CASE NO. EC-14-1550

UNITED STATES BANKRUPTCY APPELLATE PANEL
OF THE NINTH CIRCUIT

In re CITY OF STOCKTON, CALIFORNIA, *Debtor.*

FRANKLIN HIGH YIELD TAX-FREE INCOME FUND and
FRANKLIN CALIFORNIA HIGH YIELD MUNICIPAL FUND, *Appellants*,

v.

CITY OF STOCKTON, CALIFORNIA, *Appellee*.

Appeal from the United States Bankruptcy Court for the
Eastern District of California, Case No. 12-32118

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TABLE OF CONTENTS

Page

I. **PRELIMINARY STATEMENT** 1

II. **BASIS OF APPELLATE JURISDICTION** 3

III. **STATEMENT OF ISSUES PRESENTED AND APPLICABLE STANDARD OF APPELLATE REVIEW** 3

IV. **STATEMENT OF THE CASE** 4

A. **Nature Of The Case, Course Of Proceedings And Disposition In The Court Below** 4

B. **Facts Relevant To The Issues Presented For Review** 7

1. Franklin's $30.5 Million Unsecured Claim 7

2. Other Unsecured Liabilities 9

3. Settlements 13

4. The Discriminatory Plan 15

5. The City's Ability To Pay 17

6. The Pension Ruling And Confirmation 21

V. **SUMMARY OF ARGUMENT** 23

VI. **ARGUMENT** 25

A. **The Court Erred In Concluding That The Plan Was In The Best Interests Of Creditors** 26

1. The Best Interests Test Protects Individual Creditors 28

2. The Best Interests Test Requires A Fair Recovery Over Time 32

3. The Plan Fails The Best Interests Test 34

Page

4. The Court Improperly Lumped Together Franklin's Secured And Unsecured Claims 39

5. The Court Misunderstood The City's Other Liabilities And The Plan's Treatment Of Them 43

6. The Court Relied On Other Erroneous Findings 48

B. The Court Erred In Concluding That The Plan Properly Classified And Treated Franklin's Unsecured Claim. 50

1. Sections 1122, 1123(a)(4), And 1129(b) Ensure Equality Of Distribution 51

2. The Plan Improperly Classified Franklin's Unsecured Claim 52

a. The Plan Gerrymandered Franklin's Claim 53

b. The Plan Classified Franklin's Claim With Dissimilar Claims 56

3. The Plan Provided Different Treatment To Claims Within Franklin's Class....57

4. The Plan Unfairly Discriminated Against Franklin's Unsecured Claim 62

C. The Court Erred In Not Discounting Retiree Health Benefit Claims To Present Value 66

1. Accounting Rules Require Discounting 69

2. The Code Requires Discounting 71

D. The Court Erred In Concluding That The Plan Was Proposed In Good Faith....76

Page

E. The Court Erred In Excusing The City From Disclosure And Approval Of Professional Fees 81

VII. CONCLUSION 84

TABLE OF AUTHORITIES

Page

Cases

In re Adelphia Commc'ns Corp., 361 B.R. 337 (S.D.N.Y. 2007) 29, 61

In re Ambanc La Mesa L.P., 115 F.3d 650 (9th Cir. 1997) 26, 63

American United Mut. Life Ins. v. City of Avon Park,
311 U.S. 138 (1940) ....*passim*

In re AOV Indus., 792 F.2d 1140 (D.C. Cir. 1986) 55

In re Arnold & Baker Farms, 177 B.R. 648 (B.A.P. 9th Cir. 1994) 41

In re Aztec Co., 107 B.R. 585 (Bankr. M.D. Tenn. 1989) 64

Bank of Am. Nat'l Trust & Savs. Ass'n. v. 203 N. LaSalle St. P'ship,
526 U.S. 434 (1999) 29

In re Barakat, 99 F.3d 1520 (9th Cir. 1996) 53, 54, 55

In re Barney & Carey Co., 170 B.R. 17 (Bankr. D. Mass. 1994) 42, 64

In re Barnwell Cnty. Hosp., 471 B.R. 849 (Bankr. D.S.C. 2012) 34, 83

In re Beauchesne, 209 B.R. 266 (Bankr. D.N.H. 1997) 42

Begier v. IRS, 496 U.S. 53 (1990) 25, 51

Bekins v. Lindsay-Strathmore Irrigation Dist.,
114 F.2d 680 (9th Cir. 1940) 43

Bethea v. Robert J. Adams & Assocs., 352 F.3d 1125 (7th Cir. 2003) 59

In re Bonner Mall P'ship, 2 F.3d 899 (9th Cir. 1993) 29

In re Carolina Triangle L.P., 166 B.R. 411 (B.A.P. 9th Cir. 1994) 4

In re Castle Pines N. Metro. Dist., 129 B.R. 233 (Bankr. D. Colo. 1991) 83

In re CF&I Fabricators of Utah, Inc., 150 F.3d 1293 (10th Cir. 1998) 71, 72

Page

In re Chateaugay Corp., 115 B.R. 760 (Bankr. S.D.N.Y. 1990), vacated by consent order, 1993 U.S. Dist. LEXIS 21409 (S.D.N.Y. June 7, 1993) 72, 73

In re City of Colo. Springs Spring Creek Gen. Improvement Dist., 187 B.R. 683 (Bankr. D. Colo. 1995) 83

In re City of Detroit, 524 B.R. 147 (Bankr. E.D. Mich. 2014) 66, 82, 83

In re City of Stockton, 493 B.R. 772 (Bankr. E.D. Cal. 2013) ....*passim*

Clarke v. Rogers, 228 U.S. 534 (1913) 25

In re Colorado Centre Metro. Dist., 139 B.R. 534 (Bankr. D. Colo. 1992) 83

In re Corcoran Hosp. Dist., 233 B.R. 449 (Bankr. E.D. Cal. 1999) 51, 53, 54

In re Cranberry Hill Assocs., L.P., 150 B.R. 289 (Bankr. D. Mass. 1993) 64

In re Creekside Landing, Ltd., 140 B.R. 713 (Bankr. M.D. Tenn. 1992) 42

In re Crosscreek Apartments, Ltd., 213 B.R. 521 (Bankr. E.D. Tenn. 1997) 64

In re CSC Indus., 232 F.3d 505 (6th Cir. 2000) 72

Dewsnup v. Timm, 502 U.S. 410 (1992) 31

Fano v. Newport Heights Irrigation Dist., 114 F.2d 563 (9th Cir. 1940) ....*passim*

In re Glenn, 796 F.2d 1144 (9th Cir. 1986) 41

In re Greate Bay Hotel & Casino, Inc., 251 B.R. 213 (Bankr. D.N.J. 2000) 64

In re Homestore.com, Inc. Sec. Litig., 347 F. Supp. 2d 814 (C.D. Cal. 2004) 7

Howard Delivery Serv. v. Zurich Am. Ins., 547 U.S. 651 (2006) 25, 26, 59

In re Icenhower, 755 F.3d 1130 (9th Cir. 2014) 7

Page

John Hancock Mut. Life Ins. v. Route 37 Bus. Park Assocs., 987 F.2d 154 (3d Cir. 1993) 55

In re Johnston, 21 F.3d 323 (9th Cir. 1994) 56

Kaufman Cnty. Levee Improvement Dist. No. 4 v. Mitchell, 116 F.2d 959 (5th Cir. 1941) 77

Kelley v. Everglades Drainage Dist., 319 U.S. 415 (1943) ....*passim*

Kucin v. Devan, 251 B.R. 269 (D. Md. 2000) 72

In re Lettick Typographic, Inc., 103 B.R. 32, 38 (Bankr. D. Conn. 1989) 52

In re Loewen Grp. Int'l, 274 B.R. 427 (Bankr. D. Del. 2002) 73

In re Loop 76, LLC, 465 B.R. 525 (B.A.P. 9th Cir. 2012) 40, 41, 56

In re MCorp Fin., 137 B.R. 219 (Bankr. S.D. Tex. 1992) 51

In re Mount Carbon Metro. Dist., 242 B.R. 18 (Bankr. D. Colo. 1999) 26, 77, 78

In re Multiut Corp., 449 B.R. 323 (Bankr. N.D. Ill. 2011) 79

In re New Century TRS Holdings, Inc., 407 B.R. 576 (D. Del. 2009) 61, 62

In re O.P.M. Leasing Servs., 79 B.R. 161 (S.D.N.Y. 1987) 73

In re Oakwood Homes Corp., 449 F.3d 588 (3d Cir. 2006) 74, 75

Pennsylvania Dept. of Pub. Welfare v. Davenport, 495 U.S. 552 (1990) 32

In re Pierce Cnty. Hous. Auth., 414 B.R. 702 (Bankr. W.D. Wash. 2009) 26, 34, 78, 79

In re Sanitary & Improvement Dist., #7, 98 B.R. 970 (Bankr. D. Neb. 1989) 30, 31

In re Sentry Operating Co., 264 B.R. 850 (Bankr. S.D. Tex. 2001) 64

In re The Finova Grp., Inc., 304 B.R. 630 (D. Del. 2004) 62

Page

In re Thomson McKinnon Secs., 149 B.R. 61 (Bankr. S.D.N.Y. 1992) 72

Town of Belleair v. Groves, 132 F.2d 542 (5th Cir. 1942) 77

In re Trace Int'l Holdings, 284 B.R. 32 (Bankr. S.D.N.Y. 2002) 71, 72

In re Tribune Co., 472 B.R. 223 (Bankr. D. Del. 2012) 63, 64

In re Tucson Self-Storage,
166 B.R. 892 (B.A.P. 9th Cir. 1994) 42, 54, 63, 64

Union Bank v. Wolas, 502 U.S. 151 (1991) 25

United Savs. Assn. of Texas v. Timbers of Inwood Forest Assocs.,
484 U.S. 365 (1988) 31, 32

