MEMORANDUM

TO:	Michael Jenkins	DATE:	June 3, 2009
FROM:	David S. Kupetz	FILE:	9527-0001
RE:	City of Hermosa Beach (the "City")/Macpherson Oil Company ("MOC") – Issues re Chapter 9 Plan of Debt Adjustment		

I.

INTRODUCTION

Based on the recent mediation where you have advised me that the mediator (retired Judge John Ryan) essentially dismissed out-of-hand the ability of the City to confirm a plan of debt adjustment over the objection of MOC because of what he apparently identified as insurmountable issues regarding classification and unfair discrimination, you have asked that I prepare a memorandum discussing those issues. As I have previously indicated, including in our group discussions shortly prior to and during the first day of mediation, the classification and discrimination issues are significant and could be impediments to confirming a plan of debt adjustment in the event that the City were to file a chapter 9 case and the plan were opposed by MOC. However, I do believe that there would be a reasonable basis to assert that a plan providing for separate classification of the claim of MOC and somewhat different treatment from the claims of other unsecured creditors could potentially be confirmed. Moreover, if a chapter 9 plan presented by the City were to be found by the Court not to be confirmable, the Court would likely either provide the City with additional time to file a modified plan or would dismiss the chapter 9 case placing the City in the same position where it stood prior to the commencement of the chapter 9 case. Most likely, at least initially, the Court would allow the City the opportunity to file a modified plan. *See e.g.*, In re Sanitary & Improvement Dist., #7, 98 B.R. 970, 976 (Bankr. D. Neb. 1989).

II.

GENERAL CONTEXT OF CHAPTER 9 CASE

Chapter 9 of the Bankruptcy Code is designed to enable a governmental entity that is unable to pay its debts as they come due to continue to provide essential services to residents while working out a plan to adjust its debts. *See* In re Addison Community Hosp. Auth., 175 B.R. 646 (Bankr. E.D. Mich. 1994).

> Chapter 9 of the Bankruptcy Code was drafted solely for municipalities. The provision allows debt adjustment which fosters continuance of municipalities rather than their dissolution. Because of the purpose of municipalities (i.e., police protection, fire protection, sewage, garbage removal, schools) is to provide essential services to residents, it is crucial that chapter 9 relief allow these entities enough flexibility to remain viable.

Id. at 648-49 (citing H.R. Rep. No. 1011, 100th Cong., 2d. Sess. 2 (1988), *reprinted* in 1988 U.S.C.C.A.N. 4415, 4416); In re City of Bridgeport, 129 B.R. 332, 336-37 (Bankr. D. Conn. 1991) (citing H.R. Rep. No. 1011) ("Chapter 9 is essential to enable a financially distressed city to 'continue to provide its residents with essential services such as police protection, fire protection, sewage and garbage removal, and schools . . .,' while it works out a plan to adjust its debts and obligations."). *See also* In re City of Bridgeport, 128 B.R. 688, 702-03 (Bankr. D. Conn. 1991) (*citing* H.R. Rep. No. 595, 95th Cong., 1st Sess. §§ 264-64 (1977), *reprinted* 1978 U.S.C.C.A.N. 6221) ("Chapter 9 provides a workable procedure so that a municipality of any size that has encountered financial difficulty may work with its creditors to adjust its debts.").

In this case, if MOC obtains a substantial judgment, the City will be unable to pay the debt. As a result, the City may be forced to seek relief under chapter 9. "The two main benefits of a Chapter 9 filing are (1) the breathing spell provided by the automatic stay, and (2) the ability to adjust debts of claimants through the plan process." Alliance Capital Management LP and Putnam Investment Management v. County of Orange (In re County of Orange), 179 B.R. 185, 191 (Bankr. C.D. Cal. 1995). Moreover, the bankruptcy court cannot interfere with the City's "ability to continue its operations or dictate what type of services or level of services the debtor municipality may provide." County of Orange v. Merrill Lynch & Co., Inc. (In re County of Orange), 191 B.R. 1005, 1018 (Bankr. C.D. Cal. 1996). Bankruptcy Code § 904 states:

> Notwithstanding any power of the court, unless the Debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with --
> (1) any of the political or governmental powers of the debtor;
> (2) any of the property or revenues of the debtor; or
> (3) the Debtor's use or enjoyment of any income-producing property.

