, Harrisburg, Pennsylvania, and Central Falls, Rhode Island, have both recently filed for Chapter 9 protection. State governments may have neither the economic reserves nor the political will to bail out troubled cities and counties. These circumstances have raised the focus on Chapter 9 as a tool for reorganizing municipality debt obligations and have deepened the debate between states and their municipalities about the best strategies for addressing a fiscal crisis.

In enacting Assembly Bill No. 506 on October 9, 2011, California weighed in by adopting additional legal hurdles before a California municipality may file for Chapter 9 protection. Assembly Bill No. 506 requires a new "neutral evaluator process" prior to filing, which effectively mandates mediation under the auspices of a third party neutral, among the municipality and numerous creditor constituencies. California unions, who lobbied for this new law, are now effectively guaranteed a seat at the

Craig A. Barbarosh, a partner in the Costa Mesa, CA, office of Pillsbury Winthrop Shaw Pittman LLP, practices in the areas of financial restructuring and insolvency and related corporate law. Karen B. Dine is a partner in the firm's Insolvency & Restructuring Practice Group in New York. Brandon R. Johnson is an associate in the firm's New York office. The authors can be reached at craig.barbarosh@pillsburylaw.com, karen.dine@pillsburylaw.com, and brandon.johnson@pillsburylaw.com, respectively.

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table during these negotiations if their collective bargaining agreements would be implicated by the Chapter 9. The only exception that enables a municipality to avoid the neutral evaluation process is a declaration of a "fiscal emergency," which itself still requires the municipality to meet specific criteria before filing.

SUMMARY OF CHAPTER 9

Chapter 9 is designed to permit both general municipalities (issuers of general obligation bonds serviced by tax revenue) and certain quasi-governmental municipal authorities (issuers of special obligation bonds serviced by project revenue, such as public transportation, sewerage systems, etc.) to reorganize their debts pursuant to a plan of reorganization provided that certain criteria are satisfied. Chapter 9 of the Bankruptcy Code is similar to Chapter 11, which is applicable to most private companies except banks and insurance companies, in that both provide a mechanism for the restructuring of obligations under the protection of the bankruptcy court's automatic stay. There are, however, certain important differences. For example, Chapter 11 provides heightened standards for the rejection of collective bargaining agreements, including the requirement that the debtor make a proposal to an employee representative to modify the existing contract in a way that would both permit the debtor to reorganize and assure all affected parties are treated fairly and equitably. Chapter 9 does not include this requirement. This difference helped facilitate the debtor's rejection of certain collective bargaining agreements, over strenuous union objection, in the recent California Chapter 9 case of City of Vallejo.

The Bankruptcy Code already provides strict threshold requirements that must be satisfied in order for a municipality to seek relief under Chapter 9. Not only must a Chapter 9 debtor be insolvent and desire to effect a plan to adjust its debts, it must also have previously negotiated with creditors holding at least a majority of each class of debt that the municipality's Chapter 9 plan would impair. The Bankruptcy Code does not require that a municipality necessarily negotiate with its employees or their union representatives prior to filing under Chapter 9. If an agreement with creditors

cannot be reached, the municipality must then demonstrate that it negotiated in good faith, or that negotiations were somehow impracticable. The only permitted exception is if the municipality reasonably believes that a creditor will attempt to secure the benefit of a transfer that would otherwise be avoidable as a preference under the Bankruptcy Code. However, a municipality can demonstrate that creditor negotiations were impracticable (and therefore not required) due to the emergency nature of its fiscal crisis.

CALIFORNIA'S LAW

An otherwise qualifying municipality must also be "specifically authorized" by state law to file for relief under Chapter 9. Several states have exercised their prerogative to either condition or prohibit Chapter 9 filings by their resident municipalities. California Assembly Bill No. 506 is an example of a state adding additional conditions for a Chapter 9 filing.

As noted above, the Bankruptcy Code already requires that a debtor under Chapter 9 engage in negotiations with its creditors. California Assembly Bill No. 506 raises the bar substantially concerning these negotiations. Specifically, the bill requires that a California municipality, before filing for Chapter 9 relief, participate in a so-called "neutral evaluation process."

The neutral evaluation process is akin to a procedurally complex mandatory mediation. To commence the process, the debtor is required to give 10 business days' notice to all creditors with non-contingent claims of at least $5 million (or claims that comprise more than five percent of the municipality's total debt). Notice must also be given to indenture trustees, unions that have standing under their collective bargaining agreement to initiate contract or debt restructuring negotiations with the municipality, committees of creditors and retirees, pension funds, and other enumerated parties. Under the Bankruptcy Code, the municipality must only negotiate with creditors holding a majority of each class of debt that a forthcoming Chapter 9 plan would impair.

Assembly Bill No. 506 envisions that the "neutral evaluator" will be selected through a mutually agreed upon process, but includes detailed regulations concerning the multi-step selection process if an agreement

cannot be reached, as well as requirements designed to ensure the neutrality and expertise of the evaluator. The bill also provides that the entire process not last for more than 60 days after the evaluator is selected, unless either the municipality or a majority of participating interested parties elects to extend the process for an additional 30 days. For the process to extend further, both the municipality and a majority of participating interested parties must consent. Under the new law, unless otherwise agreed to by the parties, the municipality "shall pay 50 percent of the costs of neutral evaluation, including but not limited to the fees of the evaluator, and the creditors shall pay the balance." It is unclear how this will work in practice and whether or not all participating interested parties would have to agree to pay their share of the cost before participating in the process.

As an exception, the bill permits a California municipality to file for Chapter 9 relief if it declares a "fiscal emergency." The municipality must also adopt a corresponding resolution by a majority vote of its governing board at a public hearing. The resolution must state that the municipality's financial condition, absent the protections of Chapter 9, would jeopardize the health, safety or well-being of residents. The resolution must also make findings that the municipality is or will be unable to pay its obligations within the next 60 days.

CONCLUSION

As noted above, the Bankruptcy Code already provides detailed negotiation requirements that a municipality must satisfy in order to file for relief under Chapter 9. These requirements are significantly increased by California Assembly Bill No. 506. This may prove practically unworkable for many municipalities. Given the additional expense and complication of the neutral evaluation process, municipalities may seek to implement the "fiscal emergency" exception. This exception is also not problem-free. In the first place, the emergency exception does not relieve the municipality of the pre-petition negotiation requirements provided for in the Bankruptcy Code. In addition, the public resolution requirement set forth in the exception may increase disruptions prior to filing.

California Assembly Bill No. 506 may be best understood as a lobby-

ing victory for unions and others who were dissatisfied with the City of Vallejo's Chapter 9 proceedings. Under the new law, for example, unions are expressly required to be offered a seat at the table during the neutral evaluation process. By erecting additional hurdles to Chapter 9 protection, while it may be more inclusive for some, California's new law will also likely increase the uncertainty and already high transaction costs associated with a municipality's relief of last resort.