United States v. Bekins, 304 U.S. 27 (1938) 42, 43

United States v. Noland, 517 U.S. 535 (1996) 47

United States v. Ron Pair Enters., 489 U.S. 235 (1989) 32

In re Val-Mid Assocs., Case No. 4:12-bk-20519-EWH,
2013 Bankr. LEXIS 2521 (Bankr. D. Ariz. June 14, 2013) 79

In re Walat Farms, Inc., 64 B.R. 65 (Bankr. E.D. Mich. 1986) 41, 42

West Coast Life Ins. Co. v. Merced Irrigation Dist.,
114 F.2d 654 (9th Cir. 1940) 43

In re Wisconsin Engine Co., 234 F. 281 (7th Cir. 1916) 73

In re Wolf Creek Valley Metro. Dist. No. IV,
138 B.R. 610 (D. Colo. 1992) 77, 78

Wright v. City of Coral Gables, 137 F.2d 192 (5th Cir. 1943) 78

Young v. Higbee Co., 324 U.S. 204 (1945) 25

Page

Statutes and Legislative History

11 U.S.C. § 101(5) 59
11 U.S.C. § 502(b) 71, 73, 75
11 U.S.C. § 502(b)(6) 8, 77
11 U.S.C. § 506(a) 40, 41
11 U.S.C. § 507(a)(5) 59
11 U.S.C. § 901(a) 40
11 U.S.C. § 922(d) 9
11 U.S.C. § 927 9
11 U.S.C. § 928 9
11 U.S.C. § 943(b)(3) 4, 81, 82
11 U.S.C. § 943(b)(7) ....*passim*
11 U.S.C. § 1122(a) 3, 51, 53, 57
11 U.S.C. § 1123(a)(4) ....*passim*
11 U.S.C. § 1126 31
11 U.S.C. § 1129(a)(3) 4, 76, 79
11 U.S.C. § 1129(a)(7) 29, 73
11 U.S.C. § 1129(a)(9) 73
11 U.S.C. § 1129(a)(15) 73
11 U.S.C. § 1129(b) ....*passim*
11 U.S.C. § 1129(b)(1) 50, 62
11 U.S.C. § 1129(b)(2)(A) 41

Page

28 U.S.C. § 158(b) 3

28 U.S.C. § 158(c) 3

CAL. CIV. CODE § 1951.2 74

CAL. GOV'T CODE § 53760(a) 13

CAL. GOV'T CODE § 53760.3 13

STOCKTON, CAL., MUN. CODE § 16.72.260(B)(1) (2013) 20

STOCKTON, CAL., MUN. CODE § 16.72.260(C) (2013) 20

30 Stat. 544, 55th Cong., 2d Sess., ch. 541, § 12(d)(1) (1898) 29

50 Stat. 655, 75th Cong., 1st Sess., ch. 657, § 83(e)(1) (1937) 29

H.R. Rep. No. 94-686 (1975), reprinted in 1976 U.S.C.C.A.N. 539, 571...............34

H.R. Rep. No. 95-595 (1977),
reprinted in 1978 U.S.C.C.A.N. 5963, 6368 ....29, 30, 59, 74

124 Cong. Rec. H 11,100 (Sept. 28, 1978) 32

124 Cong. Rec. S 17,417 (Oct. 6, 1978) 32

Other Authorities

Fed. R. Evid. 201(d) 7

4 COLLIER ON BANKRUPTCY ¶ 506.03[4][a][iv] (16th ed. 2014) 41, 42

6 COLLIER ON BANKRUPTCY ¶ 943.03 (16th ed. 2014) 30, 34, 82

7 COLLIER ON BANKRUPTCY ¶ 1122.02 (16th ed. 2014) 57

7 COLLIER ON BANKRUPTCY ¶ 1122.03[3] (16th ed. 2014) 41, 52

7 COLLIER ON BANKRUPTCY ¶ 1129.03[3][a] (16th ed. 2014) 63

7 COLLIER ON BANKRUPTCY ¶ 1129.04[2] (16th ed. 2014) 41

5 NORTON BANKR. L. & PRAC. 3d § 90:20 (2015) 32

Page

Jim Christie, *Stockton Bankruptcy The Result of 15-Year Spending Binge*, REUTERS (July 4, 2012), *available at* http://www.huffingtonpost.com/2012/07/04/stockton-bankruptcy_n_1648634.html 12

Richard M. Hynes & Steven D. Walt, *Fair And Unfair Discrimination In Municipal Bankruptcy*, 37 CAMPBELL L. REV. 25 (2015) ....*passim*

Kurt O. Wilson, *An Open Letter To The Community* (Feb. 25, 2015), *available at* http://www.stocktongov.com/featured/feature1.html?rand=806 ....7, 34, 39

This is the Opening Brief of Appellants Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund ("Franklin").

I. PRELIMINARY STATEMENT

"Compositions under [chapter 9] envisage equality of treatment of creditors." *American United Mut. Life Ins. v. City of Avon Park*, 311 U.S. 138, 147 (1940). The City of Stockton (the "City") defied that bedrock principle through a plan of adjustment that reinstated $412 million of unfunded pensions, delivered recoveries between 52%-100% to creditors holding half a billion dollars in other claims, but discharged Franklin's $30.5 million unsecured claim in a single payment of *less than 1%* – far less any other material stakeholder. No bondholder has ever received so little in the history of municipal bankruptcy.

In confirming that discriminatory and punitive plan, the Bankruptcy Court disregarded statutory protections designed to ensure fair, equitable and non-discriminatory treatment of dissenting creditors. The Bankruptcy Code, for example, requires that a municipal plan of adjustment be "in the best interests of creditors." The Supreme Court long ago held that this requires a municipal debtor to devote a "fair" amount of "probable future revenues" to the payment of creditor claims. The City's plan, however, discharged Franklin's unsecured claim through one *de minimis* payment, with no prospect of further payment over time.

The Court erred by neglecting evidence that the City could pay Franklin from future revenues, even if it chose not to impair pensions or alter the treatment of other creditors (who also are to be repaid over time). The Court instead reduced the "best interests" test to an impotent assessment of whether the plan was "the best that can be done" for creditors collectively, without considering Franklin's harsh individual treatment.

The Code also prohibits a municipal debtor from discriminating unfairly against dissenting classes. The City gerrymandered its plan to evade that rule, classifying Franklin with retirees who voted yes in exchange for the City's agreement not to impair their pensions. The Court endorsed that gerrymander, disregarded the plan's superior treatment of retiree claims within Franklin's class, and simply failed to address the abject discrimination against Franklin.

In fact, after five days of trial, reams of briefing, and a full day of post-trial argument, the Court ignored or glossed over *all* of the major legal and factual issues raised by Franklin, issuing a cursory ruling that does violence to basic tenets of bankruptcy law and provides no guidance about important issues of municipal restructuring. It is up to this Court to restore equality and equity by reversing confirmation and directing the City to fashion fair, non-discriminatory plan treatment for Franklin.

II. BASIS OF APPELLATE JURISDICTION

This Court has jurisdiction under 28 U.S.C. §§ 158(b) and 158(c).

III. STATEMENT OF ISSUES PRESENTED AND APPLICABLE STANDARD OF APPELLATE REVIEW

Did the Bankruptcy Court err in confirming the *First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California, As Modified (August 8, 2014)* (the "Plan")? Confirmation implicates five primary issues:

1. Did the Court err in concluding that the Plan was "in the best interests of creditors" within the meaning of section 943(b)(7) of the Code, where Franklin received less than 1% of its unsecured claim despite evidence that the City could pay more from future revenues?

2. Did the Court err in concluding that the Plan satisfied sections 1122(a), 1123(a)(4) and 1129(b) of the Code, where the City gerrymandered classification to neuter Franklin's vote, provided superior recovery to claims within Franklin's class, and unfairly discriminated against Franklin by making greater payments on similarly-situated unsecured claims?

3. Did the Court err in concluding that claims for retiree health benefits payable over eighty years should not be discounted to present value, thereby reducing the distribution on Franklin's unsecured claim by more than 50%?

4. Did the Court err in concluding that the Plan was "proposed in good faith" within the meaning of section 1129(a)(3) of the Code notwithstanding the City's efforts to minimize payment to Franklin?

5. Did the Court err in concluding that section 943(b)(3) of the Code applied only to unpaid fees, allowing the City to pay approximately $20 million to professionals during the bankruptcy case without disclosure or approval?

"An order confirming a plan of reorganization is a conclusion of law subject to *de novo* review." *In re Carolina Triangle L.P.*, 166 B.R. 411, 414 (B.A.P. 9th Cir. 1994).

IV. STATEMENT OF THE CASE[1]

A. Nature Of The Case, Course Of Proceedings And Disposition In The Court Below.

The City filed a petition under chapter 9 on June 28, 2012. The list of creditors accompanying the petition identified the California Public Employees Retirement System ("CalPERS"), the City's pension administrator, as the largest unsecured creditor, with a claim for "Unfunded Pension Costs" of $147.5 million.[2] The City, however, declared that employees and retirees had "borne more than

[1] Excerpts of the record that accompany this brief are cited as "ER." Other items from the docket of the bankruptcy case are cited as "DI." Capitalized terms not otherwise defined have the meanings set forth in the Plan.