11 U.S.C. § 904.

The goal of a Chapter 9 case is confirmation of a plan of debt adjustment. The standards for confirmation of a chapter 9 plan incorporate many of the chapter 11 confirmation standards. However, chapter 11 concepts do not uniformly fit chapter 9. Beyond the classification and unfair discrimination issues focused on by the mediator and discussed in separate sections below (which would likely be addressed in essentially the same manner as in a chapter 11 case), each of the other three key confirmation requirements that would face the City in a chapter 9 case (the "best interests of creditors", "feasibility", and "fair and equitable" tests) are somewhat different in the chapter 9 context from how they are applied in chapter 11.

The best interests of creditors test in the context of a chapter 9 case does not compare treatment under the plan to a liquidation, but rather to other realistic alternatives to the plan. "Section 943(b)(7) [with respect to the best interests of creditors provision] . . . simply requires the Court to make a determination of whether or not the plan as proposed is better than the alternatives." Hollstein v. Sanitary & Improvement Dist. No. 7 (In re Sanitary & Improvement Dist., No. 7), 98 B.R. 970, 974 (Bankr. D. Neb. 1989). Moreover, the debtor need not necessarily utilize all of its assets or resort to its taxing powers in order to satisfy the best interests of creditors test. 98 B.R. at 974.

> Creditors cannot expect that all excess cash go to the payment of their claims. The debtor must retain sufficient funds from which to operate and to make necessary improvements in and to maintain its facilities. The courts . . . must apply the test to require a reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case. On the basis of a flexible standard, creditors can hope to receive a reasonable recovery in a chapter 9 case, and the municipality can retain sufficient tax revenues to provide the services that its inhabitants require. The municipal debtor is not required to meet too strict a standard. . . . The court must also temper its examination into the debtor's ability to pay with due regard for the debtor's exercise of its political and governmental powers.

6 Collier on Bankruptcy, ¶ 943.03 [7][[a] (15th ed. rev. 2009) (footnotes omitted).

The chapter 9 case of Ventura Port District (the "District") filed in the Central District of California involved a situation where a former tenant of the District had obtained a large judgment against the District which the District did not have the ability to pay. The Ventura Port District case is much closer to the type of case the City would have if it were to file for chapter 9 relief than the much larger Orange County chapter 9 case presided over by Judge Ryan. In connection with the Ventura Port District chapter 9 case, litigation was conducted in the United States District Court for the Central District of California regarding the rights of the judgment holder ("VGV") under state law. The Ninth Circuit described the holding of the district court as follows:

> On January 1997, pursuant to its grant of summary judgment to Ventura County and its final judgment after a bench trial, the district court held that (1) Proposition 13 prohibited the County from levying an additional property tax to satisfy VGV's judgment, (2) Proposition 13 and *California Revenue and Taxation Code* § 95 prohibited the County from reallocating revenue generated from permissible property taxes to satisfy the judgment, (3) the District could not levy a special assessment to satisfy VGV's judgment, (4) VGV could not proceed with a writ of execution against the District's property, (5) VGV's abstract of judgment did not create a judgment lien for the purpose of establishing VGV's priority, and (6) the other creditors had superior liens to VGV.
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> The District Court did hold that VGV could obtain a writ of mandate against the District for the purpose of satisfying the judgment, and that a court considering the issuance of the writ could order the District to sell some of its property [not necessary to fulfill its governmental functions] to satisfy the judgment. The District did not cross appeal this determination. VGV limited its Ninth Circuit appeal to the consideration of the first three issues listed in the preceding paragraph along with federal constitutional claims . . . ."

Ventura Group Ventures, Inc. v. Ventura Port District, 179 F.3d 840, 843 (9th Cir. 1999). Thereafter, upon certification by the Ninth Circuit to the California Supreme Court, the California Supreme Court determined that a District could not impose assessments and that Proposition 13 precluded the levying of property taxes in excess of one percent to pay the VGV judgment. Ventura Group Ventures, Inc. v. Ventura Port District, 24 Cal. 4th 1089 (2001).

In order to satisfy the feasibility test, the City must show that it can meet its obligations under the plan and still maintain its operations at a level satisfactory to the City. The Court would review whether the evidence submitted by the City shows that it can perform its obligations under the plan. *See* In re Sanitary & Improvement Dist. No. 7, 98 B.R. at 975.

> In order to meet the feasibility standard, the debtor must demonstrate its ability to make the payments required under the plan and still maintain its operations at the level that it selects as necessary to continued viability of the municipality. The Court's role will be limited to determining whether the revenue and expense projections that the debtor submits are reasonable forecasts and whether, based on those numbers, the debtor will be able to make the payments called for under the plan. As the best interest test provides a floor for payments under the plan, the feasibility test provides the ceiling, and the debtor cannot be expected more than is reasonably feasible.

