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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re: CITY OF STOCKTON, CALIFORNIA, Debtor.	Case No. 12-32118 D.C. No. OHS-11 Chapter 9 **SUMMARY OBJECTION OF FRANKLIN HIGH YIELD TAX-FREE INCOME FUND AND FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND TO CONFIRMATION OF FIRST AMENDED PLAN OF ADJUSTMENT OF DEBTS OF CITY OF STOCKTON, CALIFORNIA (NOVEMBER 15, 2013)** Date: May 12, 2014 Time: 9:30 a.m. Dept: C, Courtroom 35 Judge: Hon. Christopher M. Klein

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1 Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal
2 Fund (collectively, "Franklin") hereby object to the *First Amended Plan For The Adjustment Of*
3 *Debts Of City Of Stockton, California (November 15, 2013)* (the "Plan"). Franklin files this
4 Objection in summary form pursuant to the Court's scheduling order to identify issues to be
5 addressed at the confirmation hearing. As contemplated by the scheduling order, Franklin will file a
6 supplemental objection upon conclusion of fact and expert discovery.[1]
7
8 **I. PRELIMINARY STATEMENT**

9 In 2009, Franklin loaned $35 million to the City. The City used Franklin's loan to build and
10 equip Fire Station No. 13, modernize and improve Fire Station No. 7, relocate and construct the
11 Police Communications Center, acquire land for and construct seven City parks, and acquire,
12 construct and install numerous paving, bridge, widening, lighting, landscaping and other street
13 improvement projects throughout the City. Franklin's funds were put to good civic use.

14 The City made just four interest payments – with no repayment of principal – before
15 defaulting on that thirty-year loan prior to bankruptcy. In the ensuing pre-bankruptcy "neutral
16 evaluation" process, the City offered to restructure and extend Franklin's Bonds through a proposal
17 that it claimed would enable Franklin to recover all scheduled principal and interest over the next
18 forty years and ultimately obtain a net present value recovery of 54.5%.

19 Now, however, the City seeks to cram down a plan of adjustment that essentially provides
20 Franklin with no recovery whatsoever. By the Plan, the City asks the Court to permanently
21 discharge Franklin's claim through a one-time payment of less than $94,000 – a recovery of
22 approximately one-quarter of one percent (¼%) of Franklin's principal. The City refuses to repay
23 any portion of Franklin's claim from future revenues or otherwise repay the Bonds over time. This
24 attempt to wipe out bond debt through a single minuscule payment is unprecedented in the history of
25

26 [1] *See Order Governing The Disclosure And Use Of Discovery Information And Scheduling Dates*
27 *Related To The Trial In The Adversary Proceeding And Any Evidentiary Hearing Regarding Confirmation Of Proposed Plan Of Adjustment* [Doc. No. 1224, as amended by Doc. No. 1242].
28 Capitalized terms not defined in this Objection have the meanings given to them in the Plan.

1 municipal bankruptcy, which the Supreme Court long ago held to require a municipal debtor to
2 propose a plan that devotes a "fair" amount of "probable future revenues" for "satisfaction of
3 creditors." *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415, 420 (1943).

4 In contrast, the Plan treats every other material category of creditors and class of claims –
5 including bondholders and retirees – much more favorably, honoring the City's obligation to repay
6 claims over time from future revenues. Those creditors have been promised distributions over the
7 course of the next forty years with expected net present values ranging from more than 52% to over
8 100% of their claims. In the process, the Plan provides treatment for all bondholders – other than
9 Franklin – superior to that offered in the pre-bankruptcy neutral evaluation process, highlighting the
10 punitively discriminatory treatment that the City seeks to impose on Franklin.

11 At the same time, the City ignores the elephant in the room, proposing to assume its massive
12 unfunded pension liabilities and thereby forgo its only opportunity to truly put its financial house in
13 order. The City projects that its annual payments to CalPERS will more than triple in just a decade –
14 from $14.14 million in Fiscal Year 2011-12 to $42.43 million in Fiscal Year 2020-21, and then
15 climb to $54.13 million a decade later in Fiscal Year 2030-31. By Fiscal Year 2019-20, pension
16 payments will consume 18.5% of the City's general fund, with the safety plan accounting for an
17 astounding 57.1% of payroll according to CalPERS.

18 By assuming all pension liabilities, the City will continue to pay for its well-documented sins
19 of the past (allowing employees to turn "pension spiking" into an "art form") and expose itself to the
20 absolute discretion of CalPERS, which retains sole control over the City's future pension
21 contribution rates (which have increased three times in just the last twenty-four months). Simply
22 put, if the City is willing and able to assume wholesale a liability that it recently described as
23 "staggering" and unpredictable, without any adjustment in this case, the City cannot credibly claim
24 that it has no future ability whatsoever to pay any portion of its substantially-smaller debt to
25 Franklin.

26 As shown below, the Plan as presently constructed violates a number of the Bankruptcy
27 Code's fundamental requirements for confirmation of a plan of adjustment. Among other things –
28

1 2 3 4 5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28

- The Plan is not "in the best interests of creditors" as required by section 943(b)(7) of the Bankruptcy Code. The "best interests" standard – which is the fundamental protection for individual dissenting creditors, even in cases where "the vast majority of security holders may have approved a plan," *Kelley*, 319 U.S. at 418-19 – requires the City to "exercise its taxing power to the fullest extent possible for the benefit of creditors" and establish that the "amount proposed to be paid under the plan was all that the creditors could reasonably expect under the circumstances."

The Plan fails that basic standard here, as the City can pay vastly more to Franklin from future revenues. In fact, the City itself projects that it has the capacity to pay Franklin in full by the end of the City's financial forecast period without cutting a single projected expenditure from the Long-Range Financial Plan on which the Plan is based. There also are tens of millions of additional dollars in restricted public facilities fees ("PFFs") that the City can use to pay Franklin's claim but not other general fund liabilities. Prior to bankruptcy, the City offered to use PFFs to provide Franklin a 54.5% recovery, and the Long-Range Financial Plan on which the Plan is based "assumes a conservative $500,000" in annual available PFF revenues to be used to pay Franklin, but the City now punitively withholds every single dollar of them.

- The Plan improperly classifies, disparately treats, and unfairly discriminates against Franklin's claim, in violation of the requirements of sections 1122(a), 1123(a)(4), and 1129(b) of the Bankruptcy Code. Those provisions operate to ensure fundamental "equality of treatment of creditors" in municipal restructuring, *American United Mut. Life Ins. v. City of Avon Park*, 311 U.S. 138, 147 (1940), but the Plan provides Franklin vastly unequal treatment.

To start, after separately classifying each and every one of its other general fund bond obligations (including the wholly-unsecured Pension Obligation Bonds), the City attempts to gerrymander the vote by classifying Franklin's Bonds together with the dissimilar Retiree Health Benefit Claims in an attempt to avoid section 1129(b)'s "cramdown" standards. The Plan then provides disparate treatment to the retiree claims classified together with Franklin, providing retirees with a combined recovery on their health benefit and pension claims (which the City and retirees have linked together via the Retirees Settlement) of over 70% (according to the City's calculations)

1 while proposing a ¼% recovery for Franklin. Finally, the Plan discriminates unfairly against
2 Franklin, providing similarly-situated creditors dramatically superior recoveries.

3 • The Plan has not "been proposed in good faith" pursuant to section 1129(a)(3) of the
4 Bankruptcy Code, which the City concedes "requires a fundamental fairness in dealing with one's
5 creditors" and a plan that provides creditors "the potential for the greatest economic return from its
6 assets." There is nothing "fundamentally fair" to Franklin about the Plan here.

7 Rather than providing the greatest economic return from its assets, the City deliberately is
8 minimizing Franklin's recovery by refusing to use a single dollar of restricted PFFs – which may not
9 be applied to other general fund liabilities – to pay Franklin's claim, despite the fact that it sold the
10 Bonds to Franklin on the premise that PFFs would be sufficient to pay all scheduled debt service,
11 proposed to use PFFs to pay Franklin in the pre-bankruptcy neutral evaluation, and assumed in its
12 own Long-Range Financial Plan that available PFFs would be paid to Franklin over the entire
13 projection period. Just eight months ago, the City recognized that its failure to take all steps to
14 maximize the amount of PFFs available for payment of the Bonds would be "a sign of bad faith."
15 Now, the Plan withholds them all – the opposite of the good faith required by the Bankruptcy Code.

16 Moreover, the City's wholesale assumption of its single largest liability – unfunded pensions
17 – further evidences the City's lack of good faith. If the City truly desired to "treat all interested
18 parties fairly" and to "provide creditors the potential for the greatest economic return from its
19 assets," it would have confronted and addressed its growing "pension problem" in this case, which
20 presents the only opportunity for the City to restructure that massive out-of-control liability.

21 • The Plan violates section 943(b)(3) of the Bankruptcy Code, which requires the Court
22 to find that "all amounts to be paid by the debtor or by any person for services or expenses in the
23 case or incident to the plan have been fully disclosed and are reasonable." The City flouts its
24 disclosure obligations, failing to disclose any of the tens of millions of dollars of fees it has paid to
25 its counsel and other professionals and to the counsel employed by the Retirees Committee.

26 • The Plan fails to comply with other applicable statutory provisions in violation of
27 section 943(b)(1) of the Bankruptcy Code. Most notably, the City has massively inflated the amount
28

of the Retiree Health Benefit Claims in order to drive down the so-called "Unsecured Claim Payout Percentage" (based upon the ratio of distributions to the allowed amount of Retiree Health Claims) that it seeks to apply to Franklin's claim. The City has stipulated to an allowed amount of $545 million, apparently by simply tallying up the estimated amount that the City would pay for health benefits over the next forty years or more (the expected lifespan for each of the retirees at issue), without discounting those projected expenses to present value. This has the effect of making the claims vastly overstate the actual amount of the City's liability and results in staggering individual claim amounts, with an <u>average</u> listed health benefit amount for <u>each</u> of the 1,100 retirees of nearly $500,000, and 67 retirees with listed claims over $1 million.

In so doing, the City not only ignores the way that it reports its unfunded liability in respect of retiree health claims in its audited financial statements (which discount the City's liability to present value at less than half of the amount to which it has now stipulated) but also contravenes section 502(b) of the Bankruptcy Code, which requires a discounting of claims for future employment-related benefits to present value as of the bankruptcy petition date.

* * *

The City seeks to portray Franklin as the "bad guy," claiming that Franklin "has decided to litigate instead of settle." Franklin, however, objects to the Plan not because it favors litigation but because the City truly has given it no other choice. While Franklin would like to be a cooperative partner in the City's rehabilitation – as evidenced by Franklin's own good-faith settlement offers both prior to and during the bankruptcy case – Franklin's fiduciary obligations to its stakeholders (including countless retirees and investors who have entrusted their own retirement funds to Franklin) obligate it to fight for the fair recovery to which the Bankruptcy Code entitles it. As shown below, the Plan does not remotely provide such a recovery and cannot be confirmed.

II. BACKGROUND[2]

Franklin is the beneficial owner of 100% of the $35,080,000 Stockton Public Financing Authority Lease Revenue Bonds, 2009 Series A (Capital Improvement Projects) (the "Bonds") issued pursuant to the Indenture of Trust, dated as of September 1, 2009 (the "Indenture"), between the Stockton Public Financing Authority (the "Authority") and Wells Fargo Bank, N.A., as indenture trustee ("Wells Fargo"). As described in Franklin's Complaint for Declaratory Relief (the "Complaint") initiating Adversary Proceeding No. 13-02315 (the "Adversary Proceeding"), Franklin has full power and authority to exercise rights and remedies in respect of the Bonds (or to direct Wells Fargo to do so).

Franklin purchased the Bonds at issuance in 2009. The City used Franklin's loan to finance major civic works throughout the City, described in the Official Statement for the Bonds as follows:

> Fire Station Facilities Improvements. The City used approximately $5.335 million of proceeds to finance the costs of constructing and installing fire station facilities improvements, including modernizing and expanding Fire Station No 7, located in northern Stockton, from 3,800 square feet to 5,600 square feet; constructing and equipping an approximately 7,250 square foot Fire Station No. 13 in northeast Stockton; and developing a master plan study for fire station facilities within the City.
>
> Police Communication Center Expansion and Relocation. The City used approximately $3.8 million of proceeds to finance the costs of relocating and constructing an approximately 24,000 square foot Police Communications Center located at 22 East Weber Street.
>
> Park and Facility Improvements. The City used approximately $11.12 million of proceeds to finance the costs of acquiring land and constructing seven parks located throughout the City.
>
> Street Improvements. The City used approximately $10.457 million of proceeds to finance the costs of acquiring, constructing and installing various paving, bridge, widening, lighting, landscaping and other street improvements within the City.[3]

---

[2] Discovery is ongoing in this case, and facts and expert opinion remain to be developed. As a consequence, and as contemplated by the scheduling order, this Objection does not include detailed citations to the record evidence, although certain documents produced in discovery are cited by Bates number for illustrative purposes. Pursuant to the scheduling order, Franklin will file a supplemental objection upon the conclusion of fact and expert discovery.

[3] Official Statement at 15-16 (copy attached as Exhibit B to Franklin's Complaint).

1 The City made four interest payments on the Bonds and then defaulted by missing the
2 payment due on March 1, 2012. The City subsequently initiated the pre-bankruptcy "neutral
3 evaluation" process required by state law, in which the City proposed (in its "Ask") to repay the
4 Bonds over the next forty years – extending their maturity by twelve years – from restricted PFFs.[4]
5 The City projected that Franklin would "receive[] its full principal and interest payments including
6 repayment of impaired amounts but [because payment] takes place over an extended period of time
7 [the restructuring] result[s] in a 45.5% discount on a net present value basis."[5] Alone among
8 bondholders and other so-called "capital markets" creditors, Franklin made a counterproposal to the
9 City,[6] but the parties were unable to reach agreement and the City ultimately commenced this case.
10 During the case, Franklin made several additional offers for a restructuring of the Bonds, all of
11 which were rejected by the City.

12 The City has now filed the Plan. The Plan purports to reject the agreements underlying the
13 Bonds as leases of nonresidential real property and to apply section 502(b)(6) of the Bankruptcy
14 Code to "cap" Franklin's claim at $10 million (three years of debt service on the Bonds).[7] The Plan
15 classifies that capped claim into Class 12 (General Unsecured Claims), and proposes to discharge it
16 through a one-time payment of no more than 0.93578% (and possibly less) – approximately
17 $93,578.[8] Accordingly, the City proposes Franklin a recovery of approximately 0.25% on its
18 prepetition claim of principal and interest accrued through the petition date.

19 Franklin has cast a ballot against confirmation of the Plan. Franklin also has commenced the
20 Adversary Proceeding seeking, among other things, a declaration that the agreements underlying the

21

[4] City of Stockton's Proposals for Modification to Obligations Under AB506 Process (the "Ask")
22 at 45, 783-86. The Ask was admitted as City Exhibit 50 in the trial on eligibility and, per the
scheduling order, remains in evidence for purposes of the hearing on confirmation of the Plan.
23 [5] Ask at 44-45.
24 [6] *In re City of Stockton, California*, 493 B.R. 772, 783 (Bankr. E.D. Cal. 2013) ("Objector
Franklin Advisors did make a counterproposal regarding a different bond issue, which the City
25 concedes was made in good faith but which was too far removed from the relief the City needed
on that bond issue to open a path for exploration.").
26 [7] Disclosure Statement at 31, 56-57.
27 [8] Disclosure Statement at 82; Plan § I.A.185 (definition of "Unsecured Claim Payout
Percentage"). The City also threatens to make the payment to Franklin over two years. *Id.*
28

Bonds are not leases of nonresidential real property susceptible to rejection under section 365 of the Bankruptcy Code or limitation under section 502(b)(6) of the Bankruptcy Code, that the Bonds are secured by Franklin's interest in certain City property and that, in the event the Court determines the agreements to be leases, Franklin is entitled to payment of an administrative claim for postpetition "rent" in the amount of at least $7.5 million.[9]

Franklin now objects to confirmation of the Plan on the grounds set forth below.

III. THE PLAN DOES NOT SATISFY THE STATUTORY REQUIREMENTS FOR CONFIRMATION

Section 943(b) of the Bankruptcy Code establishes the requirements for confirmation of a plan of adjustment in a chapter 9 case. The burden is on the City to prove by a preponderance of the evidence that it has satisfied each of those requirements. *E.g.*, *In re Pierce County Hous. Auth.*, 414 B.R. 702, 715 (Bankr. W.D. Wash. 2009) ("The debtor bears the burden of satisfying the confirmation requirements of § 943(b) by a preponderance of the evidence.") (citing *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 31 (Bankr. D. Colo. 1999)); *see also Liberty Nat'l Enters. v. Ambanc La Mesa L.P. (In re Ambanc La Mesa L.P.)*, 115 F.3d 650, 653 (9th Cir. 1997) (same burden on chapter 11 debtor).

Although discovery is ongoing, the evidence developed to date conclusively establishes that the City has not met, and cannot possibly meet, its burden of proof. In fact, the evidence shows that the Plan does not satisfy several of the fundamental criteria for confirmation under section 943(b).

A. The Plan Is Not In The Best Interests Of Creditors.

First and foremost, the Plan is not "in the best interests of creditors" as required by section 943(b)(7) of the Bankruptcy Code. 11 U.S.C. § 943(b)(7).

[9] The Adversary Proceeding is to be tried concurrently with the hearing on confirmation of the Plan and will be the subject of separate briefing.

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1. The "Best Interests" Test Provides Protection To Franklin As A Dissenting Creditor.

The phrase "best interests of creditors" is a familiar one to bankruptcy practitioners. Broadly stated, it embodies the core requirement that a proposed plan provide a recovery to each dissenting creditor that is superior to that otherwise available to the creditor. This basic protection for dissenting creditors has been part of statutory bankruptcy law for well over a century. The earliest bankruptcy laws specifically required that both corporate plans of reorganization (Chapter XI of the Bankruptcy Act)[10] and municipal plans of adjustment (Chapter IX of the Bankruptcy Act)[11] be in the "best interests of creditors."