[2] ER513 (Top 20). As shown in Section IV.B.6, the City's actual unfunded pension liability was nearly triple the listed amount.

their share of the bankruptcy burden" and vowed to exempt pension claims from the restructuring process.[3] The City also assured "vendors and service providers" that they would be paid in full in the ordinary course of business "without approval required by the Bankruptcy Court" (as they were in short order). Rather than seeking to restructure all of its liabilities, the City said it would focus on "unsustainable long term debt."[4]

The Court determined the City to be an eligible chapter 9 debtor and entered an order for relief on April 1, 2013, concluding that the City was insolvent and unable to pay its debts as they came due.[5] The City then filed the initial version of a plan of adjustment that, as amended, became the Plan. The Plan made good on the City's vow to leave pensions unimpaired. It also bestowed recoveries on other unsecured creditors – through future payments over thirty years or more – with present values ranging from 52% to 100%. For Franklin's unsecured claim, however, the Plan provided for a single payment of less than 1%.

Franklin objected to confirmation. Following extensive pre-trial briefing, the Court conducted a five-day trial, received multiple post-trial submissions, and heard a day of post-trial argument. On October 1, 2014, the Court issued an oral ruling concluding that the City's unfunded pension liabilities "could be adjusted"

[3] DI1657 (City post-trial br.) at 19.

[4] ER855-56 (vendor letter); ER649-51 (5/12/14 Tr.) (Burke).

[5] *In re City of Stockton*, 493 B.R. 772, 787-91 (Bankr. E.D. Cal. 2013).

in the bankruptcy case.[6] The Court kept the matter of confirmation under submission until October 30, 2014, when it issued an oral decision overruling Franklin's objection even though the Plan did not "adjust" pensions (the largest unsecured debt) despite the City's ability to do so.[7] By subsequent oral decision, the Court denied Franklin's motion for a stay pending appeal, concluding that it could fashion effective relief – which "most certainly would involve more money for Franklin" – on remand in the event of appellate reversal.[8]

At the time of confirmation, the Court stated that it was "not planning on writing something separately."[9] Three months later, without giving a reason for the change, the Court issued an *Opinion Regarding Confirmation And Status Of CalPERS*, a fifty-four page published opinion that "supplements" the oral rulings regarding pensions and confirmation.[10] The Court entered a confirmation order that same day, followed by an amended Opinion on February 27, 2015.[11]

The Plan became effective on February 25, 2015. Confirming the evidence of its rehabilitated finances and bright future, the City declared on that day that

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[6] ER386-408 (10/1/14 Tr.).

[7] ER411-55 (10/30/14 Tr.).

[8] ER479 (1/20/15 Tr.).

[9] ER445 (10/30/14 Tr.).

[10] DI1873 (Confirmation Opinion).

[11] ER304-61 (Amended Opinion) ("Op."); ER224-303 (Confirmation Order).

"we emerge from bankruptcy a renewed city, perhaps better prepared for our future than any other city in the State."[12] This appeal ensued.

B. Facts Relevant To The Issues Presented For Review.

1. Franklin's $30.5 Million Unsecured Claim.

The Franklin funds in this appeal invest in municipal bonds and securities with the primary objective of generating tax-exempt income for fund investors, who include many retirees. They typically purchase bonds at issuance and hold them through maturity.

Consistent with that mission, in 2009 Franklin funded the entire issuance of $35 million 2009 Stockton Public Financing Authority Lease Revenue Bonds, 2009 Series A (the "Bonds"). The City used Franklin's loan to build police and fire stations, seven parks, and other important public facilities.[13] The City,

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[12] Kurt O. Wilson, *An Open Letter To The Community* (Feb. 25, 2015) [*Open Letter*] at 1, *available at* http://www.stocktongov.com/featured/feature1.html?rand=806. The Court may take judicial notice of this public communication by a party. *E.g.*, *In re Icenhower*, 755 F.3d 1130, 1142 (9th Cir. 2014) ("Judicial notice may be taken 'at any stage of the proceeding.'") (quoting Fed. R. Evid. 201(d)); *In re Homestore.com, Inc. Sec. Litig.,* 347 F. Supp. 2d 814, 817 (C.D. Cal. 2004) ("the Court may take judicial notice of press releases").

[13] ER632-33 (Official Statement); ER902-03 (Dieker).

however, made just four interest payments (and repaid no principal) before defaulting in March 2012, four months before it filed for bankruptcy.[14]

The Bonds were structured as "lease revenue" bonds. During the bankruptcy case, the City asserted that Franklin's claim was completely unsecured and should be capped at three years of debt service (less than $9 million) pursuant to section 502(b)(6) of the Code.[15] The City singled out Franklin for such treatment even though all but one of the City's other bond issues had the same or a "similar structure" as the Bonds.[16]

This unprecedented argument required Franklin to seek declaratory relief regarding the Bonds.[17] After substantial litigation, the City abruptly conceded defeat and stipulated that Franklin was entitled to an uncapped claim for the full amount of the Bonds, secured by possessory interests in the relevant "leased" property.[18] Yet, although it had represented the "estimated market value" to be

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14 ER583 (Disclosure Statement) ("DS"). The indenture trustee for the Bonds made interest payments due in March and November 2012 from a debt service reserve fund. DI504. No additional payments were made.

15 ER581 (DS).

16 ER582 (DS).

17 ER194-223 (AP docket).

18 ER622-25 (Partial Judgment); ER761-62 (Plan §§ I.A.94, 95, 101).

approximately $36.3 million at issuance,[19] the City insisted that Franklin's collateral was now worthless, requiring valuation litigation.

Ultimately, the Court valued the collateral at $4,052,000.[20] As a consequence, Franklin was allowed a secured claim of $4,052,000 and an unsecured deficiency claim of $30,480,190.[21]

2. Other Unsecured Liabilities.

At the time it filed for bankruptcy, the City had hundreds of millions of dollars of unsecured "general fund" debt in addition to Franklin's Bonds.[22]

Bond debt. For example, the City was liable for $266 million in additional unsecured (or partially secured) general fund bond debt, summarized as follows:[23]

[19] ER632 (Official Statement). As explained in Section VI.A.6, Franklin's expert found that representation to be "flawed, misleading and erroneous for any lending or extension of credit purpose." ER589, 598 (Chin Report).

[20] ER364-83 (7/8/14 Tr.).

[21] ER779-81 (Judgment); ER762-63 (Plan §§ I.A.101-102); ER225 (Confirmation Order). The allowed unsecured claim accounts for funds held in reserve by the indenture trustee for the Bonds as of the petition date. *See* Op. at 1 n.1; DI504.

[22] "General fund" debt means obligations of the City's general fund, like the Bonds, as opposed to obligations payable exclusively from special revenues or restricted funds, which were not subject to impairment in the City's case. *See* 11 U.S.C. §§ 922(d), 927, 928.

[23] ER544 (Ask).

Table 1: City Unsecured/Undersecured Debt For Borrowed Money		
Claim	**Security (possessory interests)**	**Amount (millions)**
2003 Fire/Police/Library Certificates	Police/fire stations; library	$12.6
2004 Arena Bonds	Stockton Arena	$45.1
2004 Parking Bonds	Parking structures	$31.6
2006 SEB Bonds	Eberhardt Building	$12.1
2007 Office Building Bonds	400 E. Main Office Building	$40.4
Pension Obligation Bonds	*None*	$124.3
	Total	***$266.1***

The City's largest bond issue – the Pension Obligation Bonds – was completely unsecured. The City's other bonds were "lease revenue" bonds with a "similar structure" as Franklin's Bonds.[24] At the time the Bonds were issued to Franklin with an "A" rating in 2009, Standard & Poor's gave the *same underlying rating* to those other bonds.[25]

During the case, the City refused to disclose a value for any collateral securing the other bonds,[26] and the Court overruled Franklin's request for valuation information in the City's disclosure statement.[27] City witnesses testified that *the*

[24] ER582 (DS).

[25] ER912-16 (S&P ratings). The "underlying rating" is that which removes the rating associated with the bond insurer.

[26] DI1198 (City DS rpy.) at 4.

[27] ER772-77 (11/18/13 Tr.).

City never valued any of the relevant collateral.[28] The record therefore is void of evidence establishing the extent to which the other bonds were secured, if at all.

Retiree liability. The City also had substantial prepetition debt to retirees for unfunded retirement benefits. That liability had two intertwined components. *First*, the City had promised 1,100 retirees (and a dependent each) health care benefits for life.[29] The City's Human Resources Director testified that, because there was no minimum service requirement, "an employee could work in Stockton for a few months and obtain uncapped health benefits for the rest of his or her life."[30] The benefits were "well beyond what other cities offered"[31] and City representatives described them as a "Lamborghini plan" that was, "if not the most generous, one of the most generous in the state."[32]

"The problem with conferring such a benefit was that the City did not fund it on an actuarially sound basis. The City set aside no money to fund this future liability."[33] The former City Manager thus described the health benefit program as

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[28] ER630 (Toppenberg) ("The City has not appraised any of these properties."); ER671-74 (5/13/14 Tr.) (Toppenberg).

[29] ER515, 518-21 (Haase).

[30] ER515 (Haase).

[31] ER515 (Haase).

[32] ER783 (Miller video); ER789 (Deis).

[33] ER516 (Haase).

a "Ponzi scheme."[34] Indeed, by the time of bankruptcy the program had exploded into a liability that exceeded 400% of payroll and required annual funding over 30% of payroll, much higher than obligations of peer cities.[35] The Court concluded that the retiree claims for health benefits should be allowed in a total undiscounted amount of $545 million.[36]

Second, retirees also had $289 million in prepetition claims for unfunded pensions, calculated on a market value basis excluding pensions owed to current employees.[37] Unfunded pensions were very large because the City had allowed employees to turn "pension spiking into an art form," resulting in "much larger pensions for the rest of their lives."[38]

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[34] Jim Christie, *Stockton Bankruptcy The Result of 15-Year Spending Binge*, REUTERS (July 4, 2012), *available at* http://www.huffingtonpost.com/2012/07/04/stockton-bankruptcy_n_1648634.html.