6 Collier on Bankruptcy, ¶ 943.03 [7][b] (15th ed. rev. 2009) (footnotes omitted).

Bankruptcy Code Section 1129(b)(1), incorporated into chapter 9 by § 901, requires the court in a situation where not all impaired classes of creditors vote to accept the plan to determine that the plan does not discriminate unfairly and is fair and equitable. In general, in chapter 9 cases, in order for the municipal debtor to satisfy the fair and equitable test the court will likely look and determine whether the plan provides creditors with what the creditors could reasonably expect under the circumstances.

> In determining what can be reasonably expected under the circumstances it is not necessary that all taxes collected go to the payment of creditors, or even the taxes be increased. The district must still have adequate revenues to continue operations, because the debtor cannot be dismantled or liquidated as in ordinary bankruptcy. Indeed one court has held that where a debtor effectively abandons it governmental functions under a plan, the plan is not proposed in good faith.

6 Collier on Bankruptcy, ¶ 943.03 [1][f][i][B] (15th ed. rev. 2009) (footnotes omitted).

To the extent that the MOC may assert that the City should be compelled under a plan to pay the judgment in full or in any fixed amount beyond what can be reasonably expected, MOC fails to recognize how the "fair and equitable" test applies in the context of a chapter 9 case.

> In a municipal debt adjustment case, the strict fair and equitable rule of corporate reorganization cannot be applied without some adjustments. A municipality cannot generally be valued as a going concern, taking into account its projected income stream and capitalizing that based on factors that consider the risk of failure of the enterprise. Nor can a going concern valuation be compared to a liquidation valuation, because a municipality cannot be liquidated to satisfy its creditors' claims. Indeed, it is because traditional balance sheet or going concern notions of solvency do not translate into a chapter 9 case that "insolvency" of a municipality is defined in terms of municipality's ability to pay its debts. Further, because there are no holders of equity interests in a chapter 9 case, the fair and equitable rule does not prevent a municipal debtor from continuing to operate, even if its creditors are not paid in full.

6 Collier on Bankruptcy, ¶ 943.03 [1][f][i][A] (15th ed. rev. 2009) (footnotes omitted).

As the court in In re City of Columbia Falls, Montana, Special Improvement Dist., No. 25, 143 B.R. 750, 759 (Bankr. Mon. 1992), held in approving a chapter 9 plan of debt adjustment where the plan did not pay prepetition bond holders the full amount of their claims with interest in contravention of state law, "to create a federal statute based upon a theory that federal intervention was necessary to permit adjustment of a municipality's debts and then to prohibit the municipality from adjusting such debts is not, in the point of view of this Court, a logical or necessary result." *Id.* (quoting Sanitary & Improvement Dist., No. 7, 98 B.R. at 974. The court specifically concluded that bankruptcy law supersedes the state law requiring the full payment of bondholders' prepetition claims. *Id.* at 757.

III.

CLASSIFICATION ISSUES

The applicable Bankruptcy Code provisions require that a chapter 9 plan designate classes of claims. *See* §§ 943(b)(1), 103(a), 901(a), 1123(a)(1), and 1122. A claim may be placed in a particular class under a plan only if such claim is substantially similar to the other claims of such class. 11 U.S.C. § 1122(a). While the Bankruptcy Code requires substantial similarity between claims that are placed in the same class, it does not require that all similar claims necessarily be placed in the same class. *See* In re Jersey City Medical Ctr., 817 F.2d 1055, 1061 (3d Cir. 1987); Teamsters First Nat'l Freight Ind. Negotiating Comm. v. United States Truck Co. (In re United States Truck Co.), 800 F.2d 581, 584-87 (6th Cir. 1986). In the Ninth Circuit, separate classification of unsecured claims is appropriate when there is "a legitimate business or economic justification." Barakat v. The Life Insurance Company of Virginia (In re Barakat), 99 F.3d 1520, 1526 (9th Cir. 1996). Further, separate classification is appropriate when the legal character of the claim is different from that of creditors in other classes. Steelcase, Inc. v. Johnston (In re Johnston), 21 F.3d 323, 327-28 (9th Cir. 1994).