In the 1978 overhaul of the Bankruptcy Act, Congress added specificity to the "best interests" test applicable in chapter 11, requiring a dissenting creditor to receive or retain "property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date." 11 U.S.C. § 1129(a)(7). The legislative history explains that this provision "incorporates the former 'best interests of creditors' test found in chapter 11, but spells out precisely what is intended." H.R. REP. NO. 95-595, 1st Sess. 412 (1977).

At the same time, for municipal restructuring under chapter 9 Congress maintained the historic "best interests" terminology in section 943(b)(7). The legislative history notes that the newly-formulated chapter 11 test "is phrased in terms of liquidation of the debtor. Because that is not possible in a municipal case, the test here is phrased in its more traditional form, using the words of art 'best interests of creditors.'" H.R. REP. NO. 95-595, 1st Sess. 400 (1977).

The purpose of the "best interests" test, however, remained unchanged. Specifically, in both chapter 9 and chapter 11, the test operates as the key protection for individual dissenting creditors in a reorganization case. While the "cramdown" protections of section 1129(b) apply in the event that

[10] *See* 30 Stat. 544, 55th Cong., 2d Sess., ch. 541, § 12(d)(1) (1898) ("The judge shall confirm a composition if satisfied that (1) it is for the best interests of creditors . . . .").

[11] *See* 50 Stat. 655, 75th Cong., 1st Sess., ch. 657, § 83(e)(1) (1937) ("At the conclusion of the hearing, the judge shall make written findings of fact and conclusions of law thereon, and shall enter an interlocutory decree confirming the plan if satisfied that (1) it is fair, equitable, and for the best interests of creditors and does not discriminate unfairly in favor of any creditor or class of creditors . . . .").

a dissenting class rejects a proposed plan, the protections of the "best interests" test apply to all individual dissenting creditors, even those whose claims are classified within a class that has accepted the plan. *Bank of Am. Nat'l Trust & Savs. Assoc. v. 203 North LaSalle Street Partnership*, 526 U.S. 434, 441 n.13 (1999) ("The 'best interests' test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan."). Thus, "[i]f even one dissenting member of an impaired class would get less under the Plan than in a hypothetical liquidation, the fact that the class as a whole approved the Plan is immaterial." *ACC Bondholder Grp. v. Adelphia Communications Corp. (In re Adelphia Communications Corp.)*, 361 B.R. 337, 364 (S.D.N.Y. 2007); *see, e.g.*, *In re Sierra-Cal*, 210 B.R. 168, 171 (Bankr. E.D. Cal. 1997) (the "best interests" test "cannot be finessed by a 'cram down' under § 1129(b)").

Consequently, the "best interests" test "is one of the strongest protections individual creditors have." *Adelphia*, 361 B.R. at 364. This Court has described it as "a cornerstone of the theoretical underpinnings of chapter 11. It stands as an 'individual guaranty to each creditor or interest holder that it will receive at least as much in reorganization as it would in liquidation.'" *Sierra-Cal*, 210 B.R. at 172 (quoting 7 COLLIER ON BANKRUPTCY ¶ 1129.03[7] (15th ed. rev. 1997)); *see, e.g.*, *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co. (In Re Bonner Mall Partnership)*, 2 F.3d 899, 914 n.35 (9th Cir. 1993) ("Creditors are given guarantees as individual creditors under the best interests test.") (emphasis in original). As the legislative history quoted above makes clear, the same holds true in chapter 9.

Simply put, "the best interests test . . . is designed to protect individual creditors even in the face of majority support for a plan." *Adelphia*, 361 B.R. at 367. This has been true in municipal restructurings for as long as chapter 9 has existed. As the Supreme Court held long ago, "minorities under the various reorganization sections of the Bankruptcy Act cannot be deprived of the benefits of the statute by reason of a waiver, acquiescence or approval by the other members of the class. The applicability of that rule to proceedings under Ch. IX is plain. [T]he fact that the vast majority of security holders may have approved a plan is not the test of whether that plan satisfies the statutory standard. The former is not a substitute for the latter. They are independent." *Kelley*, 319

1 U.S. at 418-19 (emphasis added) (quotations and citations omitted); *see, e.g.*, *Fano v. Newport*
2 *Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940) (reversing confirmation of proposed plan of
3 adjustment on the grounds that it was not in the "best interests" of a dissenting bondholder despite
4 the fact that 90% of bondholders had accepted the plan); *In re Sanitary & Improvement Dist., #7*, 98
5 B.R. 970, 971 (Bankr. D. Neb. 1989) (denying confirmation of proposed plan of adjustment on the
6 grounds that it was not in the "best interests" of creditors despite the fact that the plan "has been
7 accepted by all classes of creditors").

8 As shown below, the City's Plan provides Franklin a recovery far less than that which it
9 reasonably can expect under the circumstances and that which it could achieve in the absence of the
10 City's chapter 9 case. As a result, the Plan is not in the "best interests" of Franklin and hence does
11 not satisfy section 943(b)(7) of the Bankruptcy Code.

12

13 2. The "Best Interests" Test Requires The City To Provide Franklin A Reasonable Recovery Under The Circumstances.

14 As noted, in enacting chapter 9 Congress recognized that the "liquidation value" approach to
15 the "best interests" test does not work in the context of municipal restructuring. Instead, Congress
16 directed courts to apply the "traditional" analysis developed in *Kelley* and *Fano*, two Depression-era
17 decisions from the Supreme Court and the Ninth Circuit, respectively: "The best interests of
18 creditors test does not mean liquidation value as under chapter XI of the Bankruptcy Act. In making
19 such a determination, it is expected that the court will be guided by standards set forth in *Kelley v.*
20 *Everglades Drainage District*, 319 U.S. 415 (1943) and *Fano v. Newport Heights Irrigation District*,
21 114 F.2d 563 (9th Cir. 1940), as under present law, the bankruptcy court should make findings as
22 detailed as possible to support a conclusion that this test has been met." 124 Cong. Rec. H 11,100
23 (Sept. 28, 1978), S 17,417 (Oct. 6, 1978); *see* 5 NORTON BANKR. L. & PRAC. 3d § 90:20 (2014)
24 ("The legislative history suggests that determination of the best interests of creditors in a Chapter 9
25 case may be guided by reference to two cases.") (citing *Kelley* and *Fano*).

26 In *Kelley*, the debtor proposed a plan that would provide bondholders a recovery of
27 approximately 57 cents on the dollar. *Kelley*, 319 U.S. at 417-18. A "very small minority" of
28

bondholders objected. *Id.* The Supreme Court reversed an order of confirmation on the grounds that the bankruptcy court had not made findings of fact that would enable it to conclude, among other things, that the plan was in the best interests of creditors. In particular, the Court held that it was necessary for the bankruptcy court to assess the debtor's ability to pay claims from future tax revenues: "[W]here future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available basis for appraising the respective interests of different classes of creditors. In order that a court may determine the fairness of the total amount of cash or securities offered to creditors by the plan, the court must have before it data which will permit a reasonable, and hence an informed, estimate of the probable future revenues available for satisfaction of creditors." *Id.* at 420.

Similarly, in *Fano*, the Ninth Circuit reversed an order of confirmation, and sustained the objection of a single dissenting bondholder to a plan accepted by 90% of bondholders, on the grounds the plan was not in the best interests of creditors. The Circuit concluded that payment of 62.5 cents on the dollar to bondholders "would be highly unjust" because there was no "reason why the tax rate should not have been increased sufficiently to meet the [debtor]'s obligations." *Fano*, 114 F.2d at 565-66.

The common theme of both *Kelley* and *Fano* is consideration of the municipal debtor's <u>future</u> ability to pay. Under *Kelley* and *Fano*, a plan that impairs and discharges debt based upon a static "snapshot" of the debtor's current assets and liabilities does not satisfy the "best interests" test. Rather, to achieve confirmation over the objection of a dissenting impaired creditor, the debtor must prove that the plan devotes a "fair" amount of "probable future revenues" for "satisfaction of creditors." *Kelley*, 319 U.S. at 420. Congress recognized precisely this point in the legislative history to the bill that served as the precursor of chapter 9:

> Fair and equitable has additional [content] in Chapter IX. <u>The petitioner must exercise its taxing power to the fullest extent possible for the benefit of its creditors</u>, *Fano v. Newport Heights Irr. Dist.*, 144 F.2d 563 (9th Cir. 1940). <u>The court must find that the amount proposed to be paid under the plan was all that the creditors could reasonably expect under the circumstances</u>.

H.R. Rep. 94-686, 1st Sess. 33 (1975) (emphasis added).

From *Kelley*, *Fano*, and the legislative history emerge a straightforward inquiry: does the proposed plan of adjustment provide dissenting creditors with "all that could reasonably be expected in all the existing circumstances?" *See, e.g.*, *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 114 F.2d 654, 678 (9th Cir. 1940) ("[T]he only question before this court is whether or not the 51.501 [cents] on the dollar is all that could reasonably be expected in all the existing circumstances."); *Bekins v. Lindsay-Strathmore Irrigation Dist.*, 114 F.2d 680, 685 (9th Cir. 1940) ("It seems clear to us that the 59.978 cents on the dollar of principal amount of their bonds is all that the bondholders can reasonably expect in the circumstances.").

Relatedly, the "best interests" test also has been interpreted as an inquiry into whether "a proposed plan provide[s] a better alternative for creditors than what they already have." *Mount Carbon*, 242 B.R. at 34 (citing 4 COLLIER ON BANKRUPTCY ¶ 943.07[7] (15th ed. 1999)) (*dicta* due to the fact that the parties had stipulated that the plan at issue satisfied the "best interests" test); *see Pierce County*, 414 B.R. at 718 (same). So phrased, the test "require[s] 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." 6 COLLIER ON BANKRUPTCY ¶ 943.03[7] (16th ed. 2013);[12] *see also* 5 NORTON, *supra*, § 90:20 ("The basic consideration is reasonableness. The court should consider evidence of the municipality's tax base, its services requirements to its inhabitants, and the level to which taxes can be raised to fund the plan.").

Indeed, "since the test is designed to protect the dissenting minority of a class that has accepted the plan, one must not be so carried away with the potentially adverse consequences of the

[12] The City agrees that the "best interests" standard requires "a reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case." *City Memorandum Of Law In Support Of Confirmation Of First Amended Plan Of Adjustment Of Debts* [docket no. 1243] ("City Mem.") at 22. Tellingly, however, the City omits the latter part of the passage quoted from COLLIER, tacitly recognizing that the City's Plan does not provide Franklin "a reasonable recovery in a chapter 9 case."

alternative to a chapter 9 plan that one reaches the conclusion that any plan is better than the alternative." 6 COLLIER, *supra,* ¶ 943.03[7]. Rather, the "best interests" standard is best interpreted as "a floor requiring a reasonable effort at payment of creditors by the municipal debtor." *Pierce County*, 414 B.R. at 718 (quotation omitted). "A plan that makes little or no effort to repay creditors over a reasonable period of time may not be in the best interest of creditors." *Id.* (emphasis added).

Stated in its most straightforward terms, the "best interests" test in chapter 9 requires the debtor to prove that a proposed plan "affords all creditors the potential for the greatest economic return from the debtor's assets." *In re Barnwell County Hosp.*, 471 B.R. 849, 869 (Bankr. D.S.C. 2012) (emphasis added); *accord, e.g.*, *In re Connector 2000 Assn.*, 447 B.R. 752, 765-66 (Bankr. D.S.C. 2011).

3. The Plan Fails To Provide Franklin A Reasonable Recovery.

Prior to bankruptcy, the City recognized its obligation to use best efforts to repay creditors over time when it laid down a set of restructuring "principles" that included the goal of "[e]stablishing debt service payments at a level the City can afford to pay over time without placing essential services at risk of further cutbacks."[13] In the Plan, however, the City has ignored those principles and punitively plunged Franklin through the statutory "floor". While the Plan pays the claims of every other major creditor constituency over the next thirty or more years, the City does not devote any future revenues to the payment of Franklin's claim, much less a "fair" amount of "probable future revenues." *Kelley*, 319 U.S. at 420. The Plan neither represents "a reasonable effort by the municipal debtor" nor provides "a reasonable recovery" to Franklin. 6 COLLIER, *supra,* ¶ 943.03[7]. To the contrary, the Plan is the epitome of "[a] plan that makes little or no effort to repay creditors over a reasonable period of time." *Id.*

Notably, the City does not attempt to justify the treatment of Franklin's claim or argue that it is making a reasonable effort to provide reasonable recovery to Franklin. Instead, the City's entire argument is premised on its assertion that the Plan is in the "best interests" of creditors

[13] Ask at 20 (emphasis added).

collectively.[14] The City goes so far as to assert that the Plan satisfies the statutory standard because police protection to be funded by Measure A will "make the City a safer and more desirable place to live. This outcome can only have a positive impact on the City's future tax and other revenues, which in turn makes the recoveries of its creditors that much more certain."[15]

Under the Plan, however, Franklin does not benefit in any way from "a positive impact on the City's future tax and other revenues." The City seeks to permanently discharge Franklin's claim through a one-time payment of less than $94,000. Such a *de minimis* payment is not a reasonable effort by the City and it is not a reasonable recovery for Franklin. The City's allegations about the collective betterment of creditors are irrelevant in the context of the statutory standard established by section 943(b)(7) of the Bankruptcy Code, which protects Franklin individually. Indeed, the recoveries the City provides to other, similarly-situated creditors serve only to demonstrate that Franklin reasonably can expect to do better than the meager payment the City seeks to foist upon it.

The City's attempt to change the subject is not surprising. The Plan's negligible proposed payment to Franklin is unprecedented in the annals of municipal bankruptcy. Even cases decided in the throes of the Great Depression resulted in material payments to bondholders. *See, e.g.*, *Kelley*, 319 U.S. at 417 ("bondholders are to receive 56.918 cents in cash for each dollar of principal amount"); *United States v. Bekins*, 304 U.S. 27, 46 (1938) ("59.978 cents for each dollar of the principal amount"); *Fano*, 114 F.2d at 564 ("The plan proposes that the ratio for reducing and refinancing shall be 62.50 on the dollar of the principal amount of the bonded indebtedness."); *West Coast Life*, 114 F.2d at 658 ("51.501 [cents] on the dollar of bond principal"); *Lindsay-Strathmore*, 114 F.2d at 685 ("59.978 cents on the dollar of principal amount of their bonds").

Modern cases typically have produced even greater recoveries for bondholders, including full recovery of principal in the two largest California chapter 9 cases (County of Orange and City of Vallejo). *See also In re City of Colo. Springs Spring Creek Gen. Imp. Dist.*, 187 B.R. 683, 685

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[14] *See* City Mem. at 22 ("Dismissal of the Chapter 9 Case is not in the best interests of the City's creditors."); at 23 (dismissal "would be disastrous for creditors"); at 23 ("in this Plan, the City makes a reasonable effort to repay its creditors fairly"); at 24 ("This Plan provides creditors with the greatest and earliest possible recoveries") (emphasis added in each quote).

[15] City Mem. at 24.

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(Bankr. D. Colo. 1995) (repayment of full principal amount). Commenting on the City's pending case, one source recently observed that, "[s]ince at least 1981, and possibly as far back as the 1930s, no U.S. municipality has used bankruptcy to force bondholders to take less than the full principal due" over time through a cramdown. Steven Church, "*Stockton Threatens to Be First City to Stiff Bondholders*," BLOOMBERG NEWS, June 29, 2012.[16] The municipal debtors in those cases observed their statutory duty to make a reasonable effort to provide a reasonable recovery to all of their creditors. Here, in contrast, the City seeks to cram down a plan providing a one-time payment of 0.25% of Franklin's principal, for which it seeks a permanent discharge of the entirety of Franklin's claim. Franklin is unaware of any case in which a municipality proposed a recovery for bondholders remotely in the range of that which the City attempts here.

As shown below, the City demonstrably has the ability to pay Franklin substantially more.

a) *The City's Own Projections Demonstrate That The City Is Able To Pay Franklin In Full.*

Most fundamentally, the City itself projects that it has the capacity to pay Franklin in full by the end of its financial forecast period without cutting a single projected expenditure from the City's existing Long-Range Financial Plan (which is attached as Exhibit B to the Disclosure Statement). The Long-Range Financial Plan represents "[t]he financial underpinning of the Plan."[17] By the City's own admission, the Long-Range Financial Plan "model[s] likely fiscal performance in a conservative manner" with the consequence "that on balance [the City] can expect that variances are somewhat more likely to be 'good news' than 'bad news.'"[18] In fact, the City already has exceeded its revenue projections by $3 million through "the receipt of an estimated $3,000,000 in one-time property tax administration fee refunds from San Joaquin County,"[19] which apparently are not

[16] Available at: http://www.bloomberg.com/news/2012-06-29/stockton-threatens-to-be-first-city-to-stiff-bondholders.html.

[17] Disclosure Statement at 96.

[18] Long-Range Financial Plan at 2.

[19] City Mem. at 24.

otherwise accounted for in the Long-Range Financial Plan. According to the City, even a half-percent annual increase in revenue produces nearly half a billion dollars in additional excess funds:

> [W]e have been conservative in developing model assumptions, so it is possible that actual performance will be somewhat better than projected. Small ongoing improvements to base revenues, compounded over time, can significantly improve the fund balance outlook and capacity to address unmet needs. For example, . . . if our annual growth in core revenues (all taxes, including Measure A) is just 0.5% better than projected . . . [,] mission critical spending capacity over the entire 30-year period increases from $253 million under the forecasted revenue level to $735 million under a "forecast+0.5%" growth in core revenues.[20]

Even as "conservatively" modeled, the City predicts that it will have built up a cash reserve of $58.3 million by the end of the forecast period.[21] Additionally, the City also budgets for a $2 million annual "contingency" that is not otherwise allocated to any specific forecasted expense.[22] The $2 million contingency is repeated every year in the forecast regardless of whether the contingency is needed in prior years, resulting in cumulative "contingency" funds – which are not projected to be used and which may or may not be needed in any given year – of $57.5 million. As a result, the *pro forma* cash balance at the conclusion of the City's own forecast is $115.8 million, not including the additional $3 million the City already has received from San Joaquin County but apparently not included in the Long-Range Financial Plan.