[35] ER522-25 (Haase).

[36] ER782 (Minute Order); ER458 (12/10/14 Tr.). As described in Section VI.C, the Court erred in not discounting that liability to present value.

[37] ER612 (Moore Report); ER741-44 (5/14/14 Tr.) (Moore). The unfunded pension liability to retirees was approximately $149 million using the "actual value of assets" methodology. *Id.*; Op. at 23 n.25.

[38] ER783 (Miller video); *see City of Stockton*, 493 B.R. at 779 (noting "phenomenon of so-called 'pension-spiking' in which a pension could be substantially greater than the retiree's actual final salary").

Although the City classified retiree health and pension obligations separately, the liabilities arose from the same contracts – collective bargaining agreements – and were components of the same claims.[39]

Trade debt. Finally, the City had more than $4 million in prepetition trade debt. The City paid all of it during the bankruptcy case without approval of the Court and without determining whether trade creditors would have stopped dealing with the City if not paid, whether their services could have been replaced, or whether they were "critical" to operations.[40]

3. Settlements.

Prior to bankruptcy, the City engaged in the pre-bankruptcy "neutral evaluation" mediation process required by California law.[41] During that mediation, the City proposed a restructuring through what became known as the "Ask."[42]

In the Ask, the City proposed to pay Franklin's claim over forty years from restricted funds known as public facilities fees ("PFFs"), which were not available to pay other general fund liabilities. The City projected that Franklin would "receive[] its full principal and interest payments including repayment of impaired amounts but [because payment] takes place over an extended period of time [the

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[39] ER764-65 (Plan § I.A.163); ER527-30 (TRO app.); ER532-39 (Milnes).

[40] ER654-56 (5/12/14 Tr.) (Burke); ER646-51 (5/12/14 Tr.) (Leland); ER790-92 (LRFP).

[41] *See* CAL. GOV'T CODE §§ 53760(a), 53760.3.

[42] *Stockton*, 493 B.R. at 781-83.

proposal] result[s] in a 45.5% discount on a net present value basis."[43] Franklin made a good faith counterproposal but the City neither responded nor engaged Franklin in a back-and-forth settlement dialogue.[44]

Franklin did not accept the City's "take-it-or-leave it" offer and the City commenced bankruptcy. The Court appointed Bankruptcy Judge Perris (D. Or.) as mediator for plan-related matters[45] and the City and Franklin participated in multiple mediation sessions over the next year, but no compromise was reached.[46]

The City eventually cut deals with all other material unsecured creditors.[47] Most notably for this appeal, the City reached agreement with the official committee of retirees (the Retirees Committee) regarding treatment of claims for retirement benefits. The settlement had two intertwined elements (just like the retiree claims themselves): (1) payment of $5.1 million on the unsecured health benefit claims; *and* (2) assumption and full payment of all $289 million of

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[43] ER542-43, 545-48 (Ask).

[44] *Stockton*, 493 B.R. at 783 ("Objector Franklin Advisors did make a counterproposal regarding a different bond issue, which the City 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."); ER621 (4/7/14 Tr.).

[45] Op. at 52; *Stockton*, 493 B.R. at 783; DI384 (Order Appointing Mediator).

[46] ER580 (DS); ER415 (10/30/14 Tr.); ER770-71 (11/18/13 Tr.); DI1243 (City conf. br.) at 40 n.21; DI1198 (City DS rpy.) at 1-2.

[47] Op. at 53.

unfunded pensions.[48] Full payment of pensions was the lynchpin of the settlement.[49] Considered together, according to the City's calculations, the settlement resulted in an average 70% recovery by retirees.[50]

4. The Discriminatory Plan.

The Plan memorialized the City's creditor settlements as follows:[51]

Table 2: Unsecured/Undersecured Creditor Recoveries Under The Plan

Class	Claim	Recovery	Payment
1	2003 Certificates	106.4%	Through 2048
2	2006 SEB Bonds	100% (unimpaired)	Through 2031
3	2004 Arena Bonds	96.7%	Through 2036
4	2004 Parking Bonds	85.6% (plus new collateral)	Through 2047
5	2007 Office Building Bonds	53.9% (based on creditor appraisal; City did not value)	n/a (transfer of fee simple title)
6	Pension Obligation Bonds	51.9% (plus contingent sums payable from future revenues)	Through 2053
12	***Franklin unsecured claim***	***0.93578%***	***One payment of ≈ $285,000***
12/15	Retirees (health benefits/pensions)	53%-70%	Lifetime of each retiree

[48] ER841-42 (settlement summary).

[49] ER843-46 (Retiree Committee letter); ER847-50 (Retiree Committee responses); ER871-76 (newsletter); ER877-81 (newsletter); DI1657 (City post-trial br.) at 22; DI1655 (retiree br.) at 4-5; DI1659 (SPOA br.) at 12-13.

[50] ER579 (DS) ("The elimination of City paid health benefits for current retirees and their dependents on average amounted to 30% of their total postemployment benefits.").

[51] ER617-18 (Moore Report); ER745-46 (5/14/14 Tr.) (Moore).

These recovery percentages were calculated by Franklin's expert. *The City itself never valued distributions made under the Plan*. Like its refusal to disclose collateral values, the City argued that Franklin should do its own calculations based upon information obtained in discovery.[52] Here again, the Court overruled Franklin's request for creditor recovery information in the disclosure statement.[53]

The Plan's treatment of *Franklin's* unsecured claim, however, was unambiguous. The City provided for Franklin to receive a *single* payment of just 0.93578% on its $30.5 million unsecured claim – approximately $285,000. The City justified that *de minimis* distribution by comparing it to the retiree health benefit claims, which received a total payment of $5.1 million. Using an inflated amount of $545 million for the health benefit liability – calculated without discounting to present value[54] – the City computed the retirees' percentage recovery on their health benefit claims alone (ignoring full payment of their pensions) and imposed that percentage on Franklin's unsecured claim.

The City knew that Franklin would object to receiving less than 1% on its unsecured claim. In order to avoid cramdown and the unfair discrimination test, the City neutered Franklin's "no" vote by classifying retiree *pension* claims

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[52] DI1198 (City DS rpy.) at 4-5.

[53] ER772-77 (11/18/13 Tr.).

[54] As described in Section VI.C, the present value of the prepetition health care liability was $261.9 million.

(Class 15) *separately* from retiree *health benefit* claims (Class 12). Knowing that retirees would vote in favor of the Plan due to the promise of unimpaired pensions, the City then classified Franklin's unsecured claim *together* with the health benefit claims in Class 12. At the same time, the City separately classified all other material unsecured claims (including the other bonds with "similar structures" and identical underlying ratings) so that it could provide the more favorable treatment it had negotiated for them.

Ultimately, as the City intended, Franklin's "no" vote in Class 12 was swamped by "yes" votes of 1,100 retirees who had been promised full pensions.[55]

5. The City's Ability To Pay.

Faced with a recovery of less than one cent on the dollar of its unsecured claim, Franklin objected to confirmation. In May and June 2014, the Court held a confirmation hearing that included live testimony from thirteen fact and expert witnesses (plus an additional seven via written declaration). At trial, as summarized in greater detail in Section VI.A.3, Franklin established that the City had the ability to pay much more than $285,000 on Franklin's unsecured claim, even without impairing pensions or otherwise altering the negotiated treatment of other creditors under the Plan. Among other things –

[55] DI1380 (Nownes-Whitaker) at 5 and Ex. B.

The Long-Range Financial Plan. During the bankruptcy case, City residents voted for an increase in the City sales tax rate from 8.25% to 9% ("Measure A") and an advisory measure ("Measure B") directing the City to use 35% of new sales tax revenue to fund ongoing expenses, including payments to creditors in bankruptcy.[56] Building on that anticipated new revenue, the City prepared a thirty-year forecast known as the "Long-Range Financial Plan," or "LRFP," which was the "financial underpinning of the Plan."[57]

The City designed the Long-Range Financial Plan to be a "conservative" forecast in which "variances are somewhat more likely to be 'good news' than 'bad news.'"[58] Thus, the City used "discounted" revenue projections,[59] prepared at the trough of the "Great Recession," that were well below historical average growth rates[60] and not reflective of the economic recovery already underway in the City.[61] The Long-Range Financial Plan modeled an "upside" scenario establishing that, if the City exceeded the discounted revenue projections by just a half-percent (0.5%),

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[56] ER584 (DS); ER420 (10/30/14 Tr.).

[57] ER790-827 (LRFP); ER586-87 (DS).

[58] ER790-93 (LRFP).

[59] ER660-61 (5/12/14 Tr.) (Leland).

[60] ER601-02 (Moore Report); ER696-700 (5/14/14 Tr.) (Moore); ER917-19 (revenues).

[61] ER590-97 (Chin Report); ER749-55 (5/15/14 Tr.) (Chin).

it would generate nearly an extra half billion dollars over the forecast period.[62] The City was so confident it would meet or exceed its intentionally conservative forecast that it did not bother to model any "downside" scenario.[63]

Even as conservatively forecast (including full payment of pensions and treatment of other claims as set forth in the Plan) the City projected that it would accumulate substantial cash with which it could have paid Franklin's claim in the future. The City projected that, by the end of the Long-Range Financial Plan, it would have $58 million in cash on hand *plus* $56 million in unused "contingency" funds – a total of $114 million potentially available to pay Franklin.[64] The City also forecast that, over the same period, it would spend $236 million of otherwise surplus cash on unidentified "mission critical" expenses[65] *plus* $123 million in subsidies for non-critical "entertainment venues" like the Stockton Arena, Ice

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[62] ER792 (LRFP).

