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California's AB 506 Process: What Creditors Can Expect in the Wake of California Municipal Bankruptcies

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California's AB 506 process was intended to help a municipality in restructuring its debt obligations and avoid bankruptcy. However, the lessons of the bankruptcies of the City of Stockton, the Town of Mammoth Lakes and the City of San Bernardino support the reality that a meaningful restructure requires material involvement by the major stakeholders. California's recent wave of municipal bankruptcies tend to show that the AB 506 process has not changed this reality, but rather made a difficult process longer and more arduous.

In the wake of numerous municipalities filing for Chapter 9 protection, California in late 2011 adopted Assembly Bill No. 506, which added certain legal hurdles before a California municipality may file for Chapter 9 protection. Assembly Bill No. 506 requires a "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, which lobbied for this new law, are now effectively guaranteed a seat at the 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. Since adoption of AB 506, a number of California municipalities have filed for Chapter 9 protection, including the City of Stockton ("Stockton"), the City of San Bernardino ("San Bernardino") and the Town of Mammoth Lakes ("Mammoth Lakes"). Additional California municipalities are likely to follow in similar suit as budget deficits continue to mount and strain the financial position of California cities.

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 for 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 California Chapter 9 case of the 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.

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.

Summary of California Assembly Bill No. 506

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 “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 5% 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.

California Assembly Bill No. 506 represents a lobbying 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. However, critics note that erecting additional hurdles to Chapter 9 protection, while more inclusive for some, will also likely increase the uncertainty and already high transaction costs associated with a municipality’s relief of last resort.

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.

California Assembly Bill No. 506 in Practice—A Mixed Review

Each of the three recent California municipalities that have filed for Chapter 9 protection have had a different experience with the AB 506 process. Stockton and Mammoth Lakes endeavored to use the AB 506 process to avoid bankruptcy but were unsuccessful, and San Bernardino filed for protection under Chapter 9 without engaging in the AB 506 process first.

The purpose of the AB 506 process is to allow creditors to have frank discussions with the municipality about the financial situation and possible solutions under the shroud of confidentiality, as the AB 506 process is a protected settlement negotiation. While the AB 506 process was ultimately designed to help keep a municipality from filing for bankruptcy, as discussed below both Stockton and Mammoth Lakes filed for bankruptcy despite participating in the AB 506 process. Although both municipalities reported successful negotiations with smaller creditors, the municipalities’ inability to restructure debt obligations owed to its largest creditors necessitated bankruptcy protection. Accordingly, as with any restructuring, settlement with the most significant stakeholders will ultimately determine whether the municipality will be successful in restructuring its debts out of bankruptcy.

Stockton

On February 28, 2012, Stockton decided to utilize the AB 506 process to restructure its debt in an attempt to avoid bankruptcy. Although the AB 506 process is slated to last 60 days, Stockton actually extended the negotiations for an additional 30 days to further negotiate with creditors. Despite the 90 days of negotiations, Stockton was unable to reach agreements with its largest creditors. Consequently, the city filed for bankruptcy protection on June 28, 2012.

Stockton sought bankruptcy court approval to introduce evidence from the AB 506 process to establish its eligibility for Chapter 9 protection. The court denied the request and issued a protective order to prevent the disclosure of the confidential negotiations, but allowed Stockton to submit its 790-page “ask,” which detailed Stockton’s current situation and proposal. Despite Stockton’s apparent efforts to fulfill the requirements of the AB 506 process, a number of creditors have accused Stockton of not negotiating in good faith, claiming that Stockton had not asked CalPERS, its largest creditor, for any reductions or restructuring of its debt.

Currently, the case is proceeding on a dual track of mediation and trial. At a hearing on August 23, 2012, the court noted that January 2013 is the earliest date for trial. Accordingly, the court encouraged creditors and Stockton to continue mediation with US Bankruptcy Judge Elizabeth Perris, who recently succeeded in mediating a settlement with Mammoth Lakes’ largest creditor.

Mammoth Lakes

On April 30, 2012, Mammoth Lakes initiated a 60-day AB 506 mediation with creditors. Out of the 24 entities that participated in the AB 506 process, 18 creditors either entered into a memorandum of understanding with Mammoth Lakes or renegotiated the contracts/agreements with agreed concessions. While the AB 506 process yielded many concessions, the process did not ultimately allow Mammoth Lakes to avoid bankruptcy. Mammoth Lakes’ largest creditor, MLLA, refused to participate in the AB 506 process, claiming that Mammoth Lakes had failed to respond to its payment proposal and request for financial information. MLLA ultimately won a \$43 million judgment against Mammoth Lakes over a development dispute. Despite the resolution of a majority of Mammoth Lakes’ debts, the failure to come to an agreement with MLLA necessitated bankruptcy protection. Consequently, Mammoth Lakes filed for Chapter 9 protection on July 3, 2012. The concessions and memorandums of understanding executed in connection with the AB 506 process became the basis upon which Mammoth Lakes predicated its plan for the adjustment of debts, which was concurrently filed with Mammoth Lakes’ Chapter 9 petition.

On August 22, 2012, through the help of US Bankruptcy Judge Elizabeth Perris as mediator, Mammoth Lakes and MLLA reached a settlement. Accordingly, the hearing on the town’s eligibility for Chapter 9 relief and the adequacy of the town’s proposed disclosure statement is scheduled for October 17, 2012, and confirmation of the town’s plan for adjustment of debts is to be heard on December 10, 2012.

San Bernardino

San Bernardino bypassed the AB 506 process by declaring a fiscal emergency on July 18, 2012, and filed for Chapter 9 protection on August 1, 2012. San Bernardino’s option to forgo the AB 506 process has not been without consequence. San Bernardino’s motion for entry of an order (1) directing and approving form of notice and (2) deadline for filing objections to petition (the “motion”) was met with numerous oppositions from creditors. In its motion, San Bernardino sought an objection deadline of September 21, 2012, to its bankruptcy petition. Creditors balked at the shortened deadline, saying that San Bernardino has not provided them with sufficient financial information to evaluate San Bernardino’s bankruptcy eligibility, especially given that San Bernardino did not go through the AB 506 process. Additionally, there may be larger issues in that it has recently come to light that for the 13 of the past 16 years the City Council had been given falsified budget documents that claimed San Bernardino was operating within its budget when in fact it had been deficit spending. The court granted the motion, but extended the objection deadline to October 24, 2012, with a status conference hearing scheduled for November 5, 2012. Creditors have suggested, and will likely argue, that San Bernardino is not eligible for Chapter 9 protection because of its failure to previously negotiate with creditors holding at least a majority of each class of debt as required under the Bankruptcy Code. However, San Bernardino will likely rely on its fiscal emergency to argue that negotiations with creditors were impracticable and therefore not a requirement for its eligibility. Additionally, the lack of legitimate budget figures may prove to impede San Bernardino’s ability to devise a plan for the adjustment of its debt, or in the very least delay San Bernardino’s emergence from Chapter 9.

Conclusion

The AB 506 process was implemented to help municipalities avoid bankruptcy. To date, it has yet to successfully prevent a Chapter 9 filing. Instead, it appears that unless the major stakeholders can be brought to the table and be a meaningful part of the restructuring, the process will not lead to an out-of-court restructuring but rather add additional time and complications to an already difficult process.

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