A primary reason that classification is frequently so important is that when a plan is being confirmed without the consent of an impaired class of creditors (this is called "cramdown"), the Bankruptcy Code requires as a condition of confirmation that at least one class of impaired claims must accept the plan. *See* §§ 1129(a)(10), 1124, 1126, 943(b), and 901(a). A class of claims is impaired if the legal rights of the claimants in the Class are altered in any way under the plan. *See* § 1124. In order for an impaired class to accept the plan, at least two-thirds in amount (amount of allowed claims) and more than one-half in number of the members in that class who actually vote must vote to accept the plan. 11 U.S.C. § 1126(c). A bankruptcy court, in a chapter 9 case, discussing Ninth Circuit law regarding classification stated:

> In short, there must be a business or economic justification for separate classification of unsecured claims. In re Tucson Self-Storage Inc., 166 B.R. 892, 898 (9th Cir. BAP 1994); In re Baldwin Park Towne Center, Ltd., 171 B.R. 374, 376 (Bankr. C.D. Cal. 1994). Thus, while § 1122 on its face does not require that similar claims be classified together, within the Ninth Circuit, separate classification of unsecured claims will require a business or economic justification. That justification cannot consist solely of the Debtor's wish to obtain a consenting impaired class of creditors voting in favor of its plan. *Id.*

In re Corcoran Hospital District, 233 B.R. 449, 455 (Bankr. E.D. Cal. 1999) (upholding separate classification where the separately classified claim had a right to recoupment against the debtor and had entered into a settlement with the debtor).

The Corcoran court, discussing a Third Circuit Court of Appeals decision in another chapter 9 case involving classification issues, stated:

> The Third Circuit Court of Appeals addressed a similar issue in a Chapter 9 case, also involving a public hospital. In the matter of Jersey City Medical Center, Inc., 817 F.2d 1055 (3rd Cir. 1987). In that case, the debtor's plan divided unsecured creditors into four separate classes. Class 2 creditors were doctors with claims arising out of agreements with the debtor for indemnity against medical malpractice awards. Class 2 creditors were to receive 100% of their claims under the plan. Class 3 creditors were holders of pre-petition medical malpractice claims against the debtor. They were to receive 30% of their allowed claims. Class 4 creditors were employee benefit plan non-priority claims, and Class 5 creditors were general unsecured creditors. Classes 4 and 5 were to each receive 30% of their claims under the plan, along with pro rata shares from a surplus fund and a pool with excess revenues. . . . Classes 3 and 4 rejected the plan, and Class 5 accepted it. The bankruptcy court confirmed the plan, and the district court affirmed. On appeal by one general unsecured creditor, apparently a member of Class 5, the Third Circuit Court of Appeals affirmed.

In re Corcoran Hospital District, 233 B.R. at 456. *See also* In re U.S. Truck Co., Inc., 800 F.2d 581 (6th Cir. 1986) (it was appropriate to separately classify a union's claims and other unsecured claims, even claims arising from the rejection of other executory contracts, where the union's interests differed from those of other creditors even though its right to payment was on the same priority level); In re EBP, Inc., 172 B.R. 241, 244 (Bankr. N.D. Ohio 1994) (separate classification justified for trade creditors and for judgment, which as a non-recurring judicial event provided no continuing benefit to debtor's estate, and which was the largest single unsecured claim, representing more than 70% of all unsecured debt); In re Atlanta West VI, 91 B.R. 620 (Bankr. N.D. Ga. 1988) (separate classification allowed because it was for the purpose of facilitating reorganization and not for abusive or manipulative purposes); In re Coram Healthcare Corp., 315 B.R. 321, 349 (Bankr. D. Del. 2004) ("Numerous courts have held that separate classification and treatment of trade claims is acceptable if the separate classification is justified because they are essential to a reorganized debtor's ongoing business."). Courts reject separate classification when they find that the classification scheme was set up to gerrymander voting on the plan.

While courts have recognized that plan proponents and courts addressing plans are to be afforded broad discretion in formulating classes under a plan and in deciding the propriety of such classification, it is uniformly recognized that classification must be reasonable. *See* Jersey City Medical Center, at 1061. In the Jersey City Medical Center case, the Third Circuit pointed out that it was reasonable to distinguish among the claims of physicians, medical malpractice victims, employee benefit participants, and trade creditors. Similarly, while it is a significant issue involving uncertainty, it would seem that separate classification of the various classes of unsecured creditors of the City (trade creditors, employee benefit claims, Macpherson judgment claim, etc.) could reasonably be justified. The next issue that then arises is whether different treatment of such separately classified claims constitutes unfair discrimination.