[63] Financial results during the bankruptcy case confirmed this optimism. In the first year of the forecast (FY2012-13) the City's general fund revenues were $6.2 million higher and expenses were $9.7 million lower than budget – *a net positive swing of $15.9 million* in just one year. ER602 (Moore Report). Payment of that sum alone would have resulted in recovery of 52% of Franklin's unsecured claim. In the next year (FY2013-14), higher-than-anticipated property tax revenues prompted the City to increase projected revenues by $18.4 million over the first decade of the forecast. *Id.*

[64] ER602-03 (Moore Report); ER719-21 (5/14/14 Tr.) (Moore); ER921 (cash generation).

[65] ER920 (balances); ER706-14 (5/14/14 Tr.) (Moore); ER602-06 (Moore Report).

Rink, Ballpark and Theater,[66] resulting in another $359 million potentially available to make payments to Franklin.

Thus, the City's projections indicated that up to *$473 million* in cash might be available to pay Franklin over the forecast period. Extending the Long-Range Financial Plan to 2053 (the date to which the City restructured payments for the Pension Obligation Bonds) produced a projected cash balance of $179 million, $80 million in unused contingency funds, and $824 million in expenditures on unsubstantiated "mission critical" expenditures, resulting in more than a *billion dollars* of cash potentially available to pay Franklin's claim over time.[67] The Plan, however, provided for nothing to be paid to Franklin beyond the effective date.

Public Facility Fees. The City also could have paid Franklin over time from restricted public facility fees, which are not general funds (and hence not reflected in the Long-Range Financial Plan) but are legally available to pay Franklin's Bonds.[68] This was not a novel concept. The City sold the Bonds with the representation that PFFs would pay all of the debt service[69] and, as noted, proposed to pay Franklin with future PFF revenues during pre-bankruptcy mediation.

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[66] ER609 (Moore Report); ER729-30 (5/14/14 Tr.) (Moore).

[67] ER920 (balances); ER706-14 (5/14/14 Tr.) (Moore); ER605-06 (Moore Report).

[68] ER547 (Ask); STOCKTON, CAL., MUN. CODE §§ 16.72.260(B)(1), (C) (2013).

[69] ER635 (Official Statement).

Although diminished from their pre-recession peak, PFF revenues were projected to increase as the City's housing market recovered. The City's consultants forecast a sustained long-term average of 700 single family residence permits per year,[70] which would produce far more PFF revenue than needed to pay Franklin in full. Even with new home sales at existing levels, PFFs generated more than $1 million a year that could have been paid to Franklin.[71] The Plan, however, provided for none to satisfy Franklin's claim.

6. The Pension Ruling And Confirmation.

By any measure, the City's prepetition pension obligations were very large. Its total unfunded petition date pension liability was nearly $412 million on a market value basis.[72] The Long-Range Financial Plan projected that the City's annual pension payments would triple within a decade (from $14.1 million to $42.4 million) and then climb by another $12 million during the following decade.[73] Pension payments were projected to consume 18.5% of the City's general fund within eight years, with contributions to the safety plan comprising 57.1% of payroll, well above historical norms and peer city liabilities.[74]

[70] ER831-34 (EPS Report); ER793 (LRFP).

[71] ER607-08 (Moore Report); ER724-28 (5/14/14 Tr.) (Moore).

[72] Op. at 23 n.25. As noted, $289 million was attributable to existing retirees.

[73] ER822-27 (LRFP).

[74] ER613-16 (Moore Report); ER739-40 (5/14/14 Tr.) (Moore).

Despite this, the City insisted that it must "continue to honor its obligations to its employees and retirees to fund employment retirement benefits under the CalPERS Pension Plan."[75] Franklin argued that the City could not discharge Franklin's unsecured claim through a negligible 1% payment while assuming the much larger pensions *in toto*. CalPERS responded by arguing that pensions were immune from impairment, putting the issue before the Court.[76] Ultimately, the Court concluded that "pensions may, as a matter of law, be modified by way of a chapter 9 plan of adjustment."[77]

However, despite the City's ability to impair pensions and the discriminatory treatment of Franklin's unsecured claim in comparison to unimpaired pensions and other unsecured City debts, the Court overruled Franklin's objection and confirmed the Plan. The Court's perfunctory ruling – first set forth in oral findings and then memorialized in the last five pages of its written Opinion – glossed over all of the legal issues raised by Franklin and ignored all evidence of the City's ability to pay Franklin over time. It must be reversed for the reasons set forth below.

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[75] ER585 (DS).

[76] Op. at 7 n.6 ("For whatever reason, CalPERS chose to intrude itself into this case and repeatedly (at virtually every hearing) insist that it is impossible as a matter of law to reject or modify its pension administration contract and the related pensions. This opinion answers the question that CalPERS kept thrusting upon the Court.").

[77] Op. at 54; *see* ER386-408 (10/1/14 Tr.).

V. SUMMARY OF ARGUMENT

Disregarding the Code's "central policy" of equality among similarly-situated creditors, the Court erred in confirming the City's discriminatory and inequitable Plan for at least five independent reasons.

1. The "best interests" test (Section VI.A). The Code requires that a chapter 9 plan be "in the best interests of creditors." To satisfy this standard, the plan must provide each dissenting creditor with a fair recovery paid over time from the debtor's future revenues.

The Court erroneously assessed creditor recoveries *collectively*, ignoring the Plan's treatment of Franklin *individually*. The Court compounded that error by neglecting evidence that the City could pay much more than 1% on Franklin's unsecured claim over time, even while honoring all other commitments under the Plan. The Court also erred by (a) considering Franklin's combined recovery on its secured and unsecured claim, in violation of the bifurcation required by the Code; and (b) misunderstanding the City's other liabilities and misconstruing the Plan's treatment of them.

2. Improper classification, disparate treatment, and unfair discrimination (Section VI.B). The Code ensures equality among creditors by forbidding classification of dissimilar claims together, requiring the same treatment of claims within the same class, and prohibiting unfair discrimination against a dissenting

class. The City violated all three mandates by classifying Franklin's unsecured claim together with dissimilar retiree health benefit claims in order to neuter Franklin's vote, providing more favorable recoveries on the retiree claims in Franklin's class, and distributing just 1% on Franklin's unsecured claim notwithstanding 52%-100% recoveries by similarly-situated unsecured claims.

The Court erred by permitting the gerrymander and disparate treatment of claims within Franklin's class, thus concluding that the City could discriminate freely because Franklin's gerrymandered class had voted to accept the Plan.

3. Failure to discount retiree health benefit claims (Section VI.C). The City designed the Plan so that Franklin's recovery would decrease as the amount of retiree health benefit claims increased. The City then proposed to allow the health benefit claims without discounting them to present value, even though benefits were payable over eighty years. This doubled the size of the liability reflected in the City's audited financial statements and halved the payment to be made on Franklin's unsecured claim. The Court erred by allowing the claims without discounting, contrary to holdings of the Third, Sixth, Seventh and Tenth Circuits that the Code "mandates that all claims for future payment must be reduced to present value."

4. Lack of good faith (Section VI.D). The Code requires that a plan be "proposed in good faith," mandating fair and evenhanded treatment of *all* creditors.

The City did not act in good faith because it actively minimized the distribution on Franklin's claim. The Court erred by endorsing the City's punitive conduct.

5. No disclosure or approval of fees (Section VI.E). The Code requires that "all amounts to be paid by the debtor . . . for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable." The Court disregarded that requirement and confirmed the Plan without disclosure or approval of any of the approximately $20 million the City paid to professionals during the bankruptcy case.

Taken together, these errors amount to a gross distortion of bankruptcy law and compel reversal of confirmation.

VI. ARGUMENT

"Equality of distribution among creditors is a central policy of the Bankruptcy Code." *Begier v. IRS*, 496 U.S. 53, 58 (1990); *e.g., Union Bank v. Wolas*, 502 U.S. 151, 161 (1991) ("policy of favoring equal distribution"); *Young v. Higbee Co.*, 324 U.S. 204, 210 (1945) ("historically one of the prime purposes of the bankruptcy law has been to bring about a ratable distribution among creditors of a bankrupt's assets"); *Clarke v. Rogers*, 228 U.S. 534, 548 (1913) ("Equality between creditors is necessarily the ultimate aim of the Bankrupt Law."). This is true in municipal bankruptcy cases. *Avon Park*, 311 U.S. at 147. Consequently, "[a]ny doubt" regarding chapter 9's confirmation requirements "is

best resolved in accord with the Bankruptcy Code's equal distribution aim." *Howard Delivery Serv. v. Zurich Am. Ins.*, 547 U.S. 651, 667 (2006).

The Bankruptcy Court lost sight of that mandate. By confirming a plan that provided a 1% distribution on Franklin's unsecured claim in the face of recoveries of 52% to 100% for other unsecured claims, the Court neglected basic statutory protections designed to implement the policy of equal treatment. The Court's errors of law, and the erroneous findings of fact on which those conclusions were premised, require reversal and remand with a direction for the City to fashion equitable plan treatment for Franklin.

A. The Court Erred In Concluding That The Plan Was In The Best Interests Of Creditors.

A court may not confirm a chapter 9 plan unless it "is in the best interests of creditors." 11 U.S.C. § 943(b)(7).[78] In its oral ruling, the Court concluded that the Plan satisfied this standard:

> The case law that is involved says, in effect, that [the Plan] must be the best possible plan under the circumstances and must be doing the best that is available under the circumstances. So I have looked long and hard at the history of this case and the responses that have been made and considered the alternatives, including the alternative of

[78] The burden was on the City to establish this and all other statutory requirements for confirmation. *E.g.*, *In re Pierce Cnty. 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 In re Ambanc La Mesa L.P.*, 115 F.3d 650, 653 (9th Cir. 1997) (same burden on chapter 11 debtor).