The City of course needs a prudent level of reserves to account for unforeseen contingencies. The evidence and expert testimony, however, will show that, in light of the acknowledged "conservative" nature of the City's forecasting, the appropriate way for the City to maintain a reserve is through maintenance of a minimum cash balance, not a blanket $2 million annual "contingency" reserve that accumulates every year regardless of whether or not the "contingency" funds were used in the prior year. In fact, even in the most prosperous of times (2006), the City adopted an aspirational reserve target of no more than 10% of its budgeted general fund annual

[20] Long-Range Financial Plan at 3 (emphasis added).

[21] Long-Range Financial Plan at 36, line 108.

[22] Long-Range Financial Plan at 31-36, line 101.

1 appropriations and transfers.[23] In practice, the City typically has maintained reserves of far less than
2 that, averaging a reserve of approximately 5% of the budgeted general fund annual appropriations
3 and transfers over the last fourteen years (the earliest data available to Franklin).
4 Unlike the City's new perpetually-accumulating annual "contingency", a minimum cash
5 reserve enables a municipality to deploy excess cash in years when positive variances occur, and to
6 draw upon the cash reserve to pay for unforeseen expenses in years when contingencies arise. In
7 contrast, the City's "annual contingency" methodology illogically assumes that only negative
8 variances from the forecast will occur and that they will occur every year, year after year.
9 Using the City's own Long-Range Financial Plan, but substituting a prudent minimum cash
10 balance for the blunderbuss flat $2 million annual contingency approach, produces more than
11 adequate funds to pay Franklin in full. Table 1 shows that Franklin would be paid in full or receive
12 substantial payment by the end of the forecast period (Fiscal Year 2040-41) if the City simply
13 maintained a minimum cash reserve, with Franklin being paid its scheduled debt service only in
14 years when excess cash is available (with unpaid amounts carrying over to subsequent periods,
15 accruing interest at the contract rate). Franklin's recoveries would be even greater if the City used
16 excess cash to repay it through Fiscal Year 2051-52 (the extended maturity date for the restructured
17 Bonds proposed by the City in the Ask) or Fiscal Year 2052-53 (the extended maturity date of the
18 restructured Pension Obligation Bonds provided to Assured under the Plan).
19

Table 1

Minimum Cash Balance	*Cash Available To Pay Franklin Through 2040-41*	*Result For Franklin (Net Present Value Of Principal)*
5% of general fund	$87,563,123	100%
10% of general fund (2006 aspirational goal)	$78,024,000	95.5%
15% of general fund	$59,117,500	64.4%
16⅔% of general fund[24]	$52,802,729	56.4%

20 21 22 23 24 25

26 [23] City of Stockton City Council Policy No. 700-4, Reserve Policy-General Fund, adopted by Resolution No. 06-0299 dated June 6, 2006.
27 [24] This is the reserve level that the City claims to be recommended by the Government Finance
28 Officers Association. Long-Range Financial Plan at 14 n.3. The City, however, ignores the

1 Moreover, the City's "conservative" projections are just that. In particular, the evidence and expert testimony will show that the City's projection of future property tax, sales tax, utility user tax, and other revenues are low when considered in light of historical results and current economic factors. In fact, when times were good, the City actually cut taxes, reducing its utility user tax from 8% to 6% between 2005 and 2007, resulting in a reduction of revenue of more than 10%.[25] Now that it is mired in fiscal crisis, the City has not even attempted to raise the tax back to its baseline level. The evidence and expert testimony also will show that the City has not undertaken – and is not projecting for – certain basic initiatives that would enhance future revenues and reduce future expenses, freeing up still more funds for the payment of Franklin's claim.[26]

Finally, the evidence and expert testimony will show that, while the City proposes to cram down a miniscule one-time 0.25% recovery on Franklin, the Long-Range Financial Plan contemplates ample spending on various non-essential services. Table 2 contrasts the City's proposed annual expenditures in certain categories with the amounts necessary to pay the full scheduled debt service on the Bonds (principal and interest), in each case as an average percentage of projected annual general fund expenses over the term of the Long-Range Financial Plan.

Table 2

Expense Category	***Annual Average Of Projected General Fund Expenses***
Recreation	1.7%
Entertainment Venues	1.5%
Library	2.4%
Full debt service on the Bonds	***1.2%***

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recommendations of the Government Finance Officers Association, which for example also has recommended that cities adopt an approach of pre-funding retiree health care benefits.

[25] Long-Range Financial Plan at 6.

[26] For example, the City projects that it will achieve a total of $3 million in "efficiencies" and "improved cost recoveries" in the first several years of the Long-Range Financial Plan. Long-Range Financial Plan at 32, line 100. Beyond that point, however, the City projects not a single dollar of additional savings from efficiencies or cost recoveries, meaning that the City forecasts a total of $3 million in savings for the entire thirty-year projection period.

In light of its willingness to fund such discretionary expenditures, the City's paltry one-time payment to Franklin does not constitute a "a reasonable effort by the municipal debtor" or "a reasonable recovery" to Franklin, and it certainly does not represent a "fair" amount of "probable future revenues." *Kelley*, 319 U.S. at 420.

b) *There Are Millions Of Dollars Of Public Facility Fees Available To Pay Franklin.*

In addition to the tens of millions of dollars of excess general fund revenues that the Long-Range Financial Plan projects to be available, the City also will have tens of millions of dollars of restricted PFFs that it can use to pay Franklin's claim.

The City levies a public facilities fee on the issuance of building permits "to pay for municipally owned public facilities, including but not limited to City office space, fire stations, libraries, police stations, community recreation centers, street improvements, and water and sewage facilities, and to pay for acquisition, enhancement, restoration, maintenance, and/or operation of habitat/open space conservation lands." STOCKTON, CAL., MUN. CODE § 16.72.260(B)(1) (2013).[27] PFFs are restricted funds maintained in separate accounts (not the general fund) and, with exceptions not relevant here, may be used only for the construction and payment of such public facilities and "[t]o reimburse the City for designated public facilities constructed by the City with funds . . . from other sources." *Id.* § 16.72.260(C). The ability to "reimburse" itself for projects constructed with general funds enables the City to pay debt service on bonds used to finance public facilities.

As noted, Franklin's Bonds financed more than $30 million in qualifying public facilities and infrastructure. As a consequence, the City is able to use various PFFs to make the debt service and principal payments on the Bonds. According to the City, the City is able to utilize PFFs "from four different funds (Funds 910-915 Street Improvements, Fund 940 Fire Stations, Fund 960 Police Stations and Fund 970 Parkland) to make debt service payment [with] each fund paying its

[27] Available at: http://qcode.us/codes/stockton/view.php?topic=16-3-16_72-16_72_260&frames=on.

respective share" according to the amount of Bond proceeds used for construction of the facilities for which such funds are maintained.[28]

In fact, when it sold the Bonds to Franklin the City stated that it "expects that the Public Facilities Impact Fees generated from the General City Office Space, Fire Stations, Parkland, Street Tree and Street Signs and Police Stations [Funds] will be sufficient to pay the debt service, when due on the 2009 Bonds."[29] In other words, the City projected that the entirety of the Bonds would be repaid from PFFs. To that end, prior to bankruptcy the City historically allocated 34.05% of the debt service on the Bonds to the Streets Funds, 17.37% to the Fire Stations Fund, 12.37% to the Police Stations Fund, and 36.21% to the Parkland Fund.[30] To this day, the City commonly refers to the Bonds as the "2009 PFFs"[31] and "2009 Public Facilities Fees."[32]

In its pre-bankruptcy "Ask", the City proposed to continue this practice by using the PFFs deposited into the applicable Funds "to pay up to that account's legally allocable share of the debt service" on the Bonds for the next forty years, "until the end of Fiscal Year FY51-52."[33] The City stated that this would enable Franklin to receive "full principal and interest payments . . . over an extended period of time," and valued Franklin's recovery at 54.5% on a net present value basis.[34] In contrast, under the Plan, the City proposes to discharge Franklin's claim through a one-time payment of less than $94,000 without using any of its future PFF revenue. Given the availability of PFFs to pay some or all of the claim, this treatment does not reflect "a reasonable effort at payment of

[28] Ask at 785.

[29] Official Statement at A-8 (emphasis added). The Long-Range Financial Plan confirms that "PFFs from the streets, police, fire and parklands funds were expected to be used as an internal source of funds as available" to pay the Bonds. Long-Range Financial Plan at 19.

[30] Ask at 785.

[31] Ask at 43; CTY064080.

[32] CTY016914.

[33] Ask at 785-86. The City proposed first "to restore any of the historical negative balances in those accounts," and asserted that the Fire Stations Fund and the Police Stations Fund had "negative fund balances." *Id.* To date, the City has been unable to substantiate that assertion or explain how it is possible (or legally permissible) for any PFF Fund to have a negative balance.

[34] Ask at 44-45.

creditors" and does not provide Franklin with a "fair" amount of "probable future revenues." *Kelley*, 319 U.S. at 420.

Moreover, while development permits (and hence PFF revenues) have dropped materially from the historical highs achieved in the latter part of the last decade, PFFs are still a significant source of potential revenue with which to pay Franklin. The Long-Range Financial Plan itself "assumes a conservative $500,000 in available PFF revenues" annually for payment of debt service on the Bonds.[35] The evidence will show that, in fact, the City can expect substantially greater available PFF revenues than those that it "conservatively" forecasts.

For example, in determining the appropriate rate of building permit fees last Summer the City concluded that "a profitable, sustainable new home market will return to Stockton on its own accord, in two to three years."[36] History supports that conclusion. Over the twenty years prior to the petition date, the City averaged 1,332 building permits a year, with a median of 1,192. Removing the five years with the highest and lowest single family residence permits – to adjust for the late-2000s boom and bust – results in an average of 1,145 single-family residence permits and a median of 1,139.[37] Using the City's historical allocations across the various PFF Funds that can be used to repay the Bonds and applying the current single family residence permit fee amount, the Bonds could be repaid in full from PFF revenue if there is an average of just 650 building permits a year during the period of the Long-Range Financial Plan. During the bankruptcy case the City's own consultants projected a "sustained average" of approximately 700 permits during that period,[38] and the City itself forecast more than 600 permits a year by Fiscal Year 2020/21.[39]

Even if those forecasts are wildly optimistic, PFF revenue nevertheless could provide a source of substantial payment to Franklin. The City would generate more than $1.8 million that

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[35] Long-Range Financial Plan at 19.

[36] CTY023542.

[37] CTY257649-53.

[38] CTY133495; *see also* Long-Range Financial Plan at 4 ("a market absorption study prepared for the City projects an average of 700 units annually going forward").

[39] CTY031660.

1 could be applied to payment of the Bonds at 300 permits a year, around $1.6 million at 200 permits a
2 year, and nearly $1 million at 100 permits a year, even assuming that the Fire Stations Fund and the
3 Police Stations Fund contribute nothing toward debt service due to the alleged "negative balances"
4 within those funds. The revenue available for debt service would increase even more if the Fire
5 Stations Fund and Police Stations Fund also paid their historically-allocated share of debt service.

6 The City's refusal to apply the restricted PFF revenues – which cannot be used for general
7 fund purposes – to payment of Franklin's claim makes a mockery of the "best interests" standard and
8 provides further, independent evidence that the Plan fails to satisfy the requirements of
9 section 943(b)(7) of the Bankruptcy Code.[40]

10

11 c) *The City's Refusal To Confront Its Pension Problem Provides No Justification For Franklin's Meager Proposed Recovery.*

12 Independently, the City's voluntary agreement to assume its massive liability for unfunded
13 pension obligations deprives it of any reasonable basis to claim that it cannot "afford" to pay
14 Franklin more than $94,000. The City's willingness to pay tens of millions of dollars every single
15 year for the next thirty or more years to satisfy the prepetition pension claim completely undercuts
16 its assertion that it cannot make any future payments in any amount to Franklin.

17 The evidence and expert testimony will show that the City's pension liabilities are a serious
18 issue. The City projects that its annual payments to CalPERS will more than triple in just a decade –
19 from $14.14 million in Fiscal Year 2011-12 to $42.43 million in Fiscal Year 2020-21, and then
20 climb to $54.13 million a decade later in Fiscal Year 2030-31.[41] By Fiscal Year 2019-20, pension
21 payments will consume 18.5% of the general fund – well above the City's historical norms and
22 above the payments made by "peer cities" of comparable size and demographics. The liabilities also
23 are completely disproportionate to the size of the City's workforce. According to CalPERS
24 Stockton's safety plan contributions currently are 34.6% of payroll and are projected to reach an

25 [40] Notably, the City proposes to use PFFs to make future debt service payments on the 2006 SEB
26 Bonds and to use other restricted funds to make future debt service payments on the Pension
Obligation Bonds. *See* Long-Range Financial Plan at 17 and 18. It is only Franklin that
27 punitively has been denied access to the PFFs available to pay its claim.

[41] Long-Range Financial Plan at 31-33, line 51.
28

1 astounding 57.1% of payroll by Fiscal Year 2019-20. Here again, the ratio of pension liability to
2 payroll exceeds those of the peer cities and is forecast to grow at a substantially greater rate than the
3 peer cities.

4 The reasons the City's pension contributions are high in relation to its peers are well
5 documented. As the City freely admits, its past practices enabled employees to turn "pension
6 spiking into an art form" and thus get "much larger pensions for the rest of their lives."[42] While the
7 City apparently now has curbed those abuses, it will continue to pay for its past mistakes – for the
8 next three decades or more – due to its wholesale assumption of the pension liabilities.

9 To make matters worse, the pension liabilities are unpredictable and completely out of the
10 City's control, as they are dependent on contribution rates established by CalPERS. Those
11 contribution rates have tended to increase year over year, making it difficult if not impossible to
12 prepare responsible and accurate forecasts. For example, the 2010 CalPERS valuation report for the
13 City forecast a safety plan contribution rate for 2016-17 of 34.6% of payroll. The 2011 CalPERS
14 valuation report then increased that forecast rate to 40.6%, and the 2012 CalPERS valuation report
15 increased it yet again to 47.7%. Just last week CalPERS announced yet another increase to
16 contribution rates – the third announced increase in the last twenty-four months. *See, e.g.*, Tim Reid,
17 *California Pension Rate Hikes Loom After CalPERS Vote*, REUTERS, February 18, 2014;[43] Fenit
18 Nirappil, *California Pension Board Hikes Contributions*, ASSOCIATED PRESS, February 18, 2014.[44]

19 The City knows this. At the Disclosure Statement hearing, the City's lawyer candidly
20 admitted that the City has no idea how high the pension liabilities might rise: "MR. LEVINSON:
21 And let alone CalPERS, who knows what's going to happen in 10, 20, 30 years. The fact of the
22 matter is, CalPERS' obligation is staggering. It's laid out in Exhibit B to the Disclosure Statement,
23 with our projections, and that's our best information as of today. That CalPERS' projections may be
24

25 [42] Eligibility Ex. 410 at 1.

26 [43] Available at: http://www.reuters.com/article/2014/02/19/us-usa-pensions-calpers-idUSBREA1I08120140219.

27 [44] Available at: http://hosted2.ap.org/CAANR/703431ceb9e54ef59a493df79e81e2f3/Article_2014-02-18-California%20Pensions/id-df0a23663b57466c901518fbf7df5784.

28

different is okay. That's CalPERS projections. These are our projections. These are the ones that our financial team has put together using the best information it could."[45]

If the City is willing and able to assume that "staggering", unpredictable liability without any adjustment in this case, the City cannot credibly claim that it has no future ability whatsoever to pay any portion of its substantially smaller debt to Franklin.

d) *Franklin Could Recover Substantially More Outside Of Bankruptcy.*

Finally, Franklin would collect far more on its claim in the absence of the Plan and outside of bankruptcy. To start, the City seeks to limit Franklin's claim to three years of scheduled debt service by invoking section 502(b)(6) of the Bankruptcy Code, a claim for more than $35 million in principal at a mere $10 million.[46]

Franklin will demonstrate in its Adversary Proceeding that section 502(b)(6) has no applicability to its claims against the City. However, if the City is correct that the statutory cap does apply, Franklin clearly would be better off in the absence of this bankruptcy case because there is no such claim limitation outside of bankruptcy. Given the *de minimis* distribution that the City proposes to make in respect of the capped claim, this by itself is sufficient to cause the Plan to fail the "best interests" test. *See In re Quigley Co.*, 437 B.R. 102, 144 (Bankr. S.D.N.Y. 2010) (the "best interests" analysis must account for situations in which "a Code provision may affect the amount of a creditor's claim under one chapter but not the other, altering the distribution to the remaining creditors"); *Sierra-Cal*, 210 B.R. at 175-76 (plan fails "best interest" test where claimants would receive a greater distribution in chapter 7 due to the automatic disallowance of certain claims pursuant to section 502(d) of the Bankruptcy Code).

Moreover, in the event of dismissal, Franklin would have available to it a host of rights that the City seeks to permanently strip away from it via the Plan. Most notably, for at least the next thirty-five years, Franklin would have the right to bring suit every six months and obtain a judgment

[45] Tr. 11/18/13 at 44:14-22 (emphasis added).

[46] *See* City Mem. at 15 n.6. This is the reason that Franklin's recovery under the Plan is 0.25% rather than the "Unsecured Claim Payout Percentage" applicable to the General Unsecured Claims classified with Franklin into Class 12, which are to receive a recovery of approximately 0.93578%.