IV.

UNFAIR DISCRIMINATION ISSUE

In order to confirm over the objection of MOC a plan of debt adjustment, the City would be required to show that the "plan does not discriminate unfairly . . . with respect to each class of claims . . . that is impaired under, and has not accepted, the Plan." 11 U.S.C. § 1129(b)(1). There can be "discrimination," so long as it is not "unfair." The Collier treatise states:

> This makes some practical sense: unsecured creditors under nonbankruptcy law include such diverse entities as tort claimants, trade creditors, bond holders and possibly nontax governmental claims. On liquidation, all of these claimants share *pro rata*. To hold, however, that all such creditors should share proportionately in the reorganization surplus, when each group does not contribute proportionately to its creation and maintenance, makes little sense.

7-1129 Collier on Bankruptcy – 15th Edition Rev. P 1129.04 (2009). The test boils down to whether the proposed discrimination has a reasonable basis and is necessary for reorganization. *See* In re 203 North LaSalle Street Ltd. P'ship, 190 B.R. 567, 585-86 (Bankr. N.D. Ill. 1995), *aff'd,* 195 B.R. 692 (N.D. Ill. 1996), *aff'd*, 126 F.3d 955 (7th Cir. 1997), *rev'd on other grounds*, 526 U.S. 434 (1999).

In In re Jersey City Med. Center, 817 F.2d 1055 (3d Cir. 1987), the plan had separately classified physicians, medical malpractice claims, and general unsecured claims, even though each class had the same nonbankruptcy priority rights against the estate. The plan paid physicians 100% of their claims, and 30% to the other classes. *See also* In re Kliegl Bros. Universal Elec. Stage Lighting Co., 149 B.R. 306, 308 (better treatment of unsecured claim of union was justified on the basis that "the Debtor's ability to continue to operate a union shop is absolutely critical to its ability to function successfully in its industry."); In re Rochem, Ltd., 58 B.R. 641, 643 (Bankr. D.N.J. 1985) (separate classification of unliquidated and disputed tort claimant upheld where plan gives tort claimant $50,000 in respect of unliquidated $35,000,000 tort claim and would, over 36 months, pay unsecured trade creditors a dividend of 50% of their claims of approximately $171,000). In contrast, there are many cases holding that disparate treatment of classes of unsecured claims constitutes unfair discrimination. *See e.g.*, In re Sentry Operating Co. of Texas, Inc., 264 B.R. 850, 863-64 (Bankr. S.D. Tex. 2001 (denial of confirmation of plan which paid 100% to one class of creditors, with whom the reorganized debtor believed it would have to deal, while remaining unsecured creditors were paid 1% of claims).

V.

CONCLUSION

In this case, the first issue regarding classification/unfair discrimination would be whether there any creditors with different legal rights (i.e., secured creditor) that would justify separate classification and different treatment under the plan. At this point, I am assuming the answer is no, but that could change by the time, if ever, the City were to file a chapter 9 petition.

Regardless, there are various options for how MOC might be treated under a plan compared to other unsecured creditors. One possible option is to separately classify and pay the other creditors (necessary for the City's ongoing provision of essential governmental services to its citizens) first or faster than paying MOC. Further, a court might allow MOC to be paid at a substantially lower percentage than other creditors out of necessity or, if not, the City could propose a plan paying all creditors with respect to liquidated prepetition claims at a discounted rate in order to demonstrate feasibility and overcome the unfair discrimination blocking point. Another option could be to provide an upfront payment to MOC under the plan that is only a fraction of the percentage paid to other creditors and to have future annual payments paid (either wholly or partly to MOC) from a surplus fund of excess revenues (as could be defined under the Plan). There are various other possibilities that could be proposed, either in an initial plan or in a modified plan if the court were to decline to confirm the City's initial plan. These could include, among other things, transferring real estate not necessary for governmental functions to MOC and/or pledging future revenues from such real estate or other revenue sources to MOC.

While I agree that the potential classification and unfair discrimination issues connected with a cramdown plan presented by the City are significant and could impede confirmation of a plan, I believe that nonetheless the City would have a reasonable chance of confirming a plan over the objection of MOC. Moreover, if the initial plan presented by the City was found by the Court not to be confirmable, most likely the City would be allowed the opportunity to present a modified plan. Finally, even if the City was unable to present a plan the Court would confirm and the chapter 9 case were to be dismissed, the City would just be back in the same position it was in prior to commencing the chapter 9 case.