> putting the whole situation back to square one, which is what would be required, and going – and running up many more millions of dollars in terms of expenses for the City for what I view as probably not likely very much difference, and that's because this Plan, I'm persuaded, is about the best that can be done – or is the best that can be done in terms of the restructuring and adjustments of the debts of the City of Stockton; therefore, I conclude that Section 943(b)(7) has been satisfied because the Plan is in the best interest of creditors . . . .[79]

That is the Court's entire legal analysis. The written Opinion does not mention the best interests test at all, merely restating that "no better plan is likely under the circumstances."[80]

Respectfully, the Court missed the point. The best interests test protects *individual* dissenting creditors like Franklin, and it requires a municipal debtor to devote a fair share of future revenues to payment of a dissenter's claim. In concluding that the Plan was "the best that can be done in terms of the restructuring and adjustments of the debts of the City of Stockton," however, the Court only looked at recoveries of creditors *collectively*.

The Court considered the degree to which it believed "employees and retirees" were "sharing the pain with capital markets creditors," and concluded that "the value of what employees and retirees lose under the plan is greater than what

[79] ER441-42 (10/30/14 Tr.).

[80] Op. at 53-54.

capital markets creditors lose."[81] The Court explained that its "ultimate rationale for confirmation of the plan in terms of just the general overall fairness of the situation was that everyone, with the exception of Franklin, had come to the table and given up quite a bit."[82]

As explained in Section VI.A.5, the Court's assessment of the relative "pain" endured by groups of creditors was clearly erroneous. More fundamentally, the Court erred by focusing on aggregate "losses" of creditor *groups* rather than the Plan's specific treatment of Franklin's *individual* unsecured claim.[83] In so doing, the Court ignored overwhelming evidence that the City could pay much more than 1% on Franklin's unsecured claim, regardless of whether or not the Plan otherwise was "the best that can be done" for creditors generally.

1. The Best Interests Test Protects Individual Creditors.

The phrase "best interests of creditors" is a familiar one. It embodies the core requirement that a plan provide recovery superior to that otherwise available to dissenting creditors. The inquiry is specific to each dissenting creditor, even those whose claims are classified within a class that accepted the plan, and it does

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[81] Op. at 50; *see id.* 2 ("The value given up by retirees who accepted the plan is on the order of ten times the value lost by Franklin.").

[82] ER474 (1/20/15 Tr.).

[83] Op. at 4 (comparing "net reductions" in employee compensation with "net reductions for capital markets creditors") and 50 (comparing alleged $300 million in retiree losses with Franklin's $30 million loss).

not turn on the interests of creditors collectively. *E.g.*, *Bank of Am. Nat'l Trust & Savs. Ass'n. v. 203 N. LaSalle St. P'ship*, 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."); *In Re Bonner Mall P'ship*, 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); *In re Adelphia Commc'ns Corp.*, 361 B.R. 337, 364 (S.D.N.Y. 2007) ("If 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.").

This creditor-specific test has been part of American bankruptcy for more than a century.[84] In the 1978 overhaul of the Bankruptcy Act, Congress clarified that "best interests" in chapter 11 requires dissenting creditors to receive at least what they would in a chapter 7 liquidation. 11 U.S.C. § 1129(a)(7); H.R. Rep. No. 95-595, at 412 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6368 (this "incorporates the former 'best interests of creditors' test found in chapter 11, but spells out precisely what is intended"). At the same time, through section 943(b)(7), Congress maintained the general "best interests" terminology in

[84] *See* 30 Stat. 544, 55th Cong., 2d Sess., ch. 541, § 12(d)(1) (1898) (requiring a plan be "for the best interests of the creditors") (Chapter XI); 50 Stat. 655, 75th Cong., 1st Sess., ch. 657, § 83(e)(1) (1937) (requiring a plan be "fair, equitable, and for the best interests of the creditors and [] not discriminate unfairly in favor of any creditor or class of creditors") (Chapter IX).

chapter 9 cases. Because liquidation "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.'" *Id*. at 400 (emphasis added).

Carried forward in its "traditional form," the purpose remained unchanged. As in chapter 11, the "best interests" test operates as the baseline protection for individual dissenting creditors in a chapter 9 reorganization. *Section 943(b)(7) "is designed to protect the dissenting minority of a class that has accepted the plan*." 6 COLLIER ON BANKRUPTCY ¶ 943.03[7][a] (16th ed. 2014) (emphasis added).

This has always been the rule. Seventy years ago, the Supreme Court held that "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 v. Everglades Drainage Dist.*, 319 U.S. 415, 419 (1943) (emphasis added) (quotations and citations omitted); *see, e.g.*, *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940) (reversing confirmation because plan was not in "best interests" of dissenting bondholder despite acceptance by 90% of bondholders); *In re Sanitary & Improvement Dist.,* #7, 98

B.R. 970 (Bankr. D. Neb. 1989) (denying confirmation because plan was not in "best interests" of individual dissenting creditors despite acceptance "by all classes of creditors").

Disregarding that history, the City argued below that "[t]he plain language of [section 943(b)(7)] does not reference individual dissenting creditors" and "Congress could have made section 943(b)(7) creditor-specific if it had so intended."[85] Section 943(b)(7), however, requires that a plan be "in the best interests of creditors" – each and every one of them. There is nothing in the statutory language or legislative history that requires assessment of creditor interests collectively rather than individually. Creditors' *collective* interests *already* are protected by the Code's requirement of majority class acceptance and the "cramdown" provisions invoked if a class rejects a plan. 11 U.S.C. §§ 1126, 1129(b). The City's interpretation renders the best interests test meaninglessly duplicative of those other confirmation requirements.

It also runs afoul of the Supreme Court's admonition not to "interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, 502 U.S. 410, 419 n.4 (1992) (citing *United Savs. Assn. of Texas v. Timbers of Inwood Forest Assocs.*,

[85] DI1309 (City supp. conf. br.) at 19, 21.

484 U.S. 365, 380 (1988); *Pennsylvania Dept. of Pub. Welfare v. Davenport,* 495 U.S. 552, 563 (1990); *United States v. Ron Pair Enters.,* 489 U.S. 235, 244-45 (1989)). The City urged a "major change in pre-Code practice" but could not point to anything evincing legislative intent for such a radical reworking of this fundamental bankruptcy concept.

Despite this, the Bankruptcy Court seemingly endorsed the City's interpretation, considering aggregate "losses" of creditor *groups* rather than the Plan's specific treatment of Franklin's individual unsecured claim. This deprived Franklin of one of the basic protections of the Code.

2. The Best Interests Test Requires A Fair Recovery Over Time.

By focusing on "shared pain" and collective losses, the Court failed to address what "best interests" actually requires in chapter 9. In particular, the Court neglected that, in enacting chapter 9, Congress directed courts to apply *existing* law as set forth in the seminal *Kelley* and *Fano* decisions: "[I]t is expected that the court will be guided by standards set forth in *Kelley* . . . and *Fano* . . . [and] make findings as detailed as possible to support a conclusion that this test has been met." 124 Cong. Rec. H 11,100 (Sept. 28, 1978), S 17,417 (Oct. 6, 1978); *see* 5 NORTON BANKR. L. & PRAC. 3d § 90:20 (2015) ("The legislative history suggests that determination of the best interests of creditors in a Chapter 9 case may be guided by reference to two cases.") (citing *Kelley* and *Fano*).

In *Kelley*, the plan provided bondholders a recovery of 57%. *Kelley*, 319 U.S. at 417-18. A "very small minority" of bondholders objected. *Id.* The Supreme Court reversed confirmation because there was no evidence that the plan was in the best interests of creditors:

> [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 the satisfaction of creditors*.

Id. at 419-20 (emphasis added).

In *Fano*, the Ninth Circuit reversed confirmation because the plan was not in the best interests of a single dissenting bondholder. The Circuit concluded that payment of 62.5% "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 *Kelley* and *Fano* is consideration of the municipal debtor's *future* ability to pay. A plan that 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 an 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. The legislative history confirms that –

> The petitioner must exercise its taxing power to the fullest extent possible for the benefit of its creditors. *Fano v. Newport Heights Irr. Dist.*, 144 F.2d 563 (9th Cir. 1940). 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.

H.R. Rep. No. 94-686, at 33 (1975), *reprinted in* 1976 U.S.C.C.A.N. 539, 571.

At the core, the test establishes "a floor requiring a reasonable effort at payment of creditors by the municipal debtor." *Pierce Cnty.*, 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*." 6 COLLIER, *supra,* ¶ 943.03[7][a] (emphasis added); *see, e.g.*, *In re Barnwell Cnty. Hosp.*, 471 B.R. 849, 869 (Bankr. D.S.C. 2012) (debtor must prove that the plan "affords *all* creditors the potential for the *greatest economic return* from Debtor's assets") (emphasis added).

3. The Plan Fails The Best Interests Test.

The City knew this law. *After* emerging from bankruptcy, the City catalogued its "hard work" by explaining that "municipal bankruptcy does not erase or 'wipe out' debt."[86] Yet, that is exactly what the City's Plan did to Franklin. It wiped out Franklin's unsecured claim through a single payment of

[86] *Open Letter*, *supra*, at 2.

under 1%, despite overwhelming evidence that the City *could* have devoted much more than $285,000 to pay that claim over the thirty or more years the City agreed to pay the claims of other unsecured creditors.