1 for each missed installment payment on the Bonds, plus all accrued interest and attorneys' fees and
2 expenses.[47] To the extent that the City did not pay, the judgments would accumulate over time with
3 interest and be payable at any time the City had sufficient unappropriated funds to pay some or all of
4 them.[48] The City would be obligated to include in its budget for each fiscal year funds sufficient to
5 pay the judgments,[49] and Franklin could enforce its rights by a writ of mandate compelling the City
6 to deliver all available funds (including PFFs) to it.[50] All of this is in addition to Franklin's rights to
7 possess and re-lease the collateral for the entire term of the Bonds.[51]

8 In contrast, the Plan permanently would cut off Franklin's rights to sue for unpaid amounts in
9 exchange for a one-time payment of less than $94,000.[52] Courts regularly hold that a plan fails the
10 "best interests" test where, as here, it seeks to strip or otherwise limit rights available to a creditor
11 outside of the reorganization case. For example, in *Pierce County*, the court held that a proposed
12 chapter 9 plan did not satisfy the "best interests" test because it prohibited dissenting creditors from
13 pursuing possible insurance claims unless an independent examiner first determined that the claims
14 were viable. *Pierce County*, 414 B.R. at 719 ("The Court agrees that it is not in the best interest of
15 creditors to go through the added step and cost of requiring an examiner to review and approve for
16 tender every claim solely due to the Debtor's expressed intent of limiting litigation."). The court

17 [47] *See* Leaseback Agreement §§ 9.2, 9.5 (copy attached as Exhibit D to Franklin's Complaint). As
18 the owner of the entirety of the Bonds, Franklin has the ability to direct Wells Fargo to exercise
its remedies under the Indenture. *See* Indenture § 7.05 (copy attached as Exhibit A to Franklin's
19 Complaint). Franklin and Wells Fargo have the right to enforce all of the Authority's rights and
remedies under the Leaseback Agreement. Indenture § 5.01; Leaseback Agreement § 9.7.

20 [48] *See* Cal. Gov't Code § 970.4.

21 [49] *See* Cal. Gov't Code § 970.8; Cal. Gov't Code § 970.5.

[50] *See* Cal. Gov't Code § 970.2.

22 [51] *See* Leaseback Agreement § 9.2 (Upon an event of default, "the Authority may exercise any and
23 all rights of entry and re-entry upon the Property. The City irrevocably consents to the
Authority's repossession of the Project if such an Event of Default shall occur and consents to
24 the Authority's re-letting of the Project for the account of the City.").

25 [52] The City also purports to limit and eliminate Franklin's rights to possess and re-lease the
collateral and threatens to "request that the Court enter an order" "protecting" the City from
26 alleged adverse consequences of Franklin's possession and use of the collateral. *See* Disclosure
Statement at 56-62. Franklin disputes the City's ability to place any restriction on its rights in
27 respect of the collateral. If the City attempts to do so, the nature and contours of Franklin's
rights will be adjudicated either in the Adversary Proceeding or in connection with any such
28 "request" made by the City.

concluded that "the Debtor's attempts to forestall the ability of [creditors] to investigate potential sources of recovery does not indicate a sincere attempt by the Debtor to readjust its debts by maximizing the creditors' recovery." *Id.* at 720 Similarly, in *Quigley*, the court held that the plan at issue failed the "best interests" test because it purported to release derivative claims that would have been available to individual dissenting creditors to pursue in a chapter 7 case. *Quigley*, 437 B.R. at 108 ("Once the derivative claims against Pfizer are factored into the equation, the Fourth Plan fails the 'best interest' test.").

The City asserts that creditors' generic nonbankruptcy rights are a "hollow remedy" because "a mad scramble to litigate their claims in state court" ultimately would produce minimal recoveries.[53] The burden, however, is on the City to prove that Franklin (not just creditors generally) would fare worse in the event of dismissal of this case. The City has not attempted to and cannot do so. In fact, the City concedes that some creditors are "financially equipped" to "win 'the race to the courthouse'" and thus "would benefit disproportionately" outside of bankruptcy.[54] Franklin undoubtedly is "financially equipped" to do so and promptly would pursue all available rights and remedies. Moreover, because Franklin has the right to sue the City every six months for the unpaid installments, the amount of the judgments in Franklin's favor would be relatively small and more likely to be paid by the City in the ordinary course (including from PFFs) or dealt with through the appropriations process on a year-by-year basis. There is every reason to believe that, at some point over the next thirty-five years, Franklin could and would recover more than .25% of its claim outside of bankruptcy. The City certainly has not proven otherwise.

Interestingly, the City cites the Supreme Court's decision in *Faitoute Iron* for the proposition that the Plan satisfies the "best interests" test because, upon dismissal, "the right to enforce claims against the city through mandamus is the empty right to litigate." *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 510 (1942).[55] *Faitoute Iron*, however, proves Franklin's point.

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[53] City Mem. at 22; *see also* Disclosure Statement at 96.

[54] Disclosure Statement at 96.

[55] City Mem. at 22-23.

That case involved an objection to a proposed plan of adjustment under New Jersey's state-law statutory scheme for municipal restructuring, and a challenge to the constitutionality of the state law itself. As with its federal counterpart, the state law required the trial court to find that the proposed plan "is in the interest of all the creditors affected thereby." *Id.* at 504. The plan of adjustment at issue provided for bondholders to be repaid the full principal amount of their bonds through an issue of refunding bonds with a lower interest rate and a maturity twenty-eight years into the future, *id.* – a far cry from the City's desired cramdown of Franklin through a one-time payment of 0.25%.

In the course of upholding the statute, as the City now notes, Justice Frankfurter writing for the Court did observe that a creditor's right to litigate a claim in fact may be "empty":

> [T]he practical value of an unsecured claim against the city is inseparable from reliance upon the effectiveness of the city's taxing power. The only remedy for the enforcement of such a claim is a mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depressions of '73 and '93, shows that the right to enforce claims against the city through mandamus is the empty right to litigate.

Id. at 510. Justice Frankfurter, however, made that observation in the course of explaining why a collective insolvency proceeding was the best way to enforce claims against the municipality and to maximize recoveries for creditors:

> How, then, can claims against a financially embarrassed city be enforced? Experience shows that three conditions are essential if the municipality is to be kept going as a political community and, at the same time, the utmost for the benefit of the creditors is to be realized: impartial, outside control over the finances of the city; concerted action by all the creditors to avoid destructive action by individuals; and rateable distribution. In short, what is needed is a temporary scheme of public receivership over a subdivision of the State. A policy of every man for himself is destructive of the potential resources upon which rests the taxing power which in actual fact constitutes the security for unsecured obligations outstanding against a city.

Id. (emphasis added).

In other words, the Court concluded that the state law was effective (and constitutional) because it served as a way to ensure the ongoing and future collection of taxes to generate funds to pay creditors and provide services. Justice Frankfurter made precisely this point:

> The whole history of New Jersey legislation leaves no doubt that the State was bent on holding the municipalities to their obligations by utilizing the most widely approved means for making them effective. The intervention of the State in the fiscal affairs of its cities is plainly an exercise of its essential reserve power to protect the vital interests of its people by sustaining the public credit and maintaining local government. The payment of the creditors was the end to be obtained, but it could be maintained only by saving the resources of the municipality – the goose which lays its golden eggs, namely, the taxes which alone can meet the outstanding claims.

Id. at 512 (emphasis added).

In concluding that the state law did not violate the Contracts Clause, Justice Frankfurter returned again to the fundamental point that the challenged state law enabled the municipal debtor to generate future tax revenues for the payment of creditor claims:

> Here we have . . . no security whatever except the effective taxing power of the municipality; the effective taxing power of the municipality prostrate without state intervention to revive the famished finances of the city; state intervention, carefully devised, worked out with scrupulous detail and with due regard to the interests of all the creditors, and scrutinized to that end by the state judiciary with the result that that which was a most depreciated claim of little value has, by the very scheme complained of, been saved and transmuted into substantial value. To call a law so beneficent in its consequences on behalf of the creditor who, having had so much restored to him, now insists on standing on the paper rights that were merely paper before this resuscitating scheme, an impairment of the obligation of contract is indeed to make of the Constitution a code of lifeless forms instead of an enduring framework of government for a dynamic society.

Id. at 515-16 (emphasis added).

Now compare *Faitoute Iron* to this case. In place of a restructured obligation that repays creditors the full amount of their principal, we have a Plan that seeks to discharge Franklin's thirty-five year obligation through a one-time payment of ¼ cent on the dollar. Instead of a plan that preserves the municipal debtor for the purpose of generating future revenues for the payment of claims, we have a Plan that deprives Franklin of even a penny of the City's future taxes, including the Measure A tax revenues specifically enacted to enable the City to restructure its debts and PFFs that can only be used to satisfy Franklin's claim and no other general fund liabilities. And, instead of the "rateable distribution" at issue in *Faitoute Iron*, we have a Plan that provides similarly-

situated creditors with wildly-divergent recoveries, ranging from Franklin's 0.25% to over 100% for creditors with more leverage against the City. *See* Section III.B., below.

In simple terms, the Plan's treatment of Franklin is as bad as it can possibly get, and not remotely consistent with Justice Frankfurter's reasoning. The City's citation to *Faitoute Iron* betrays its deep misunderstanding of the nature and purpose of the "best interests" test and municipal restructuring in general. The Plan here does not satisfy the "best interests" of Franklin and dismissal of the case would be a welcome improvement of the treatment the City now deigns to provide on account of Franklin's claim. Any allegedly-dire consequences of dismissal, or an unraveling of the "monumental work that already has been done,"[56] would be squarely of the City's own making.

B. The Plan Improperly Classifies, Disparately Treats, And Unfairly Discriminates Against Franklin's Claim.

Section 943(b)(1) requires that a plan of adjustment "compl[y] with the provisions of this title made applicable by sections 103(e) and 901 of this title," 11 U.S.C. § 943(b)(1), including sections 1122, 1123(a)(4), and 1129(b)(1), 11 U.S.C. § 901(a). Section 1122(a) provides that, except with respect to a convenience class, "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." 11 U.S.C. § 1122(a). Section 1123(a)(4) in turn provides that, absent creditor consent, "a plan shall . . . provide the same treatment for each claim or interest of a particular class." 11 U.S.C. § 1123(a)(4). And section 1129(b)(1) provides in part that a debtor may not achieve confirmation over the objection of a dissenting class unless the court determines that "the plan does not discriminate unfairly." 11 U.S.C. § 1129(b)(1).

Although discrete, all three statutory provisions operate in tandem to prohibit unfairly discriminatory treatment of similarly-situated claims: "One of the cardinal principles underlying bankruptcy law is equality of treatment of similarly situated creditors. Case law suggests that a concern for this principle underlies virtually all of the cases that have dealt with classification

[56] City Mem. at 23.

controversies." 7 COLLIER, *supra*, ¶ 1122.03 (footnotes omitted); *see* G. Eric Brunstad, Jr. & Mike Sigal, *Competitive Choice Theory and the Unresolved Doctrines of Classification and Unfair Discrimination in Business Reorganizations under the Bankruptcy Code*, 55 Bus. Law. 1, 17 (1999) ("the history of these doctrines is one marked by two dominant ambitions: the enforcement of equality of distribution among claims and interests of the same rank, and the facilitation of reorganization to salvage viable businesses and enhance the creditors' return"); *id.* at 50 (rules regarding classification and unfair discrimination "operate in tandem to achieve the larger goals of the Chapter 11 process").

"[H]istorically one of the prime purposes of bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets." *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945); *see Howard Delivery Serv. v. Zurich Am. Ins.*, 547 U.S. 651, 667 (2006) ("Any doubt concerning the appropriate characterization [of a statutory provision] is best resolved in accord with the Bankruptcy Code's equal distribution aim."); *Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) (noting "the policy of favoring equal distribution"). The "policy favoring equal distributions" is as strong, if not stronger, in municipal bankruptcy cases. As the Supreme Court stated long ago, "[c]ompositions under Ch. IX [now chapter 9] envisage equality of treatment of creditors." *Avon Park*, 311 U.S. at 147; *see* Brunstad & Sigal, *supra*, at 31-32 (noting that *Avon Park* embraces "the need to scrutinize the classification process in order to maximize equality of treatment among similarly situated parties") (footnote omitted).

Sections 1122, 1123(a)(4) and 1129(b) all work toward the goal of equality: "in determining whether a separate classification under § 1122(a) and, similarly, treatment of separate classes under § 1123(a)(1) through (4) is appropriate, courts must be guided by the mandate of § 1129(b)(1) that the plan not discriminate unfairly with respect to a class of creditors that is impaired under the plan and has not voted to accept the plan." *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 455 (Bankr. E.D. Cal. 1999); *see, e.g.*, *In re MCorp Fin.*, 137 B.R. 219, 227 (Bankr. S.D. Tex. 1992) ("The key to proper classification would seem to be equality of treatment for similarly situated creditors . . . .").

Consequently, as COLLIER notes (citing a chapter 9 case), consideration of a plan's classification scheme goes hand-in-hand with an analysis of the plan's discriminatory impact on creditors:

> [S]eparate classification, when coupled with materially different economic treatment of the classes, can have the effect of unfair discrimination among similarly situated creditors. Classes may, by voting for the plan, accept the different treatment, but courts should be cautious about carrying this reasoning too far. Although the "unfair discrimination" standard technically applies only under section 1129(b) when a class has not accepted the plan, a court should consider a confirmation objection based on alleged improper classification raised by a dissenting creditor in an accepting class if the combination of separate classification and materially different treatment results in substantially different economic effects between the two classes and the purpose and effect is other than the debtor's good faith effort to protect its future business operations.

7 COLLIER, *supra*, ¶ 1122.02[3][a] (emphasis added) (citing *In re Jersey City Med. Ctr.*, 817 F.2d 1055 (3d Cir. 1987)); *see, e.g.*, *In re Lettick Typographic, Inc.*, 103 B.R. 32, 38 (Bankr. D. Conn. 1989) ("Classes must be carefully scrutinized to prevent manipulative classifications from eroding the Bankruptcy Code goal of according similar treatment to similar claims.").

The City's Plan – with its dramatically unequal treatment of creditors – runs afoul of all three statutory provisions and the basic bankruptcy policy of equality among creditors.

1. The Plan Improperly Classifies Franklin's Claim.

The Plan's classification scheme is bizarre and convoluted. The Plan separately classifies, into nineteen different classes, virtually every major claim against the City that the City has not already paid in full during the bankruptcy case. For example, other than Franklin's claims in respect of the Bonds, every single one of the City's other bond issues – including lease revenue bonds identical in structure to the Bonds – are placed into separate individual classes.[57] All other material claims – again excepting Franklin's claims – similarly are placed into their own separate classes.[58]

[57] Class 1 (2003 Fire/Police/Library Certificates); Class 2 (2006 SEB Bonds); Class 3 (2004 Arena Bonds); Class 4 (2004 Parking Bonds); Class 5 (2007 Office Building Bonds); Class 6 (Pension Obligation Bonds); and Class 10 (Restricted Revenue Bonds and Notes).

[58] Class 7 (DBW claims); Class 8 (SCC 16 claims); Class 9 (Thunder claims); Class 11 (Special Assessment and Special Tax claims); Class 14 (Tort claims); Class 15 (CalPERS claims); Class 16 (Equipment Lease claims); Class 17 (Workers' Compensation claims); Class 18 (SPOA claims); and Class 19 (Price claims).

In contrast, Franklin's claim is placed into Class 12 which, unlike the other classes, contains two materially-different types of claims: Franklin's $35+ million in claims in respect of the Bonds and the alleged $545 million in "Retiree Health Benefit Claims" resulting from the "Retirees Settlement," by which the City stipulated to allowance of retiree claims in exchange for a commitment by 1,100 retirees to vote in favor of the Plan.[59] There are no other material claims within Class 12 because the City already has paid in full all of its millions of dollars of prepetition trade debt and ordinary course liabilities, which it never had any intention of impairing.[60]

a) *The Plan Gerrymanders Franklin's Claim.*

The City has made no secret of its purpose in classifying Franklin with the retirees, and separately from the other individual classes of bond-related claims: the City wants to swamp Franklin's "no" vote on the Plan in order to avoid application of section 1129(b)'s "cramdown" requirements.[61] This effort to "gerrymander" the vote violates section 1122 of the Bankruptcy Code and renders the Plan unconfirmable.

Section 1122(a) permits the classification only of "substantially similar" claims within the same class. 11 U.S.C. § 1122(a). While section 1122(a) does not mandate that all "substantially similar" claims be placed into a single class, a plan proponent does not have unfettered discretion to separately classify similar claims. Rather, the proponent must establish a "legitimate business or economic justification" for placing similar claims in different classes, *Barakat v. The Life Ins. Co.*

[59] As shown in Section III.E.1., below, the City's stipulated amount of Retiree Health Benefit Claims is overstated by hundreds of millions of dollars.

[60] CTY084289-90; Tr. 11/18/13 at 41:17-25 and 44:7-13. The Disclosure Statement indicates that there are a *de minimis* amount of sick leave buyout claims, also held by retirees, classified into Class 12. The Disclosure Statement indicates that such claims total "approximately $806,000" while the City's counsel stated on the record that the claims aggregate $400,000. *Compare* Disclosure Statement at 31 *with* Tr. 11/18/13 at 41:17-22.

[61] *See* City Mem. at 17 ("Although voting will not be complete until February 10, 2014, the City believes that it is likely that all of the Impaired Classes will vote to accept the Plan. In particular, as shown above, Class 12 will accept the Plan in spite of the anticipated negative vote of Wells Fargo/Franklin, because Franklin does not hold a 'blocking position'. Even if section 502(b)(6) were inapplicable to the amount of Franklin's Claim (and the City believes it is applicable, thereby limiting the amount of Franklin's Claim to about $10 million), and Franklin's Claim were Allowed in an amount of the outstanding amount of the relevant bonds (of about $35 million), Franklin still would not hold one-third in dollar amount of the Claims in Class 12.").

