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Ch. 9 Appeals May Open Doors For Distressed Cities

By **Maria Chutchian**

Law360, New York (January 08, 2014, 5:26 PM ET) -- As San Bernardino's Chapter 9 eligibility ruling heads to the Ninth Circuit and Detroit gears up for its own potential fight, municipal restructuring experts say judges are likely to give the benefit of the doubt to the cities and not the pension funds challenging the bankruptcies.

The anticipated uptick in municipal bankruptcies in the coming year makes it important to cities and towns all over the U.S. — not just already bankrupt cities like San Bernardino, Stockton and Detroit — to have a firm authority on what constitutes filing a petition in “good faith,” one of the requirements for eligibility under Chapter 9, Karol Denniston of Schiff Hardin LLP said.

“As soon as you have some level of certainty as to which direction these decisions are going to go, the better for the municipalities that are trying to chart a course through it,” she said.

Courts have differed on how stringently to apply the legal standards that must be met for a municipality to be found eligible. In certifying an appeal to the Ninth Circuit by the California Public Employees' Retirement System of a ruling finding San Bernardino eligible for bankruptcy relief, U.S. District Judge Dolly Gee asked the appellate court to address questions relating to how much discretion bankruptcy judges have in applying the requirements.

She is asking the Ninth Circuit to address whether a finding that a city had “no rational option other than to file for Chapter 9 bankruptcy” is enough to satisfy requirements that a debtor must file in good faith and “desire to effect a plan,” and whether a court can decide to award eligibility even if the good faith standard is not met.

Appellate courts' opinions on these matters will presumably provide guidance for lower courts in determining how strictly to apply the eligibility requirements.

“It certainly would be a significant ruling if the Ninth Circuit did reverse [U.S. Bankruptcy] Judge [Meredith A.] Jury's decision. Not only would it be relevant in Stockton, but it could be — while not binding as to Detroit — it could be persuasive in an appeal of that eligibility decision,” said Michael Sweet of Fox Rothschild LLP.

“Having said that, I think it's unlikely that we're going to see the judge overruled,” he added. “I think Judge Jury gave a well-reasoned decision, and I think that it will be hard for the circuit to find a basis to reverse.”

It has become common in the recent financial downturn for courts to construe Chapter 9 standards as broadly as possible, though not all potential debtors have been so lucky. Harrisburg, Pa., was recently found ineligible for bankruptcy relief after the state refused

to grant authority, a threshold that must be met for municipalities to obtain relief under the Bankruptcy Code.

Twenty-six percent of Chapter 9 cases filed between 1937 and April 2012 have been thrown out without a plan of adjustment filed, according to "Until Debt Do Us Part: Subnational Debt, Insolvency and Markets," a book published last year by the World Bank.

Lately, most courts have been looking at Chapter 9 eligibility from a more pragmatic standpoint rather than a strictly legal one, according to Patton Hahn of Baker Donelson Bearman Caldwell & Berkowitz PC. Since elected leaders — or emergency manager, as in Detroit's case — are unlikely to take the plunge into bankruptcy if they have any other more politically attractive alternative, it's difficult for them to fail the good faith test.

Most practitioners don't see the good faith provision as a particularly difficult hurdle to overcome, Hahn said. However, because Judge Gee found that there is no binding precedent on the questions CalPERS brought to light and noted that courts "vigorously disagree" about how to interpret Chapter 9's eligibility requirements — specifically the good faith provision — the Ninth Circuit has the opportunity to provide clarity to that area of bankruptcy law.

"I would be surprised if the Ninth Circuit ends up making it harder for municipalities to file or be determined eligible," Hahn said.

Thousands of miles away from San Bernardino, the bankruptcy judge overseeing Detroit's Chapter 9 case recently held in his eligibility decision that although the city did not show that it negotiated in good faith to resolve its debts to all of its creditors, it was impractical to expect it to do so because it has so many creditors. With good faith negotiations difficult to achieve for municipalities with a large amount of creditors, "impracticability" has become a viable fallback argument for eligibility, Sweet said.

U.S. Bankruptcy Judge Steven W. Rhodes also said in his ruling on Detroit's eligibility that pension funds do not have a blanket protection in the event of a bankruptcy in Michigan, throwing a wrench in retirees' long-held belief that their benefits were untouchable.

That ruling will almost certainly wind up before the Sixth Circuit, where it will probably be upheld, according to Ted Gavin of Gavin Solmonese LLC. Bankruptcy judges pay a lot of attention to the impact their ruling could have on a Chapter 9 process, and because of the speed with which the Detroit case has been operating, it would be surprising if an appeals court decided to "unring the bell," he said.

"The question comes down to: 'How fine a line do you draw as to what the bargaining option is?'" he said.

The fuzzy relationship between municipal restructurings and pensions under state and federal law is still being shaped in the courts, and not just at the federal level. A California state judge ruled a couple of weeks ago that San Jose, which is not bankrupt, cannot reduce accrued pension benefits but can reduce workers' salaries.

That ruling will most likely be appealed, and experts hope the appeal will provide a better understanding as to what rights financially distressed municipalities have with respect to lowering their pension obligations, which are typically responsible for the largest chunk of cities and towns' liabilities and in some states protected under state law.

"While you can go out and do some improvement, if you can't go out and restructure pension obligations, you can't do much restructuring," Denniston said.

--Editing by Jeremy Barker and Philip Shea.

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