Long-Range Financial Plan. For example, the City's own financial forecast – the "conservative" Long-Range Financial Plan that represented the "financial underpinning" of the Plan – predicts that the City will accumulate hundreds of millions of dollars of cash over the projection period, even while spending hundreds of millions more on unspecified "mission critical" expenses and "entertainment venues" *and* while making all payments to creditors called for under the Plan (including all pension payments).

The Plan, however, did not provide for any of those future revenues to be paid to Franklin. Instead, the City designed the Long-Range Financial Plan to be a "living" forecast that it could revise whenever "inspiration strikes."[87] The forecast was built to consume every surplus dollar through "mission critical" expenses that the City could not identify, much less quantify. The "mission critical" expense category was a plug number, representing every penny in excess of the City's cash reserve target (itself an arbitrary figure set far above the City's historical average and official reserve policy).[88] The City never itemized the alleged "mission

[87] ER652-53, 657-59 (5/12/14 Tr.) (Leland).

[88] ER654-56 (5/12/14 Tr.) (Leland); ER602-06 (Moore Report); ER706-17 (5/14/14 Tr.) (Moore); ER828-29 (general fund reserve policy).

critical" expenses, much less prepared a budget or forecast of them.[89] It just assumed that every extra dollar generated over the next thirty years would be spent on things other than repayment of Franklin.

Franklin's financial expert (Charles Moore) explained that, "[t]aken together, the inclusion of an annual contingency in the LRFP, the adherence to a 15% minimum cash balance when 10% is consistent with the City's stated recommended policy (which itself is well in excess of the City's past practice), the diversion of cash to so-called 'mission critical spending' once it reaches that 15% level, and the conservatism embedded in the City's LRFP obscure that *the City is actually hoarding cash in its LRFP*. That cash could be used to pay the City's obligations in respect of the Franklin Bonds."[90] Ultimately, Mr. Moore opined that, based solely on the Long-Range Financial Plan – *without need for further tax increases or expense cuts and while honoring all of its other obligations under the*

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[89] The City stated only that "[t]he City uses 23-year-old accounting and financial payroll systems that need desperately to be replaced; the City's workers' compensation funds are still running a deficit; and deferred maintenance is still millions of dollars a year. The City remains in a service-insolvent state for libraries, administrative support, and recreation." DI1712 (City post-trial rpy. br.) at 9-10 (quotations and citations omitted). The City never quantified any of those alleged needs.

[90] ER606 (Moore Report) (emphasis added); ER692-721 (5/14/14 Tr.) (Moore); ER921 (cash generation).

Plan – "the City can afford to pay Franklin a significant percentage, if not all, of the City's obligations in respect of the Franklin Bonds."[91]

The Court never mentioned this testimony, the Long-Range Financial Plan, or the City's ability to pay in its oral findings or published Opinion. It simply ignored all of the relevant evidence.

Public Facility Fees. The City also will generate tens of millions of dollars of restricted public facility fees over the course of the projection period. The PFFs are not general funds that could be used to pay other creditor claims, but are available to pay Franklin's claim. At the time it sold the Bonds to Franklin, the City represented that PFFs were the "anticipated funding mechanism" and would "be sufficient to pay the debt service" on the Bonds.[92] The Long-Range Financial Plan confirms that PFFs "were expected to be used as an internal source of funds as available" to pay the Bonds.[93]

Consistent with that fact, before bankruptcy the City proposed to pay Franklin with future PFF revenues that it valued as an aggregate recovery

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[91] ER600 (Moore Report); ER688-730 (5/14/14 Tr.) (Moore).

[92] ER900 (S&P presentation); ER635 (Official Statement).

[93] ER808 (LRFP). At trial, a City witness contradicted this record and claimed that no PFFs could be used to make payments on Franklin's claim. Ultimately, however, even that misinformed witness conceded that PFFs would be available after payment of certain short-term expenditures. ER675 (5/13/14 Tr.) (Chase).

of 54.5%,[94] and during the bankruptcy case City staff stated that *it would "be seen as a sign of bad faith" if the City failed to devote PFFs to payment of Franklin's Bonds*.[95] Yet, the Plan provided for *no* future PFFs to pay Franklin's claim. Instead, the City kept them all for itself.[96]

Even at current depressed levels, PFFs generate more than $1 million a year that could be devoted to payment of Franklin, which would make "a meaningful contribution to the Franklin Bonds debt service obligation . . . if the City chose to use them to satisfy that obligation."[97] Here again, the Court ignored this evidence.

* * *

In sum, the evidence showed that the City *could* spare additional cash to repay Franklin's unsecured claim over time. It just chose not to do so. This was confirmed after trial when the Court valued Franklin's collateral at $4,052,000, giving Franklin an allowed secured claim in that amount. After that ruling, the City amended the Plan to provide for full immediate payment of the secured claim. In other words, the City found an extra $4 million – in just the first year of its

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[94] ER542-43 (Ask).

[95] ER836 (FY2013-14 budget) (emphasis added).

[96] Incredibly, the City used PFFs during the case to pay its bankruptcy lawyers, on the theory that expenses incurred in cramming down the Plan were legitimate "project costs" for properties funded by the Bonds (but repayment of Franklin was not). ER857-66 (FY2012-13 chapter 9 expenses); ER867-68 (FY2013-14 Chapter 9 expenses); ER644-45 (5/12/14 Tr.) (Burke).

[97] ER608 (Moore Report); ER724-28 (5/14/14 Tr.) (Moore).

thirty-year forecast – to pay Franklin's secured claim, notwithstanding its prior claim of prolonged poverty as justification for not paying more than 1% of Franklin's entire claim.

The City exited bankruptcy with a bold declaration that "[o]ur future is bright as we move our city forward toward a vibrant and healthy future."[98] Given that bright, healthy and vibrant future, the City surely had the ability to wring more than $285,000 out of the "living" Long-Range Financial Plan over the next thirty years had it so desired. The City's duty as a chapter 9 debtor was to do just that, and the Court erred by concluding that the City did not need to make any further effort to pay Franklin a fair recovery.

4. The Court Improperly Lumped Together Franklin's Secured And Unsecured Claims.

Although not explicitly stated, the Court's conclusion that the Plan was "the best that can be done" seemingly was premised on its conclusion that Franklin's *total* recovery on its secured and unsecured claim represented an "overall return [that] is not so paltry or unfair as to undermine the legitimacy of classification in the plan or the good faith of the plan proponent."[99] The Court stated that "[i]t's not appropriate to say, well, Franklin Fund is only getting less than one percent on the

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[98] *Open Letter*, *supra*, at 4.

[99] Op. at 54.

dollar. You have to look at the combination of the secured and unsecured claim."[100]

The Court made both factual and legal errors in this regard. Factually, the Court ascribed a "17.5 percent overall return" to Franklin.[101] That "overall return," however, included more than $2 million of bond proceeds held by the indenture trustee in a reserve account *funded by Franklin* for the sole purpose of providing funds to repay the Bonds on default or at maturity.[102] The City never had access to those funds; the indenture trustee simply returned Franklin's money.[103] As a consequence, Franklin's "overall return" *from the City* on its secured and unsecured claims was $4,337,227, approximately 12.5% (not 17.5%) of its claim.

Legally, section 506(a) of the Code requires the claim of an undersecured creditor like Franklin to be bifurcated into a secured claim and an unsecured claim. 11 U.S.C. § 506(a) (secured creditor has "a secured claim to the extent of the value of such creditor's" collateral and "an unsecured claim to the extent that the value of such [collateral] is less than the amount of" the creditor's allowed claim);[104] *In re Loop 76, LLC*, 465 B.R. 525, 529 n.4 (B.A.P. 9th Cir. 2012) (undersecured

[100] ER431 (10/30/14 Tr.).

[101] Op. at 54.

[102] Op. at 1 n.1 and 53.

[103] ER870 (Indenture § 5.05).

[104] All cited provisions made applicable to chapter 9 by section 901(a) of the Code.

claim is "bifurcated into two claims – one secured and one unsecured"); *In re Arnold & Baker Farms*, 177 B.R. 648, 655 (B.A.P. 9th Cir. 1994) (Section 506(a) "requires the bankruptcy court to bifurcate a claim into *separate and independent* secured claim and unsecured claim components.") (emphasis added); *In re Glenn*, 796 F.2d 1144, 1147 (9th Cir. 1986) (bifurcated claims considered separately).

The Plan's treatment of those secured and unsecured claims must be analyzed separately. Thus, for example, bifurcated claims must be classified separately. 7 COLLIER, *supra,* ¶ 1122.03[3] ("a plan of reorganization must separately classify nonpriority prepetition unsecured claims [and] secured claims"). If the creditor votes against the plan, the secured claim must be paid in full. 11 U.S.C. § 1129(b)(2)(A); 7 COLLIER, *supra,* ¶ 1129.04[2] (cramdown "entails: payment in full of the secured claim"). Most importantly, the unsecured deficiency claim must receive treatment that complies with the standards applicable to other unsecured claims. *In re Walat Farms, Inc.*, 64 B.R. 65, 69 (Bankr. E.D. Mich. 1986) ("[T]o the extent the undersecured creditor has an unsecured claim under § 506, he and [each unsecured] creditor are in the same position. Both the undersecured and unsecured creditor enjoy equal protection of their claims under the Code."). "*The mere fact that an unsecured claim was once part of a bifurcated secured obligation should not justify substantial differentiation in the treatment of*

the unsecured claim as compared to other unsecured claims." 4 COLLIER, *supra,* ¶ 506.03[4][a][iv] (emphasis added).