1 *(In re Barakat)*, 99 F.3d 1520, 1526 (9th Cir. 1996), a rule that applies with equal force in chapter 9
2 cases, *Corcoran Hosp.*, 233 B.R. at 455 ("there must be a business or economic justification for
3 separate classification of unsecured claims").
4 "Separate classifications for unsecured creditors are only justified where the legal character
5 of their claims is such as to accord them a status different from the other unsecured creditors."
6 *Oxford Life Ins. v. Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)*, 166 B.R. 892, 897
7 (9th Cir. BAP 1994) (quoting *Granada Wines, Inc. v. New England Teamsters & Trucking Indus.*
8 *Pension Fund*, 748 F.2d 42, 46 (1st Cir. 1984)). Thus, "unsecured claims will, generally speaking,
9 comprise one class, whether trade, tort, publicly held debt or a deficiency of a secured creditor,
10 because they are claimants of equal legal rank entitled to share pro rata." *Id.* (quoting *In re Fairfield*
11 *Executive Assoc.*, 161 B.R. 595, 600 n.6 (D.N.J. 1993)).
12 The reason for this is plain: "[T]here must be some limit on a debtor's power to classify
13 creditors. . . . The potential for abuse would be significant otherwise. If the plan unfairly creates too
14 many or too few classes, if the classifications are designed to manipulate class voting, or if the
15 classification scheme violates basic priority rights, the plan cannot be confirmed." *Id.* (quoting *In re*
16 *Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990)). One rampant type of abuse – classification
17 designed to manipulate voting – has led to what the Ninth Circuit described as "one clear rule":
18 "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a
19 reorganization plan." *Barakat*, 99 F.3d at 1525 (quoting *Phoenix Mut. Life Ins. v. Greystone III*
20 *Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1279 (5th Cir. 1991)).
21 That is exactly what the City has done in the Plan. The Plan, in fact, turns the general rule of
22 joint classification of unsecured claims on its head. The City has <u>separately</u> classified every material
23 category of unsecured claims other than the Retiree Health Benefit Claims and Franklin's claims in
24 respect of the Bonds, which the City classifies together. This by itself is facially suspect. *See, e.g.*,
25 *In re AOV Indus.*, 792 F.2d 1140, 1151 (D.C. Cir. 1986) ("while there is no restriction on the total
26 number of classifications, logistics and fairness dictate consolidation rather than proliferation of
27 classes").
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More importantly, the City's effort to avoid section 1129(b) by placing Franklin in a class that will accept the Plan is a classic gerrymander. *E.g.*, *Barakat*, 99 F.3d at 1525 ("[I]f the classifications are designed to manipulate class voting . . . , the plan cannot be confirmed.") (quoting *Holywell*, 913 F.2d at 880); *John Hancock Mut. Life Ins. v. Route 37 Bus. Park Assocs.*, 987 F.2d 154, 159 (3d Cir. 1993) (improper gerrymander where "the sole purpose and effect of creating multiple classes is to mold the outcome of the voting"). Critically, the City has offered no "legitimate business or economic justification" for the Plan's balkanized classification. *Barakat*, 99 F.3d at 1526.

To start, note that the claims in the various separate classes of the City's "capital markets" debt share identical legal rights against the City. The Disclosure Statement candidly admits that claims arising from the so-called "Lease Out/Lease Back Transactions" "have a similar structure" and describes an identical structure applicable to all.[62] Yet, the Plan provides for separate classification of claims under each "financing lease" transaction other than the transaction resulting in issuance of Franklin's Bonds. Similarly, the Plan also separately classifies the City's obligations in respect of the Pension Obligation Bonds, which are straight general unsecured claims.

The City apparently will attempt to justify its separate classification of the financing lease obligations on the ground that various "leased" properties (*i.e.*, the collateral) are important (or are controlled by parties who also control other important collateral). As the City's lawyer stated at the hearing on the Disclosure Statement:

> MR. LEVINSON: Assured and NPFG and Ambac are in a different position than Franklin. They have collateral and collateral counts. So the fact that NPFG is getting better recovery than Franklin – read the term sheet, you'll see – it has nothing to do with any animus towards Franklin. This has always been about dollars. It has everything to do about the legal rights, just like in any Plan when you have a secured creditor, the secured creditor will do well if it [has] collateral.[63]

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[62] Disclosure Statement at 33-34. These "financing lease" transactions are, in substance, loan agreements, as will be established in Franklin's pending Adversary Proceeding. Regarding classification issues, the key point is that the legal rights arising from the transactions – whether they be financings or leases – are the same.

[63] 11/18/13 Tr. at 46:10-18. The assertion that holders of "lease financing" bonds have "collateral" – and that "collateral counts" – completely undercuts the City's allegation that Franklin's "lease

1 To date, the City has proffered no evidence to support its bald assertions in this regard.
2 Moreover, even if the evidence ultimately does confirm those assertions, the City cannot justify the
3 classification of the Pension Obligation Bonds, which are not "financing leases" and have no
4 collateral whatsoever. The Pension Obligation Bonds represent no superior legal rights to those held
5 by Franklin in respect of the Bonds. Franklin's rights, in fact, are superior, because Franklin has
6 collateral (the properties subject to the "financing lease") and the holders of the Pension Obligation
7 Bonds do not. At the very worst, even if Franklin's collateral is valueless as the City asserts, the
8 rights of holders of the Pension Obligation Bonds are the same as Franklin's rights.
9 To date, the City has offered three grounds for the separate classification of the Pension
10 Obligation Bonds: (1) 17% of the debt service on the Pension Obligation Bonds may be paid from
11 "Restricted Funds" that are not part of the general fund. "Thus, the legal character of the Pension
12 Obligation Bonds is different than the legal character of the Class 12 General Unsecured Claims, and
13 it is therefore appropriate for the City to separately classify the Pension Obligation Bonds."
14 (2) "Assured Guaranty (the insurer of the Pension Obligation Bonds) has asserted that the Pension
15 Obligation Bonds have special status because they represent the same underlying liability as the
16 City's other pension funding obligations (which are being assumed under the Plan) and thus are
17 obligations imposed by law." (3) "Assured Guaranty also holds Claims against the City relating to
18 the 400 East Main Street Office Building Property, a commercial office building that the City had
19 intended to become its new City Hall. After arduous negotiations under the auspices of Judge Perris,
20 the City agreed to settle the disputes as to both the Pension Obligation Bonds and the 400 East Main
21 Street Office Building Property, including what the City believes is a very favorable lease of a
22 portion of that property. . . . The City believes that Assured Guaranty would not have entered into
23 the New 400 E. Main Lease on the same terms had it not reached an acceptable settlement on the
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27 financing" claim is governed by a "lease," is wholly unsecured, and is susceptible to rejection
28 under section 365 and limitation in amount under section 502(b)(6).

Pension Obligation Bonds Claims. Therefore, the City had an additional business justification for separately classifying these Claims."[64]

These flimsy pretextual grounds for separate classification do not withstand scrutiny. Taking each contention in turn: (1) The ability to pay a portion of the Pension Obligation Bonds from restricted funds does not distinguish them in any way from Franklin's Bonds. As noted above, Franklin's Bonds also can be paid from restricted funds (PFFs). In fact, at the time of issuance the City contemplated that those restricted funds would be sufficient to pay the entirety of the debt service on the Bonds. The City cannot have it both ways. If the ability to pay from restricted funds makes the Pension Obligation Bonds of "different legal character" from the straight General Unsecured Claims in Class 12, so too does the ability to pay from restricted PFFs make Franklin's Bonds of "different legal character" from those Class 12 Claims. (More on this below).

(2) Neither the City nor Assured has cited any authority for the proposition that the Pension Obligation Bonds somehow transmogrify into, or have the same legal rights as, pension claims themselves. Assured has never made such a claim in any of its pleadings in this case, and the City itself "has disputed and does dispute such contention."[65] The City repeatedly has stated that the Pension Obligation Bonds are "an unsecured obligation payable from the General Fund" as to which "there is no collateral."[66] "The obligation of the City to pay the principal and interest on the Series 2007 Bonds when due is an unsecured obligation of the City, and payment of principal of and interest on the Series 2007 Bonds is not limited to or secured by any special source of funds."[67]

Notably, the offering materials for the Pension Obligation Bonds expressly state that "<u>[t]he assets of PERS are not available for payment of the Series 2007 Bonds and the Series 2007 Bonds do not constitute an obligation of PERS</u>."[68] Moreover, holders of the Pension Obligation Bonds

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[64] City Mem. at 7-8.

[65] City Mem. at 8.

[66] Ask at 46.

[67] Ask at 769.

[68] STOCK120807 (emphasis in original).

1 explicitly were warned that their claims could be impaired in bankruptcy.[69] Assured's specious
2 after-the-fact claim to "pension status" provides no basis for separate classification of the Pension
3 Obligation Bonds.

4 (3) The ability of Assured to leverage control over the 400 East Main facility into a favorable
5 deal on the Pension Obligation Bonds provides no justification for separate classification. To start,
6 "only the nature of the claim or interest is supposed to be relevant to classification, not the identity
7 of the holder of the claim or interest." 7 COLLIER, *supra*, ¶ 1122.03[3]; *see, e.g.*, *In re Sentinel*
8 *Mgmt. Grp.*, 398 B.R. 281, 297 (Bankr. N.D Ill. 2008) ("This determination should focus on the
9 nature or legal attributes of the claims and not on the status or circumstances of the claimants."); *In*
10 *re Frascella Enters.*, 360 B.R. 435, 442 (Bankr. E.D. Pa. 2007) ("The similarity of claims is not
11 judged by comparing creditor claims *inter se*. Rather, the question is whether the claims in a class
12 have the same or similar legal status in relation to the assets of the debtor."); *In re Coram*
13 *Healthcare, Corp.*, 315 B.R. 321, 350 (Bankr. D. Del. 2004) ("a proper determination of what claims
14 are 'substantially similar' focuses on the legal attributes of the claims, not who holds them").
15 Assured's rights as a holder of the Office Building Bonds are irrelevant to the proper classification
16 of the Pension Obligation Bonds.

17 Moreover, the City's assertion that Assured's settlement regarding the Office Building Bonds
18 required separate classification of the Pension Obligation Bonds leads inexorably to the conclusion
19 that the Retiree Health Benefit Claims (held by retirees who also settled their pension claims) would
20 have to be classified separately from Franklin's claims. Here again, the City cannot have it both
21 ways – if the settlement of one set of claims held by a claimant (Assured) justifies the separate
22 classification of a different set of claims held by the same claimant, the settlement of one set of
23 claims by the retirees (pension claims) requires the separate classification of the other claims held by
24 those same claimants (the Retiree Health Benefit Claims). (More on this below).

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26 [69] STOCK120810 ("The rights of the owners of the Series 2007 Bonds are subject to the limitations on legal remedies against cities in the State of California, including applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting the enforcement of creditors'
27 rights . . . . Bankruptcy proceedings . . . may entail risks of delay, limitation or modification of their rights.").

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The City may cite *Corcoran Hospital* in an effort to justify the Plan's gerrymandered classes, but nothing in that case supports the City. In *Corcoran Hospital*, Judge Rimel approved the separate classification of an unsecured claim held by DHS on the ground that the debtor and DHS had entered into a settlement that made the proposed plan of adjustment possible. *Corcoran Hosp.*, 233 B.R. at 455-56. Unlike here, however, that settlement provided for DHS to "significantly reduce[]" its claim (by 74%), forgo set off rights and administrative expense claims, and be paid ten cents on the dollar of the reduced claim over seven years. *Id.* at 455. In contrast, the City seeks to use Assured's settlement of one set of claims (the Office Building Bonds) to justify separate classification and an <u>improved</u> sweetheart deal for an entirely different set of claims (the Pension Obligation Bonds), which are to receive vastly more favorable treatment than the General Unsecured Claims of Class 12 (into which the Pension Obligation Bonds logically should be classified).

Neither *Corcoran Hospital* nor any other authority supports the City's scheme. Indeed, Judge Rimel approved separate classification in *Corcoran Hospital* only after considering whether the proposed classification resulted in unfair discrimination against the impacted creditors. *Id.* As the City's Plan is structured specifically to provide for such discrimination, the City can take no refuge in that case.

For all these reasons, the Plan's classification of Franklin's Bonds with the Retiree Health Benefit Claims and separately from the City's other funded debt obligations – particularly the Pension Obligation Bonds – constitutes impermissible gerrymandering prohibited by section 1122(a) of the Bankruptcy Code.

b) *The Plan Classifies Franklin's Claim With Claims That Are Not Substantially Similar To Franklin's Claim.*

Even absent the City's patent effort to gerrymander Franklin's dissenting vote in order to evade the cramdown requirements of section 1129(b), the Plan's classification scheme cannot stand because Franklin's claims are not substantially similar to the Retiree Health Benefit Claims, meaning that Class 12 violates section 1122(a)'s command that only "substantially similar" claims be classified together.

1 To start, the Bonds are payable at least in part from restricted funds. In justifying its separate
2 classification of the Pension Obligation Bonds, the City recognized that claims that can be paid in
3 part from restricted funds have a different "legal character" than the straight General Unsecured
4 Claims classified into Class 12 and are not substantially similar within the meaning of
5 section 1122(a).[70] The City is correct in this regard. In the Ninth Circuit, the existence of "a third-
6 party source for payment" on an unsecured claim renders the claim dissimilar from unsecured claims
7 without an additional avenue of recovery and requires separate classification of the claim. This is
8 the precise holding of *Wells Fargo Bank, N.A. v. Loop 76, LLC (In re Loop 76, LLC)*, 465 B.R. 525
9 (9th Cir. BAP 2012), in which the Ninth Circuit BAP concluded that an unsecured claim supported
10 by a third-party guarantee was dissimilar and must be separately classified from other general
11 unsecured claims. *Id.* at 541 (citing *Steelcase Inc. v. Johnston (In re Johnston)*, 21 F.3d 323, 328
12 (9th Cir. 1994)). Similarly, in *Johnston* the Ninth Circuit held that the ability of a creditor to recover
13 from collateral of a third party rendered the creditor's unsecured claim dissimilar from other general
14 unsecured claims. *Johnston*, 21 F.3d at 328.
15 The same reasoning applies to Franklin's Bonds. The Bonds can be paid from restricted
16 PFFs. Indeed, the City sold the Bonds on the premise that the PFFs would pay the entirety of the
17 debt service on the Bonds. Just as with the Pension Obligation Bonds, the City's ability to use
18 restricted funds to pay all or a portion of the Bonds renders the Bonds dissimilar from the remainder
19 of the Class 12 General Unsecured Claims.
20 Moreover, as will be established in the Adversary Proceeding, the Bonds are at least partially
21 secured. In *Johnston*, the Ninth Circuit held that where a potentially-secured creditor was
22 "embroiled in litigation" with the debtor over the nature and extent of its claim, the claim was not
23 substantially similar to other general unsecured claims. *Id*. The same holds true here. Franklin's
24 litigation to establish the true nature of its claim – which entails issues regarding the secured nature
25 of the claim, whether the claim arises from a "lease" that may be rejected by the City, and whether
26 section 502(b)(6) applies to cap the amount of the claim – renders the claim dissimilar from the other
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[70] City Mem. at 7.

Class 12 Claims, including the Retiree Health Benefit claims to which the City has stipulated and listed as undisputed.

Thus, because Franklin's claims in respect of the Bonds are not substantially similar to the Retiree Health Benefit Claims and the other General Unsecured Claims classified within Class 12, the Plan violates section 1122(a).[71]

2. The Plan Disparately Treats Franklin's Claim.

Section 1123(a)(4) requires that a plan "provide the same treatment for each claim or interest of a particular class." 11 U.S.C. § 1123(a)(4). This provision provides "[a]n important corollary to section 1122" and is yet another way in which the Bankruptcy Code operates to prohibit unfair discrimination against dissenting creditors. 7 COLLIER, *supra*, ¶ 1122.02. To the extent that the Court upholds the classification of Franklin's claim with the Retiree Health Benefit Claims, the Plan plainly violates this statutory command.

While the Plan's treatment of Class 12 Claims superficially is the same – a meager fraction of one penny on the dollar – retirees holding Retiree Health Benefit Claims in fact are receiving substantially superior treatment on their claims against the City for retirement benefits. Specifically, retirees are receiving 100% payment in full on all of the City's unfunded pension obligations to them – an unsecured claim estimated by CalPERS at more than $291 million as of the petition date. When the City's total obligation to its retirees (pension and health benefits) is considered, retirees are to receive a recovery more than 70% on their claims (in the allowed amounts to which the City has stipulated) according to the City's own calculations[72] – far superior to the treatment the City seeks to

[71] The Plan also violates section 1122(a) because it fails to separately classify, much less provide a treatment for, Franklin's secured claim in respect of the Bonds. The nature of Franklin's claim will be determined in the Adversary Proceeding. To the extent that the Court concludes that the claim is at least partially secured, the Plan must classify and treat that secured claim separately. *See, e.g.*, *Brady v. Andrew (In re Commercial W. Fin. Corp.)*, 761 F.2d 1329, 1338 (9th Cir. 1985) ("creditors with claims against different properties generally are entitled to separate classification").

[72] Long-Range Financial Plan at 11 (with respect to the group of retirees "consist[ing] of those that retired under the more enhanced programs provided in the early 2000s," the Plan results in "an approximately 30% reduction in this group's overall benefits") (with respect to the "more senior retiree group consist[ing] of those that retired under benefit packages prior to enhancement in the early 2000s . . . [w]e do not propose a change in overall benefits to this group"); RET20010560

1 cram down on Franklin. When the amount of the retiree claims is calculated correctly, as described
2 in Section III.E.1., below, retirees actually achieve an even greater percentage recovery.
3 It is crystal clear that the Plan's treatment of retiree obligations is a single, unified treatment
4 despite the fact that the City has purported to classify the Retiree Health Benefit Claims separately
5 from the pension claims. Indeed, it is inconceivable that any retiree would vote in favor of a plan
6 discharging health-benefit claims for a cent on the dollar in the absence of a promise of an
7 unimpaired pension. The Retirees Committee has admitted this, stating that: "one of the five
8 material terms of the Retirees Settlement with the City is that the Plan shall not impair in any way
9 the provisions of the existing pension benefit plans under which employees retired, including
10 pension amounts and the capped annual cost-of-living adjustment."[73] In its letter to retirees
11 accompanying the Plan ballots and solicitation package, the Retirees Committee reiterated that
12 linkage, informing retirees that, "[w]hile the . . . Plan . . . significantly adversely affects the interests
13 of retirees who lost health benefits the City was to provide, the Plan does not impair the City's
14 obligations to CalPERS. In other words, your CalPERS pension benefits will not be altered in any
15 way by the Plan. . . . If the Plan is not approved, we run the risk that the City may also have to
16 substantially reduce your CalPERS pension benefits in order to settle all claims."[74]
17 Similarly, retiree correspondence from the Association of Retired Employees of the City of
18 Stockton ("ARECOS") – the leaders of which are members of and in control of the Retirees
19 Committee[75] – repeatedly links preservation of pensions and concessions regarding health benefit
20 claims. For example, after the City announced the Plan in late September of last year, the first bullet
21 point on the first page of the ARECOS newsletter describing the Plan states "No reduction in
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("The elimination of City-paid health benefits for current retirees and their dependents on average amounted to 30% of their total postemployment benefits . . . .").
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[73] *Official Committee Of Retirees' Objections And Responses To Franklin High Yield Tax-Free Income Fund And Franklin California High Yield Municipal Fund's First Set Of Interrogatories* at 2-3.
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[74] RET20000272.
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[75] Eight of the ten members of the ARECOS Board of Directors are members of the thirteen-member Retirees Committee.
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1 pensions are proposed for retirees." Later on the first page, ARECOS reiterates that "**Retiree**
2 **Pensions are Not Proposed to be Reduced**."[76] On the first page of a follow-up newsletter in
3 October, ARECOS was even more explicit, noting that although payment on the Retiree Health
4 Benefit Claims "is a very small amount," "**the accompanying condition is that the City Plan**
5 **provides that there will be no reduction in pensions for retirees**."[77] In December, ARECOS
6 delivered another newsletter that stated on its first page that, "[a]gain, CalPERS pension benefits will
7 not be altered in any way by the Plan."[78]

8 From the beginning of the restructuring process, the City itself has recognized that any
9 analysis of the treatment of retirees must account for both retiree health benefits <u>and</u> pensions. Thus,
10 in outlining its restructuring goals and objectives in the pre-bankruptcy Ask, the City expressly
11 linked the treatment of health and pension claims: "In determining how to restructure its obligations,
12 City management . . . developed a proposal which tries to strike an equitable balance with respect to
13 retiree obligations and keeps the City a competitive employer. Specifically the City has elected to
14 target retiree medical costs for restructuring, but to attempt [to] preserve pension funding for current
15 retirees and current employees who will retire under the CalPERS system."[79]

16 Simply put, the treatment of the City's retiree obligations (pension and health) is inexorably
17 joined. Far from receiving less than a penny on the dollar as Franklin is to receive, retirees are to
18 receive more than 70 cents on the dollar. This plainly violates the "same treatment" requirement of
19 section 1123(a)(4).

20 Several cases are instructive in this regard. The first is the Supreme Court's decision in *Avon*
21 *Park*, a municipal restructuring case decided before the Bankruptcy Code made the "same treatment"
22 requirement explicit in section 1123(a)(4). In *Avon Park*, the Court reversed an order confirming a
23 plan of adjustment in which the debtor classified all bond claims into a single class, which was to
24 receive refunding bonds. The City's fiscal agent (Crummer) held bonds classified into that class.

25 [76] RET20010559-10564 (emphasis in original).
26 [77] RET20010565-10569 (emphasis in original).
27 [78] RET20010570-10574 (emphasis in original).
[79] Ask at 38.
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Under the plan, the City proposed to pay Crummer additional amounts, apparently for its assistance in facilitating the refunding. *Avon Park*, 311 U.S. at 141. The Court held that this additional consideration, which was not available to other bondholders classified within the same class, violated basic principles of municipal restructuring:

> Compositions under Ch. IX . . . envisage equality of treatment of creditors. Under that section and its antecedents, a composition would not be confirmed where one creditor was obtaining some special favor or inducement not accorded the others, whether that consideration moved from the debtor or from another. . . . [I]f a vote is influenced by the expectation of advantage, though without any positive promise, it cannot be considered an honest and unbiased vote. That rule of compositions is but part of the general rule of "equality between creditors" applicable in all bankruptcy proceedings. That principle has been imbedded by Congress in Ch. IX by the express provision against unfair discrimination. That principle as applied to this case necessitates a reversal. In absence of a finding that the aggregate emoluments receivable by the Crummer interests were reasonable, measured by the services rendered, <u>it cannot be said that the consideration accruing to them, under or as a consequence of the adoption of the plan, likewise accrued to all other creditors of the same class</u>.

Id. at 147-48 (emphasis added) (quotations and citations omitted).

Congress codified this aspect of *Avon Park* in section 1123(a)(4), and courts have continued to apply the reasoning of *Avon Park* in situations analogous to those here. For example, in *Adelphia* the district court held that there was a substantial possibility that the bankruptcy court had erred in confirming a plan providing for a class of bondholders to receive specified *pro rata* distributions but also for certain bondholders who had voted to approve the plan to receive other consideration (including releases and exculpation):

> There is no doubt here that in return for approving the Plan, some claimants will receive a more valuable settlement than others (*i.e.*, additional benefits on top of their pro rata distributions). While such an outcome may be permissible where the added benefit is given for truly collateral reasons (*i.e.*, independent from their status as claimants), here the benefit is given in exchange for the claimant's affirmative vote for the Plan – an added benefit that is tied directly to the Plan itself and given to some claimants in a class, but not all. Such an inducement may well have led some claimants to approve the Plan when they otherwise may have rejected it. As a result, creditors opposing the Plan may have been prejudiced by a quid pro quo exchange of Plan approval for valuable releases and exculpations.

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> Section 1123(a)(4) guarantees that each class member will be treated equally, regardless of how it votes on a proposed plan. Where the receipt of valuable benefits in a plan is conditioned on a vote to accept that plan, there is a very real possibility of dissuading or silencing opposition to the plan. In this context, the Bankruptcy Court's semantic distinction between the treatment of claims and claimants goes against the spirit of section 1123(a)(4) and what it seeks to protect. If an appeal of that issue is heard, there is a substantial possibility that Appellants will succeed in their argument that the distribution of certain benefits to some claimants but not others within a class violates section 1123(a)(4).

Adelphia, 361 B.R. at 363-64 (emphasis added).

Similarly, in *New Century* the district court reversed the bankruptcy court's order confirming a plan of reorganization that classified various employee claims together (in class HC3b) and provided for certain claims to be paid at 100% and others to be paid at 130%, with the justification that those receiving a greater distribution had waived and relinquished other claims that would have been classified into class HC10b. *Schroeder v. New Century Liquidating Trust (In re New Century TRS Holdings, Inc.)*, 407 B.R. 576, 592 (D. Del. 2009). In essence, the plan at issue in *New Century* was a mirror image of the City's Plan, with a set of claimants (the retirees) agreeing to forgo distributions in one class (the Retiree Health Benefit Claims) in exchange for more favorable treatment in another class (the pension claims). The district court held that such an arrangement violated section 1123(a)(4): "[I]t is clear that the plan treats the 100% claims in that class less favorably than the 130% claims without the holders' – or at least appellants' – consent. Thus, the bankruptcy court erred in finding that the plan was in compliance with § 1123(a)(4), and the plan confirmation must be reversed." *Id.*

Finally, in *Finova* the district court affirmed the bankruptcy court's denial of confirmation on the grounds that a proposed plan violated section 1123(a)(4) despite the fact that it nominally provided the same treatment to all claims classified within the applicable class. The class at issue provided for bank creditors to receive payment of principal and interest but not "facility or other fees." *The Finova Grp., Inc. v. BNP Paribas (In re The Finova Grp., Inc.)*, 304 B.R. 630, 633 (D. Del. 2004). The bankruptcy and district courts concluded that this was unequal treatment because the "utilization fees" of some banks were denominated as interest (and thus paid) while the utilization fees of other banks (Chase and BNP) were denominated as fees (and thus not paid). As

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the district court held: "To treat Chase and BNP differently would be to ignore the economic realities of their Credit Agreements, elevate form over substance and violate the equal treatment mandate of Section 1123(a)(4)." *Id.* at 637.

The same reasoning applies here. To treat the retirees as having separate, unrelated claims – one entitled to 100% payment and another to <1% payment – would "elevate form over substance and violate the equal treatment mandate" of section 1123(a)(4). As a consequence, the Plan cannot be confirmed for this independent reason.

3. The Plan Unfairly Discriminates Against Franklin's Claim.

Properly classified separately from the Retiree Health Benefit Claims, Franklin's rejection of the Plan will cause its class to reject the Plan and trigger application of section 1129(b)'s "cram down" standards, including the requirement that the Plan "not discriminate unfairly." 11 U.S.C. § 1129(b)(1).[80] The Plan patently violates that statutory command.

As shown in Table 3, the City proposes to make distributions that are as wildly divergent and discriminatory as conceivable:[81]

Table 3		
Class/Claim	***Security***	***Recovery On Prepetition Claim***
1/Ambac Bonds	Police and fire stations; library	***106.4%***
2/NPFG SEB Bonds	Eberhardt Building	***100+%*** (assumed/unimpaired)
3/NPFG Arena Bonds	Stockton Arena	***96.7%***
4/NPFG Parking Bonds	Parking structures	***103.5%*** (plus additional collateral)
5/Assured Office Bonds	400 East Main Building	***53.9%*** (based on Assured's 2012 appraisal; not independently verified)

[80] Class 14 (tort claims) also has rejected the Plan, meaning that the City must satisfy the requirements of section 1129(b) in any event. *See Declaration Of Catherine Nownes-Whitaker Regarding Tabulation And Certification Of Ballots* [docket no. 1268].

[81] The Court will recall that the City refused to include in the Disclosure Statement any information regarding recovery ranges or collateral values for various classes of claims under the Plan. The amounts set forth in Table 3 are estimates that Franklin will support through the evidence and expert testimony at trial. Consistent with the methodology employed by the City, payments over time are discounted to present value using a 5% discount rate.

Table 3		
Class/Claim	***Security***	***Recovery On Prepetition Claim***
6/Assured Pension Obligation Bonds	None	***51.9%*** (***plus*** contingent note payable from future revenues)
7/DBW Claims	Marina revenues	Cannot be calculated from current information; City has refused to value
8/SCC 16 Claims	Setoff rights	***100+%*** (unimpaired)
9/Thunder Claims	None	Cannot be calculated from current information; City has refused to value
10/Restricted Revenue Bonds	Special revenues	***100+%*** (unimpaired)
11/Special Tax Claims	Special revenues	***100+%*** (unimpaired)
12/General Unsecured Claims	None (excluding Franklin's collateral)	***0.25%*** for Franklin
13/Convenience Claims	None	***100%***
14/Tort Claims	None	Unknown – paid from insurance where available
15/Pension Claims	None	***100+%*** (assumed/unimpaired)
16/Equipment Leases	Equipment	***100+%*** (assumed/unimpaired)
17/Workers Comp Claims – City SIR Portion	None	***100+%*** (unimpaired)
18/SPOA Claims	None	Cannot be calculated from current information; City has refused to value
19/Price Claims	None	Unknown – City to perform under consent decree as modified

Moreover, the City already has paid in full virtually all of the millions of dollars of prepetition unsecured claims that otherwise would have qualified as "General Unsecured Claims" and been classified into Class 12 had the City not voluntarily chosen to pay them (as it would have been prohibited from doing in a non-municipal case). The evidence reveals that the City filed its bankruptcy petition with no desire whatsoever to attempt to adjust those liabilities, intending from the outset to discriminate against bondholders.[82] As the Court already has held, the City's payment of prepetition claims during the case is highly relevant in the context of plan confirmation:

[82] CTY084289-90 ("In a municipality bankruptcy case, the City will control who it pays without approval required by the Bankruptcy Court. . . . The focus of the City's recovery plan will be

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> [T]he day of reckoning comes at the plan confirmation hearing. If any impaired class of claims does not accept the plan, then confirmation will require a so-called cramdown pursuant to § 1129(b)(1) in which the City must prove that the plan "does not discriminate unfairly," and is "fair and equitable" with respect to that non-accepting impaired class. . . . .
>
> [T]he capital market creditors have, in effect, given notice that they reserve the right to litigate the debtor's conduct and management and spending choices during the case at the time of plan confirmation. That is the limiting principle and the protection to which they are entitled.

In re City of Stockton, California, 486 B.R. 194, 199-200 (Bankr. E.D. Cal. 2013) (emphasis added).

Observers have noted the City's blatant discrimination among creditors, with Moody's Investor Service recently commenting that "[p]roposed recovery rates for lease revenue and other general-fund supported bonds range from 1% to 100% . . . [and] [b]etween these two extremes, holders of pension obligation bonds, which are secured by a bare contractual repayment obligation, would see a 50% recovery." Moody's trenchantly notes that those proposed recoveries may "deviate from what the bankruptcy code provides for certain classes of debt."[83]

Indeed they do. The basic function of section 1129(b)'s prohibition on unfair discrimination is straightforward – it operates to ensure that a plan does not "single[] out the holder of some claim or interest for particular treatment." *Tucson Self-Storage*, 166 B.R. at 898; *see* Brunstad & Sigal, *supra*, at 40 ("the doctrine exists to enforce the concept of equality of distribution among similarly situated creditors regardless of how their claims are classified"). Thus, "[c]ourts have denied confirmation of Chapter 11 plans that proposed widely disparate treatment of similarly situated creditors as unfairly discriminatory." *Tucson Self-Storage*, 166 B.R. at 898.

The Ninth Circuit holds that a plan proponent must establish "four criteria" for discriminatory treatment to be considered "fair" within the meaning of section 1129(b): "(1) the discrimination must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without the discrimination; (3) the discrimination is proposed in good faith; and (4) the degree of the discrimination is directly related to the basis or rationale for the

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restructuring of above market pay and benefits and unsustainable debt. . . . [O]ur trade vendors and service providers are not subject to any reduction or delay in payment.") (emphasis added).

[83] MOODY'S INVESTORS SERVICE, *Within Chapter 9 Framework, Recovery Levels Vary Widely*, February 6, 2014, at 12 (attached as Exhibit A).

1 discrimination." *Ambanc*, 115 F.3d at 656. This formulation has been criticized as being
2 unnecessarily duplicative of other confirmation standards, and ultimately distilled as an inquiry into
3 "whether the proposed discrimination has a reasonable basis and is necessary for reorganization." 7
4 COLLIER, *supra*, ¶ 1129.03[3][a].

5 Recently, most courts have adopted the "rebuttable presumption" standard, holding that a
6 presumption of unfair discrimination arises whenever a plan provides for "a materially lower
7 percentage recovery for the dissenting class (measured in terms of the net present value of all
8 payments)" in comparison to payments made to "another class of the same priority." *In re*
9 *Armstrong World Indus.*, 348 B.R. 111, 121 (D. Del. 2006) (quotations omitted). That presumption
10 may be rebutted only "by showing that, outside of bankruptcy, the dissenting class would similarly
11 receive less than the class receiving a greater recovery, or that the alleged preferred class had infused
12 new value into the reorganization which offset its gain." *Id.* (quotations omitted); *see, e.g.*, *In re*
13 *Dow Corning Corp.*, 244 B.R. 696, 701-03 (Bankr. E.D. Mich. 1999) (same); Brunstad & Sigal,
14 *supra*, at 77 ("the unfair discrimination doctrine should ordinarily require that a dissenting class of
15 unsecured claims be treated equally (in economic terms) with other unsecured classes of the same
16 rank").

17 Regardless of the formulation, the inquiry centers on "the disparity of treatment proposed in
18 the plan, and whether such disparity can be justified under the Code." 7 COLLIER, *supra*,
19 ¶ 1129.03[3][a]; *see, e.g.*, *In re Sea Trail Corp.*, No. 11-07370-8-SWH, 2012 WL 5247175, *8
20 (Bankr. E.D.N.C. Oct. 23, 2012) ("A crucial distinction . . . between cases in which plans have been
21 determined to be unfairly discriminatory and those that have not is the magnitude of the difference in
22 the amount of recovery between similarly-situated classes"). "Courts considering the issue of unfair
23 discrimination have roundly rejected plans proposing grossly disparate treatment (50% or more) to
24 similarly situated creditors, while at least two courts decided that unfair discrimination did not exist
25 when the difference in recoveries was 4% or less." *In re Tribune Co.*, 472 B.R. 223, 243 (Bankr. D.
26 Del. 2012); *see, e.g.*, *Tucson Self-Storage*, 166 B.R. at 898 (unfair discrimination where plan
27 provided 100% recovery for unsecured trade creditors and 10% to unsecured deficiency claims); *In*
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1 *re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 231 (Bankr. D.N.J. 2000) ("Courts which have
2 rejected confirmation on the basis of unfair discrimination have confronted plans proposing grossly
3 disparate treatment (50% or more) to similarly situated creditors."); *In re Sentry Operating Co.*, 264
4 B.R. 850, 863-64 (Bankr. S.D. Tex. 2001) (unfair discrimination where plan provided for 100%
5 recovery for one class of unsecured claims and 1% recovery to another class of unsecured claims); *In*
6 *re Crosscreek Apartments, Ltd.,* 213 B.R. 521, 538 (Bankr. E.D. Tenn. 1997) (unfair discrimination
7 where plan provided for 100% recovery for one class of unsecured claims and 50% recovery to
8 another class of unsecured claims); *In re Barney & Carey Co.*, 170 B.R. 17, 25-26 (Bankr. D. Mass.
9 1994) (unfair discrimination where plan provided for unsecured deficiency claims to be paid 100%
10 over ten years and for unsecured trade claims to be paid 15% upon consummation); *In re Cranberry*
11 *Hill Assocs., L.P.*, 150 B.R. 289, 290-91 (Bankr. D. Mass. 1993) (unfair discrimination where plan
12 provided for 100% recovery for one class of unsecured claims and 50% recovery to another class of
13 unsecured claims); *In re Aztec Co.*, 107 B.R. 585, 591 (Bankr. M.D. Tenn. 1989) (unfair
14 discrimination where plan provided for a class of unsecured claims to be paid in full and for a class
15 of unsecured deficiency claims to be paid 3%).

16 Here, the City proposes to pay Franklin a fraction of a cent on the dollar while paying other,
17 similarly-situated unsecured claims far more. To take the most straightforward example, the City
18 proposes to provide Assured with guaranteed payments on the Pension Obligation Bonds having a
19 present value of at least 52%, plus a contingent note that would appear to add an additional 10% or
20 more to Assured's recovery if the City exceeds its "conservative" revenue forecast by just half a
21 percent annually (something that the City already anticipated in the Long-Range Financial Plan[84]).
22 As noted above, the Pension Obligation Bonds are general unsecured claims. Even if Franklin's
23 claims in respect of the Bonds are wholly unsecured (an issue to be determined in connection with
24 the Adversary Proceeding), Franklin would have rights against the City that are identical to
25 Assured's with respect to the Pension Obligation Bonds. Paying more than 52 cents on the dollar to
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27 [84] *See* Long-Range Financial Plan at 3 (projecting half a billion in additional revenue in the event of a 0.5% annual growth in core revenues).
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1 Assured while providing a ¼ cent-on-the-dollar cram down recovery to Franklin is the epitome of
2 grossly disparate treatment and unfair discrimination.

3 Similarly, as noted above, by the City's own calculations the Plan provides retirees with a
4 recovery of more than 70 cents on the dollar in respect of their general unsecured claims for
5 promised retirement benefits (health and pension). This too is grossly disproportionate to Franklin's
6 recovery, and particularly inappropriate given the City's reckless unwillingness to fix its "pension
7 problem" – and tame its out-of-control pension liabilities – in the course of adjusting its debts in this
8 case.

9 Finally, the City has made no showing of the value of any of the collateral securing the lease-
10 revenue bonds that it proposes to pay in full or nearly in full under the Plan – *e.g.*, Class 1 (2003
11 Fire/Police/Library Certificates); Class 2 (2006 SEB Bonds); Class 3 (2004 Arena Bonds); and
12 Class 4 (2004 Parking Bonds). In fact, the City steadfastly refused to disclose such value in the
13 Disclosure Statement. To the extent that those bonds are not fully secured (or nearly so), the holders
14 have material unsecured deficiency claims that are treated far more favorably than the City proposes
15 to treat Franklin.

16 This gross disparity in treatment clearly amounts to unfair discrimination and renders the
17 Plan unconfirmable under section 1129(b)(1). The City has not even attempted to justify that
18 discrimination, whether under the *Ambanc* four-factor analysis or the rebuttable presumption
19 approach.[85] To the extent the City seeks to resuscitate its case in its supplemental memorandum in
20 support of confirmation, Franklin will respond in turn.

21 **C. The Plan Is Not Proposed In Good Faith.**

22 Section 1129(a)(3) of the Bankruptcy Code – made applicable by section 901(a) of the Code
23 – requires a plan proponent to prove that a plan "has been proposed in good faith." 11 U.S.C.
24 § 1129(a)(3). Good faith requires, at a minimum, that a proposed chapter 9 plan "treat all interested
25 parties fairly and that the efforts used to confirm the plan must comport with due process." *Mount*
26 *Carbon*, 242 B.R. at 39. As the City admits, section 1129(a)(3) "requires a fundamental fairness in
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[85] *See* City Mem. at 17.

1 dealing with one's creditors" and a plan that "provide[s] its creditors the potential for the greatest
2 economic return from its assets."[86]

3 The requirement of good faith has been a critical component of municipal restructuring since
4 the earliest enactment of Chapter IX. *See Avon Park*, 311 U.S. at 144-46 (reversing order of
5 confirmation for, among other things, lack of good faith); *Town of Belleair v. Groves*, 132 F.2d 542,
6 543 (5th Cir. 1942) (affirming denial of confirmation and dismissal of case on bad faith grounds
7 where the proposed plan did not "embod[y] a fair and equitable bargain openly arrived at and devoid
8 of overreaching"); *Kaufman County Levee Imp. Dist. No. 4 v. Mitchell*, 116 F.2d 959, 960 (5th Cir.
9 1941) (affirming denial of confirmation where "the plan was unfair and discriminated in favor of the
10 bondholders owning lands and against those who did not").

11 Modern courts have not hesitated to deny confirmation of proposed plans of adjustment
12 where the debtor seeks to abuse the restructuring process or achieve results not consistent with the
13 purposes of the Bankruptcy Code. *See, e.g.*, *Ault v. Emblem Corp. (In re Wolf Creek Valley Metro.*
14 *Dist. No. IV)*, 138 B.R. 610, 618-19 (D. Colo. 1992) (reversing confirmation order on grounds that
15 proposed plan singled out one landowner for discriminatory treatment while unduly benefitting
16 another landowner); *Pierce County*, 414 B.R. at 719-20 (denying confirmation due to lack of good
17 faith where the proposed plan would have limited creditor recoveries from other sources and hence
18 "does not indicate a sincere attempt by the Debtor to readjust its debts by maximizing the creditors'
19 recovery"); *Mount Carbon*, 242 B.R. at 39-42 (denying confirmation where the plan unduly
20 benefitted one landowner and was inconsistent with the purpose of chapter 9).

21 One early case – *Wright v. City of Coral Gables*, 137 F.2d 192 (5th Cir. 1943) – highlights
22 the importance of a municipal debtor's good faith in its dealings with creditors and illustrates the
23 City's lack of good faith in seeking to cram down the Plan on Franklin. In *Wright*, the Fifth Circuit
24 reversed an order confirming a plan of adjustment that had been accepted prepetition by more than
25 94% of bondholders. Of particular concern, the Circuit perceived the debtor to be using the
26 chapter 9 process to unfairly cram down the plan on the dissenting minority bondholders using

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[86] City Mem. at 13-14.

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1 prepetition acceptances of other bondholders or, as the Circuit put it, "to bludgeon into submission
2 those with whom the city had not been able to make settlements satisfactory to itself." *Id.* at 195.
3 That is an apt description of the City's conduct here. By the Plan, the City is attempting to
4 bludgeon Franklin into submission because the City has been unable to make a settlement with
5 Franklin satisfactory to itself. In the process, the City is not remotely attempting to maximize
6 Franklin's recovery or otherwise acting in good faith toward Franklin. In fact, the City deliberately
7 is <u>minimizing</u> Franklin's recovery by refusing to apply even a single dollar of restricted PFFs –
8 which may not be applied to other general fund liabilities – to pay Franklin's claim. The City's bad
9 faith in this regard is made crystal clear by the fact that, in its pre-bankruptcy "Ask", it previously
10 proposed to use each available PFF fund "to pay up to that account's legally allocable share of the
11 debt service" on the Bonds for the next forty years, "until the end of Fiscal Year FY51-52."[87] The
12 City projected that such a restructuring would result in a recovery on the Bonds of 54.5% on a net
13 present value basis.[88] Indeed, even the Long-Range Financial Plan on which the Plan is premised
14 "conservatively" assumes that the City will pay Franklin $500,000 annually from available PFFs.[89]
15 Just eight months ago, the City recognized that its failure to take all steps to maximize the
16 amount of PFFs available for payment of the Bonds would be "a sign of bad faith." Specifically, in
17 recommending rejection of a commission's recommendation that the City lower the amount of the
18 applicable building permit fees, City staff stated the following:

19 > [T]he Bankruptcy Ask seeks to renegotiate the terms of our debt
20 > obligations under the 2009 Lease Revenue Bonds Series A. We have
> defaulted on the bonds. The source of repayment is development impact
21 > fees collected to finance the construction of fire stations, police stations,
> parklands and street improvements throughout Stockton. The City cannot
22 > forgo the collection of the very same fees backing those negotiations. <u>To
> do so would be seen as a sign of bad faith by the Bankruptcy Court and
23 > creditors</u>. This could have major detrimental impact on our bankruptcy
> negotiations. The City's imperative need to exit bankruptcy, in a timely
24 > and sustainable manner, makes the recommendations of the Development
> Oversight Commission a non-starter.[90]

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[87] Ask at 785-86.

[88] Ask at 44-45.

[89] Long-Range Financial Plan at 19.

[90] CTY023541.

1 Three months later, the City filed the Plan, punitively refusing to apply any PFFs to payment
2 of the Bonds and proposing a recovery for Franklin that is a fraction of that proposed prior to
3 bankruptcy. In contrast, the Plan's treatment of every other class of bond debt is superior to the
4 proposals made in the Ask. For example, in the Ask the City proposed to terminate all general fund
5 debt service on the Pension Obligation Bonds and to make payments only from "solvent restricted
6 fund sources," which the City estimated could not exceed 17.38% of the amounts due.[91] The City
7 described the Pension Obligation Bonds as being "deeply or fully impaired" under the Ask.[92] In
8 contrast, the Plan now guarantees forty years of payments from the general fund for debt service on
9 the unsecured Pension Obligation Bonds – with a present value of 52% of the principal amount of
10 the Pension Obligation Bonds – plus a contingent note that is likely to add an additional 10% or
11 more to Assured's recovery.
12 The City's refusal to apply available PFFs to payment of the Bonds – particularly in light of
13 the more favorable treatment of the other "capital markets" creditors – is the opposite of the good
14 faith required by the Bankruptcy Code. In fact, "[k]nowingly sacrificing prospectively significant
15 value demonstrates a lack of good faith within the totality-of-circumstances analysis of 1129(a)(3)."
16 *In re Val-Mid Assocs.*, Case No. 4:12-bk-20519-EWH, 2013 Bankr. LEXIS 2521, at *9 (Bankr. D.
17 Ariz. June 14, 2013); *see, e.g.*, *In re Multiut Corp.*, 449 B.R. 323, 342 (Bankr. N.D. Ill. 2011)
18 (failure to maximize value for creditors "directly bears on the Plan's good faith"); *Pierce County*,
19 414 B.R. at 719-20 (same).
20 The City's wholesale assumption of its single largest liability – unfunded pensions – further
21 evidences that the Plan lacks the good faith basis necessary for confirmation. If the City truly
22 desired to "treat all interested parties fairly" and to "provide creditors the potential for the greatest
23 economic return from its assets," it would have confronted and addressed in this case its growing

24 [91] Ask at 46 ("Since there is no collateral securing this obligation the City does not intend to pay any debt service from the General Fund moving forward, but will continue to pay the portion of
25 debt service legally allocable to restricted funds.") and at 769 ("Approximately 82.62% of the
26 obligation is currently paid from the General Fund and approximately 17.38% is paid from restricted fund sources. The City's proposal is to continue only the payment from solvent
27 restricted fund sources and to discontinue payments from the General Fund.").

[92] Ask at 45.
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"pension problem." Chapter 9 presents the only opportunity for the City to restructure the massive and out-of-control pension liability. Notably, despite the repeated protests of CalPERS, the City conspicuously does not take the position that pension liabilities cannot be adjusted in this case. Nor could it. *See In re City of Detroit*, 504 B.R. 97, 2013 Bankr. LEXIS 5120, at *127 (Bankr. E.D. Mich. 2013) ("Because under the Michigan Constitution, pension rights are contractual rights, they are subject to impairment in a federal bankruptcy proceeding. Moreover, when, as here, the state consents, that impairment does not violate the Tenth Amendment.").[93] The City simply chooses not to do so.[94]

There is, of course, nothing wrong with a distressed municipality deciding that it has enough money to pay its debts after all. If it makes such a determination, however, it then has to then pay all of its debts, not just some of them. Here, the City's assumption of its massive pension liability is not indicative of the good faith necessary for confirmation of a plan that proposes to discharge Franklin's claim without any effort whatsoever at future repayment, particularly the proposed discharge through a *de minimis* payment of a quarter cent on the dollar. *Cf. Wolph v. U.S. Dept. of Educ. (In re Wolph)*, 479 B.R. 725, 732 (Bankr. N.D. Ohio 2012) ("The Court also finds troubling the disparate treatment the Plaintiff afforded to her student-loan creditors. In this adversary proceeding, the Plaintiff came to an accommodation with one of her creditors, Sallie Mae, whereby the Plaintiff agreed to partially repay the obligation. The Plaintiff explained that she was motivated to make such an accommodation for one reason: her parents were jointly liable on the obligation. For the Court, however, such a personal motive to pay one of her educational debts, while seeking to discharge all of her remaining educational obligations, does not square with the good faith prong of the Brunner test.").

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[93] Franklin is prepared to address this issue in detail should the City ever indicate a willingness to impair its pension liabilities or if the Court otherwise so requests.

[94] The City answered Franklin's interrogatory asking whether the pension liabilities could be impaired in this way: "The City has determined in the exercise of its business judgment that it should assume the CalPERS agreement and obligations in order to preserve its work force, particularly sworn police officers. In light of such determination, the City need not opine or speculate as to whether the Class 15 Claims could be impaired."

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The City's lack of good faith is highlighted by its disregard of the cautionary tale of the City of Vallejo, which recently exited chapter 9 (guided by the same counsel as that now representing the City) having failed to adjust its pension liabilities. It is now clear that Vallejo made a grave mistake in doing so, and very well may have to seek "chapter 18" relief in order to finally confront its own "pension problem." Specifically, Vallejo is facing another budget crisis less than two years after exiting bankruptcy, projecting budget deficits for this fiscal year and next due to ballooning obligations to CalPERS. Like the City, Vallejo has been unable to forecast its future pension expenses with any accuracy, with pension expenses for the current fiscal year already 38% higher than those projected in its Disclosure Statement filed just three years ago. Commentators note that "Vallejo's post-bankruptcy experience provides a warning for Stockton," and observe: "As Vallejo is discovering since it exited bankruptcy in 2011, when an already financially weak city avoids dealing with pensions in bankruptcy, it can create a significant impediment to a successful long-term restructuring. The city has a persistent structural budgetary imbalance, and it risks a second bankruptcy filing if [it] continues on its current path."[95] More directly: "Stockton is not looking to reduce pensions in bankruptcy. So, it is not clear whether it can emerge from Chapter 9 and avoid the type of future pension funding challenges that plague Vallejo, a fellow California city that exited bankruptcy and continues to struggle to fund onerous pension payments."[96]

The City's lack of good faith also is evidenced by its payment during the case of virtually all unsecured trade debt and related prepetition obligations. Those liabilities would have been "General Unsecured Claims" classified into Class 12 and paid at a rate of less than 1%. However, because the City unilaterally acted to pay its favored prepetition liabilities – without any showing that such payments otherwise comport with the Bankruptcy Code's confirmation standards – the claims instead received a recovery of 100%. This conduct indeed is "probative" of the City's good faith.

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[95] MOODY'S INVESTORS SERVICE, *Special Comment: Without Pension Relief, Bankrupt California Cities Risk Return To Insolvency*, February 20, 2014, at 1, 6 (attached as Exhibit B).

[96] MOODY'S INVESTORS SERVICE, *Municipal Bankruptcy: Update and Insights*, February 6, 2014, at 11 (attached as Exhibit A).

1 *City of Stockton*, 486 B.R. at 199 ("It is not difficult to imagine arguments that evidence of untoward
2 [pre-confirmation] settlements could be probative of § 1129(a)([3]) issues.").
3 Finally, the City's characterization of Franklin as having "drawn battle lines by filing the
4 Adversary and propounding discovery" is patently ludicrous.[97] It is not Franklin that has "drawn
5 battle lines." Franklin is facing a recovery of less than $94,000 in respect of the $35 million that it
6 loaned the City, with which the City constructed and equipped two fire stations, the police
7 communications center, seven parks, and numerous street, paving, bridge, and other civic works
8 throughout the City. It is the City that seeks to treat the Bonds as leases and to cap Franklin's claim
9 (something that has never before been attempted) and it is the City's aggressive, unsupportable
10 treatment proposal that escalated the Plan into a "battle", as it left Franklin with no choice
11 whatsoever but to litigate to protect its rights and the rights of its investors (many of whom are
12 retirees who rely on Franklin's funds for safe and steady income) under the Bankruptcy Code.
13 Further, the City's "offer" of a *de minimis* ¼ cent-on-the-dollar recovery belies its
14 insinuation that Franklin somehow made unreasonable demands in settlement negotiations over the
15 Plan. The Court can infer from the Plan the nature of the demands the City previously made of
16 Franklin, and the Plan serves to illustrate the City's bad faith in dealing with Franklin throughout the
17 restructuring process.
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19 **D. The Plan Violates Section 943(b)(3) Due To The City's Failure To Disclose Payments To Its Counsel And Other Professionals.**
20 Section 943(b)(3) of the Bankruptcy Code requires that, prior to confirming a plan of
21 adjustment, the Court find that "all amounts to be paid by the debtor or by any person for services or
22 expenses in the case or incident to the plan have been fully disclosed and are reasonable." 11 U.S.C.
23 § 943(b)(3). The City, however, has not disclosed – and apparently does not intend to disclose – any
24 of the tens of millions of dollars in fees it has paid to its counsel and other professionals and to the
25 counsel and professionals employed by the Retirees Committee during this case. Indeed, the City
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[97] City Mem. at 15.

has not even produced in discovery any of the invoices of its professionals, and the Retirees Committee has fully redacted the invoices of its professionals.

The City asserts that it need not make such disclosure because, "[a]s with its vendors, the City has been paying its professionals on a current basis and does not expect that there will be any future payments that fall within the ambit of section 943(b)(3)."[98] Apparently relying on the "to be paid" language in the statutory text, the City contends that section 943(b)(3) applies prospectively only and does not operate to require disclosure or ensure the reasonableness of payments made during the bankruptcy case prior to confirmation.

This cavalier argument is another example of the City's lack of good faith. The entire purpose of section 943(b)(3) is for "[t]he courts [to] monitor the payment of fees and the reimbursement of expenses in or in connection with a chapter 9 case to insure that the fees and expenses are reasonable, that there is no overreaching by attorneys or agents either of the debtor or of creditors, and that there is full disclosure so that those whose rights are affected directly by the plan and directly or indirectly by compensation arrangements are aware of the practice in a particular case and can determine whether the plan is being proposed for the benefit of the debtor and its creditors or is a scheme to benefit private interests at the expense of the debtor and/or its creditors." 6 COLLIER, *supra*, ¶ 943.03[3]. Congress surely did not intend for municipal debtors to be able to evade that basic statutory function by paying professionals during the case – without any disclosure whatsoever – leaving nothing left "to be paid" at the time of confirmation. There is no logical reason at all for the artificial distinction that the City seeks to draw.

In fact, disclosure of professional fees has been a required component of municipal restructuring from the earliest days of chapter 9. As noted above, in *Avon Park* the Supreme Court reversed an order confirming a plan of adjustment precisely because the debtor had not disclosed amounts it paid to a fiscal agent (Crummer) in connection with the plan. The Court held that "[t]he very minimum requirement for fair dealing was the elementary obligation of full disclosure of all of [Crummer's] interests," and that "allowance of compensation to Crummer without scrutiny of

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98 City Mem. at 19.

1 Crummer's speculation in the securities does not comport with the standards for surveillance
2 required of courts of bankruptcy before confirming plans of composition or reorganization or before
3 making such allowance." *Avon Park*, 311 U.S. at 145, 147.

4 Since *Avon Park*, courts have taken the "monitoring" responsibility noted by COLLIER
5 seriously, examining at confirmation all of the debtor's fees and expenses in a chapter 9 case,
6 regardless of whether or not the debtor previously had paid for them during the case. *See, e.g.*,
7 *Barnwell County*, 471 B.R. at 868; *Colorado Springs*, 187 B.R. at 685-86; *In re Colorado Centre*
8 *Metro. Dist.*, 139 B.R. 534, 535 (Bankr. D. Colo. 1992) ("In a Chapter 9, the Court must determine if
9 the fees paid by the Debtor or any person have been fully disclosed and are reasonable."); *see also In*
10 *re County of Orange*, 179 B.R. 195, 199-200 & n.13 (Bankr. C.D. Cal. 1995) ("Section 943 provides
11 that if a plan is to be confirmed, all allowed administrative expenses, including
12 committee/subcommittee professional fees, must be satisfied on the effective date of the plan. . . .
13 This requirement does not violate § 904(2) because in order for the County to obtain the benefits of a
14 Chapter 9 adjustment of debts, it must pay its administrative claims. The price for these benefits is
15 the County's implied consent to this court's power to apply all the provisions of 943. If the County
16 does not wish to pay this price, it can dismiss the case at any time."); *In re Castle Pines N. Metro.*
17 *Dist.*, 129 B.R. 233, 235 (Bankr. D. Colo. 1991) ("Can counsel for the Committee charge
18 unreasonable fees? Of course not! Congress provided that the court would oversee such fees in §
19 943(b)(3).").

20 The City seeks to evade that basic oversight of the Court. It wants to pay millions of dollars
21 to its counsel and others with total impunity and no scrutiny but then claim poverty and an inability
22 to pay Franklin more than $94,000. The City's failure to disclose what it has paid to its counsel and
23 professionals, and to the Retirees Committee's counsel and professionals, renders the plan
24 unconfirmable pursuant to section 943(b)(3).

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E. The Plan Does Not Comply With Other Applicable Provisions Of The Bankruptcy Code.

Section 943(b)(1) of the Bankruptcy Code provides that the Court may confirm the Plan only if the Plan "complies with the provisions of this title made applicable by sections 103(e) and 901 of this title." 11 U.S.C. § 943(b)(1). The Plan fails this basic requirement in several ways.

1. The Plan Massively Inflates The Retiree Health Benefit Claims.

Pursuant to the Retirees Settlement, the City agreed to allow the Retiree Health Benefit Claims in an aggregate amount of $545 million and to make a cash payment of $5.1 million in respect of those alleged claims (which the City had disputed in their entirety at the outset of the bankruptcy case).[99] The ratio of the $5.1 million in distributions to the $545 million in "allowed" Retiree Health Benefit Claims is defined in the Plan as the "Unsecured Claim Payout Percentage," which the City calculates as "0.93578%, i.e., $5,100,000 divided by $545,000,000."[100]

As other holders of Class 12 General Unsecured Claims (*i.e.*, Franklin) are to receive the Unsecured Claim Payout Percentage of their claims, the City's stipulated amount of the Retiree Health Benefit Claims serves as a cornerstone of the Plan. The evidence and expert testimony will show that the City has inflated those claims, with the effect being a substantial reduction in the "Unsecured Claim Payout Percentage" to be paid to Franklin and any other claimant not already paid or favored with a "settlement" with the City.

Specifically, the stipulated $545 million amount of the Retiree Health Benefit Claims appears to be a calculation of the estimated amount that the City would pay to procure health benefits over the expected lifespan of each of the retirees at issue.[101] In other words, it is simply the sum total of payments that the City might make over the next forty years or more. The City did not discount to present value those estimated future payments in any way.

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[99] Disclosure Statement at 82.

[100] Plan § I.A.185.

[101] *Motion For Order (1) Fixing A November 26, 2013 Bar Date For Retiree Health Benefit Claims, (2) Approving Form Of Notice Of Bar Date, And (3) Requiring City To Transmit Notice Of Bar Date To Retiree Health Benefit Claimants By No Later Than October 18, 2013* [docket no. 1119] at 3-5; RET20001475-1479.

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This has the effect of vastly overstating the actual amount of the City's liability. Indeed, the individual claim amounts to which the City has stipulated are staggering. By Franklin's calculation, the average listed health benefit claim amount for each of the 1,100 retirees is nearly $500,000. There are 131 retirees with listed claims over $750,000, and an unbelievable 67 with listed claims of more than $1 million.[102]

The City's calculation of the Retiree Health Benefit Claims directly conflicts not only with the way that the City reports its unfunded liability in respect of retiree health liability in its audited financial statements, which reflect the City's calculation of the net present value of that liability,[103] but also with the standards of the Governmental Standards Accounting Board.[104] Thus, for example, in 2011 the City's present value calculation of its unfunded liability for health benefits to retirees was approximately $261.9 million, less than half the amount of the claim to which the City has now stipulated.[105]

More importantly, the City's contrived approach plainly contravenes section 502(b) of the Bankruptcy Code. "To insure the relative equality of payment between claims that mature in the future and claims that can be paid on the date of bankruptcy, the Bankruptcy Code mandates that all claims for future payment must be reduced to present value. 11 U.S.C. § 502(b)." *Pension Benefit Guar. Corp. v. CF&I Fabricators of Utah, Inc. (In re CF&I Fabricators of Utah, Inc.)*, 150 F.3d 1293, 1300 (10th Cir. 1998). Such "[d]iscounting is consistent with the fundamental goal of treating similar claims in the same manner, and reflects the economic reality that a sum of money received today is worth more than the same amount received tomorrow." *Pereira v. Nelson (In re Trace Int'l Holdings)*, 284 B.R. 32, 38 (Bankr. S.D.N.Y. 2002) (citations omitted).

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[102] *Amended List Of Creditors And Claims Pursuant To 11 U.S.C. §§ 924 And 925 (Retiree Health Benefit Claims)* [docket no. 1150].

[103] Comprehensive Annual Financial Report For The Fiscal Year Ended June 30, 2012 Stockton, California, available at: http://www.stocktongov.com/files/2012_CAFR.pdf.

[104] *See* Governmental Standards Accounting Board Statement No. 45 (Accounting And Financial Reporting By Employers For Postemployment Benefits Other Than Pensions).

[105] RET20007304.

Thus, courts routinely discount claims for future employment-related benefits to present value as of the bankruptcy petition date, including claims for unfunded pension liabilities and for deferred compensation. *See, e.g.*, *Pension Benefit Guar. Corp. v. Belfance (In re CSC Indus.)*, 232 F.3d 505, 508 (6th Cir. 2000) ("the bankruptcy court must value present claims and reduce claims for future payment [of pension benefits] to present value, while also keeping in mind that a fundamental objective of the Bankruptcy Code is to treat similarly situated creditors equally"); *CF&I*, 150 F.3d at 1300 ("Inasmuch as those [pension] liabilities are for beneficiaries' payments that extend into the future, the amount of the liability must be reduced to present value so the debt can be dealt with under the reorganization plan."); *Kucin v. Devan*, 251 B.R. 269, 273 (D. Md. 2000) (claims for deferred compensation properly discounted to present value as of the petition date); *Trace Int'l*, 284 B.R. at 38 (same) ("Absent bankruptcy, a creditor like Nelson would have to wait many years before receiving and using the entire payout. Paying the face amount on an accelerated basis would overcompensate the creditor by enabling him to receive and use the money sooner."); *In re Thomson McKinnon Secs.*, 149 B.R. 61, 75 (Bankr. S.D.N.Y. 1992) (same); *LTV Corp. v. Pension Benefit Guar. Corp. (In re Chateaugay Corp.)*, 115 B.R. 760, 770 (Bankr. S.D.N.Y. 1990) ("Once the value of the aggregate future [pension] liabilities has been determined, the present value of those future liabilities is determined as a matter of bankruptcy law so that all similar claims for future liabilities are treated in an economically similar manner."), *vacated by consent order*, 1993 U.S. Dist. LEXIS 21409 (S.D.N.Y. 1993).

Courts similarly discount to present value other claims for non-interest bearing future obligations as well. *See, e.g.*, *Gas Power Mach. v. Wisconsin Trust Co. (In re Wisconsin Engine Co.)*, 234 F. 281, 282-83 (7th Cir. 1916) (claims under non-interest bearing promissory notes must be discounted to present value); *In re O.P.M. Leasing Servs.*, 79 B.R. 161, 167 (S.D.N.Y. 1987) (rejection damage claims for future installment payments must be discounted to present value) ("Equality of treatment at distribution is a fundamental principle underlying the bankruptcy laws. By discounting a claim arising from the postpetition rejection of an executory contract or unexpired lease, the postpetition claimant is treated the same as the pre-petition claimant . . . .") (citation

1 omitted); *In re Loewen Grp. Int'l*, 274 B.R. 427, 432-39 (Bankr. D. Del. 2002) (claims under non-
2 interest bearing promissory notes must be discounted to present value).[106]

3 "The rationale for discounting all of these claims is the same – where a claim has been
4 asserted in respect to a future liability of the debtor payable post-petition, the claim must be
5 discounted to present value as of the petition date." *Loewen Grp.*, 274 B.R. at 437-38. Had the City
6 discounted the stipulated $545 million amount of Retiree Health Benefit Claims to present value, the
7 actual amount of such claims would decrease materially and, as a consequence, the Unsecured Claim
8 Payout Percentage based upon the allowed amount of the Retiree Health Benefit Claims would
9 increase materially, directly impacting creditor recoveries.

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11 2. The Plan Improperly Caps Franklin's Claim And Fails To Account For Franklin's Claim For Administrative Rent.

12 The Plan provides for Franklin's claims in respect of the Bonds to "capped by
13 section 502(b)(6)," with the result allegedly that claims for recovery of $35 million loaned to the
14 City are to be transformed into "lease rejection claims" of "approximately $10 million."[107] In the
15 Adversary Proceeding, Franklin will establish that its claims are not "for damages resulting from the
16 termination of a lease of real property" and do not fall within the purview of section 502(b)(6). As a
17 consequence, the Plan violates section 502 of the Bankruptcy Code by improperly limiting
18 Franklin's allowed claim. 11 U.S.C. § 502(b).

19

20 [106] This is to be distinguished from the case of interest-bearing obligations (like Franklin's Bonds), the principal of which is not discounted to present value because "the interest already has been
21 disallowed pursuant to § 502(b)(2)." *In re Oakwood Homes Corp.*, 449 F.3d 588, 600 (3d Cir.
22 2006). In *Oakwood Homes*, the Third Circuit explained this critical difference, using the example of two 10-year promissory notes for $1,000, one with no interest and one bearing
23 interest at 5%: "The point is to recognize what the creditor bargained for, while avoiding a windfall. The key difference between interest- and non-interest-bearing debt is in that bargain –
24 the holder of a non-interest-bearing note bargained to receive only his $1,000, spread out over the 10 years. The holder of interest-bearing debt, however, bargained for much more than the
25 $1,000 – $1,628.89, in fact. Giving him $1,000 today, then, means that by the end of what would have been the note's 10-year lifetime, he could have reinvested at the same theoretical rate
26 of interest, and earned his $1,628.89. A creditor who bargained to receive only the $1,000 in principal, without interest, would be fully compensated by $613.91, which he would be able to
27 grow into his $1,000 by the end of the 10 years; not so for the creditor who bargained to receive interest, who is shortchanged by only receiving $613.91." *Id.* at 601 (emphasis in original).

[107] Disclosure Statement at 31.

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Similarly, to the extent that the Court concludes that Franklin's claims do arise from a lease of real property, Franklin will establish in the Adversary Proceeding that it is entitled to an administrative claim, in the amount of at least $7.5 million, for unpaid "rent" from and after the petition date. The Plan apparently makes no provision for the payment of that claim[108] and therefore violates sections 365(d)(3), 503(b), 507(a)(2), and 943(b)(5) of the Bankruptcy Code, which require that claims for administrative rent be paid in full in cash on the effective date of a plan of adjustment. 11 U.S.C. §§ 365(d)(3), 503(b), 507(a)(2), and 943(b)(5).

3. The Disclosure Statement Did Not Provide Adequate Information About The City's Creditor Settlements.

According to the City, the Plan is premised on "consensual agreements with all of its major creditors (including its nine labor unions and the Retirees Committee, on behalf of the approximately 1,100 holders of Retiree Health Benefit Claims that it represents), except for Franklin."[109]

Yet, despite the allegedly critical importance of those settlements, the City has not complied with its obligations to disclose many of the settlement agreements (or even the terms) of the various compromises that the City purportedly has negotiated. In particular, after Franklin objected to the City's proposed Disclosure Statement on the ground that, among other things, the City had failed to disclose the terms of its settlements, the Court ordered the City to file its "Plan Supplement" by no later than January 27, 2014 – two weeks before the deadline for voting on the Plan.[110] The "Plan Supplement" was to include "the Assured Guaranty Settlement Documents, the NPFG Arena Settlement Documents, the NPFG Parking Settlement Documents, the Price Settlement Documents,

[108] *See* Disclosure Statement at 70 (claiming that "the City has endeavored to satisfy postpetition expenses as they became due" and that "most claims that otherwise would constitute Allowed Administrative Claims previously have been or will be satisfied in the ordinary course of business").

[109] City Mem. at 23 (emphasis in original).

[110] *Order Governing The Disclosure And Use Of Discovery Information And Scheduling Dates Related To The Trial In The Adversary Proceeding And Any Evidentiary Hearing Regarding Confirmation Of Proposed Plan Of Adjustment* [docket no. 1224] ¶ 52.

and any other agreement or instrument contemplated by, or to be entered into pursuant to, the Plan."[111]

The City did in fact file a "Plan Supplement" by that date, but the City's disclosures were materially deficient by its own admission. The City admitted in the Plan Supplement that "[s]everal of the Plan Documents are not yet ready to be filed. Moreover, the attached Plan Documents remain in draft form, are subject to revision, have not yet been approved by the City Council, and may require approval of officials of the counterparties to such Plan Documents as well."[112] In particular, the City omitted critical parts of the NPFG settlement agreement – including the revised payment schedule for the Arena Bonds and a description of the new collateral to secure the Parking Bonds – and any disclosure whatsoever regarding the DBW settlement, the Price settlement, the Ports settlement, the Thunder settlement, or the Retirees Settlement.

Then, two weeks later – on the day of the voting deadline for the Plan – the City filed a "Supplemental Plan Supplement" that the City again conceded was deficient.[113] In particular, there was no disclosure – and to this day there has been no disclosure – of the new collateral to secure the Parking Bonds or any agreement documenting the Ports settlement, the Thunder settlement, or the Retirees Settlement. This lack of disclosure independently renders the Plan unconfirmable. *See, e.g.*, *In re Michelson*, 141 B.R. 715, 719 (Bankr. E.D. Cal. 1992) ("Nor does the scrutiny of the accuracy of the disclosure statement end with the pre-solicitation hearing on the question of whether

[111] Plan § I.A.140.

[112] *Plan Supplement In Connection With The First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013)* [docket no. 1236] at 1.

[113] *Supplemental Plan Supplement In Connection With The First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013)* [docket no. 1259] at 2 ("The City and the other parties to the Plan Documents have worked diligently to finalize the Plan Documents, with negotiations continuing through the date hereof and some drafts circulating through this afternoon. Two of the Plan Documents are not yet ready to be filed because the negotiations, while encouraging, are not yet completed. The attached Plan Documents are in close to final form, but remain drafts that are subject to revision. None of the attached has been approved by the City Council, and one or more may require approval of officials of the counterparties to such Plan Documents. Therefore, while the City does not believe that any modifications will be material, the City reserves the right to alter, amend, modify or supplement any of the attached Plan Documents in accordance with the provisions of the Plan. A second supplemental Plan Supplement will be filed and served in the future.").

1 the disclosure statement contains adequate information. The accuracy of disclosure is an issue that
2 must be addressed at the confirmation hearing where it must be demonstrated by a preponderance of
3 the evidence that the 'proponent of the plan complie[d] with the applicable provisions of [title 11].'
4 11 U.S.C. § 1129(a)(2).").
5
6 **IV. CONCLUSION**
7 The Plan does not provide a reasonable recovery in respect of the Bonds, discriminates
8 against Franklin, and fails many of the Bankruptcy Code's statutory prerequisites for confirmation of
9 a plan of adjustment. For all of the foregoing reasons, Franklin requests that the Court deny
10 confirmation of the Plan and grant such other and further relief as the Court deems appropriate under
11 the circumstances.
12
13 Dated: February 26, 2014 JONES DAY
14
15 By: *_/s/ James Johnston_*
16 James O. Johnston
Joshua D. Morse
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Attorneys for Franklin High Yield Tax-Free
18 *Income Fund and Franklin California High*
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