Accordingly, courts analyze treatment of a creditor's unsecured deficiency claim independently from treatment of the creditor's secured claim, without consideration of the creditor's combined "overall return." *See, e.g.*, *In re Tucson Self-Storage*, 166 B.R. 892, 898 (B.A.P. 9th Cir. 1994) (denying confirmation where plan discriminated against unsecured deficiency claim despite payment in full of secured claim); *In re Barney & Carey Co.*, 170 B.R. 17, 25-26 (Bankr. D. Mass. 1994) (same); *In re Creekside Landing, Ltd.*, 140 B.R. 713, 714-16 (Bankr. M.D. Tenn. 1992) (same); *In re Beauchesne*, 209 B.R. 266, 275 (Bankr. D.N.H. 1997) (considering best interests test solely with reference to amount paid on unsecured deficiency claim). Simply put, "the rights of the undersecured creditor to protect or satisfy its unsecured claim are the same as those of a general unsecured creditor." *Walat Farms*, 64 B.R. at 69.

The Court erred by ignoring Franklin's *independent* rights as the holder of a $30.5 million unsecured claim and instead viewing the "best interests" test through the lens of Franklin's combined "overall return."[105]

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[105] In any event, Franklin's "overall return" paled in comparison to that of other creditors. In fact, the "overall return" on Franklin's Bonds is unprecedented in the history 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 (57% return); *United States v. Bekins*, 304 U.S. 27, 46

5. The Court Misunderstood The City's Other Liabilities And The Plan's Treatment Of Them.

The Court compounded its errors by misapprehending the City's other liabilities and the Plan's treatment of them.

"Capital markets" claims. For example, the Court justified the Plan's treatment of Franklin by comparing Franklin's nonbankruptcy rights with those of other bondholders: "Franklin differs from the other capital markets creditors in that its $35,080,000.00 in bonds were issued without equivalent collateral. It turned out that the collateral was worth only $4,025,000.00, which sum is being paid in full by the City. . . . The rest is unsecured debt to be paid the same portion of 1 percent as all other unsecured creditors, including the retirees on their $550 million in terminated health benefits."[106]

There are two clear errors in that statement. *First*, there is no evidence of the value of collateral held by other bondholders. The City did not appraise any collateral and refused to ascribe a value to it. The Court's statement that other

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(1938) (60%); *Fano*, 114 F.2d at 564 (62.5%); *West Coast Life Ins. Co. v. Merced Irrigation Dist.*, 114 F.2d 654, 658 (9th Cir. 1940) (51.5%); *Bekins v. Lindsay-Strathmore Irrigation Dist.*, 114 F.2d 680, 685 (9th Cir. 1940) (60%). Modern cases have produced even greater recoveries, including full recovery of principal in the two largest prior California chapter 9 cases (County of Orange and City of Vallejo).

[106] Op. at 53; *see id.* at 4 ("All capital markets creditors, except Franklin, accepted a package of restructured bond debt in impairments reflecting their relative rights in collateral.").

bondholders took "equivalent collateral" is unsupported. In fact, Standard & Poor's gave the City's other lease revenue bonds the *same underlying rating* as Franklin's Bonds, indicating equivalency in prospects of recovery from the City.

Second, the City's largest bond issue – the $124.3 million Pension Obligation Bonds – was *entirely unsecured* with no collateral at all. Yet, the Plan provided a recovery of 52% on the Pension Obligation Bonds. Moreover, the City paid all of its $4 million prepetition trade debt prior to confirmation. The Court's statement that Franklin's unsecured claim is "to be paid the same 1 percent as all other unsecured creditors" is simply false.

<u>"Capital markets" treatment</u>. The Court also apparently believed that the Plan's treatment of other bondholders was appropriate because they cut deals in which "[p]ayments were adjusted, terms were extended by about a decade, bond debt was reduced, the City's pledge of its general fund revenues as collateral was extinguished, and the City obtained the use of such facilities as its new city hall that had been taken over by creditors."[107]

This too demonstrates a lack of understanding of the Plan. "[T]he City's pledge of its general fund revenues as collateral" was *not* "extinguished" for *four*

[107] Op. at 52; *see* ER416 (10/30/14 Tr.) ("the City's general fund will now not be responsible for backing up most of the bond issues where it had previously been doing so").

of the six applicable bond issues. The City's general fund remains responsible for future payments in respect of the –

- $12.6 million 2003 Fire/Police/Library Certificates (106% recovery under the Plan);
- $45.1 million 2004 Arena Bonds (96.7% recovery);
- $12.1 million 2006 SEB Bonds (100% recovery); and
- $124.3 million Pension Obligation Bonds (51.9% recovery).[108]

Moreover, agreement by other bondholders to "extend terms" does not justify the Plan's treatment of Franklin. Franklin received a single payment with no additional payment over time from future revenues. Franklin argued that its unsecured claim *should* be paid over time on terms comparable to that afforded the other bondholders.

Employees and retirees. Finally, the Court fixated on "the value of what employees and retirees lose under the plan" in comparison to "what capital markets creditors lose."[109] It referred many times to collective bargaining agreements in which "there were considerable changes and concessions that the unions made regarding compensation and conditions of employment," resulting in

[108] ER664-70 (5/13/14 Tr.) (Dieker).

[109] Op. at 50.

"compensation [that] is not above market" and "quite substantial concessions . . . made on the income side" by employees.[110]

None of that justified the Plan's treatment of Franklin. For one thing, concessions made by current employees merely reduced "above market" pay and benefits to a "market" level.[111] The City's financial difficulties were the result, in part, of "encrustation of a creeping multi-decade, opaque pattern of *above-market* compensation of employees."[112] Moreover, the City's new collective bargaining agreements relate to *postpetition* obligations. The City's *prepetition* obligations were paid in full with no concessions whatsoever.

Whatever concessions were made also were *temporary*. All of the collective bargaining agreements negotiated during the bankruptcy case *already expired* and are subject to renegotiation,[113] with employee bargaining groups able to negotiate to recoup prior concessions. The City anticipates this.[114] Temporary concessions intended to bring compensation down to a market level are not comparable to the *permanent* 99% impairment of Franklin's unsecured claim.

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[110] ER414, 422, 430 (10/30/14 Tr.).

[111] ER430 (10/30/14 Tr.) ("The compensation for the employees in Stockton was above what comparable municipalities within the market were paying.").

[112] *City of Stockton*, 493 B.R. at 779 (emphasis added).

[113] ER908 (Goodrich).

[114] The Chief of Police testified that officers are agitating to get "their previous 20-30% cuts restored." ER628 (Jones).

Moreover, the Court's focus on concessions by *current employees* obscured the Plan's treatment of *retirees*. Retirees provide no ongoing services to the City and have claims that relate exclusively to non-assumed *prepetition* contracts. The City "cannot justify the preferential treatment of retirees because they will not contribute to the reorganization."[115] Yet, the Plan provided recoveries between 53%-70% to the 1,100 retirees with health care benefits, and gave 100% recoveries to an additional 1,300 retirees with claims only for unfunded pensions. Concessions by retirees do not justify Franklin's treatment under the Plan.[116]

The Court appeared to believe that employees and retirees, as a group, simply deserved a priority recovery. As one commentator noted, this amounts to "categorical subordination" of the sort prohibited by the Supreme Court in *United States v. Noland*, 517 U.S. 535 (1996):

> [C]ourts cannot properly use the unfair discrimination standard to favor an entire category of claims, such as those of active and former workers. *[The] rationale for barring categorical subordination also bars categorical discrimination*. . . . *Noland*'s rationale does not

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[115] Richard M. Hynes & Steven D. Walt, *Fair And Unfair Discrimination In Municipal Bankruptcy*, 37 CAMPBELL L. REV. 25, 29 (2015) [*Fair and Unfair Discrimination*]; *id.* at 46 ("This is certainly true of the retirees, as they contribute nothing to the city's reorganization; they have retired.").

[116] The City defended assumption of unfunded pensions by claiming that "[t]he maintenance of pensions is critical to the City in order to retain employees – particularly police officers – rather than losing them to other local governments." ER578 (DS). This rationale has no application to *retirees*, who no longer work for the City.

> allow a plan to favor a class solely because its members are retirees or active workers.
>
> [Accordingly], a court could not properly reason that active and former workers, as a group, are more deserving of recovery than general creditors. This categorical subordination is inherently legislative in nature. . . . *[C]reating a judicial priority for retirement claims is inconsistent with the Code.*

Fair and Unfair Discrimination, *supra*, at 53-54 (emphasis added) (footnote omitted).

6. The Court Relied On Other Erroneous Findings.

The Court made several other clearly erroneous findings that apparently impacted its determination that the Plan was in the best interests of creditors.

No "sweetener fund" available to Franklin. For example, the Court found it "interesting that the settlement with the other capital markets creditors included an additional 'sweetener' fund that would become available by about 2040 if the City prospers. Part of that fund was offered to Franklin and held open for Franklin to join even during the confirmation hearing, but Franklin refused the offer."[117]

This is inaccurate in several ways. *First*, there was no "sweetener fund." There was only a theoretical prospect of "Contingent General Fund Payments" under the terms of the City's settlement agreement regarding the Pension Obligation Bonds (and no other "capital markets" creditors).[118] No money is to be

[117] Op. at 53; *see* ER437 (10/30/14 Tr.).

[118] DI1842, Ex. 1.a (reimbursement agreement).

set aside into a "fund" and there is no guarantee that the City will make any additional payments.

Second, the Plan had no mechanism or "offer" for Franklin to participate in the "Contingent General Fund Payments." Under the Pension Obligation Bond settlement, the City merely had the right (but not the obligation) to offer a small portion of the potential future payments, but only in the context of a settlement with Franklin, which would have been conditioned on Franklin's acceptance of the Plan. Because Franklin opposed the Plan's proposed 1% payment on its unsecured claim, there was never any "offer" for Franklin to "refuse."

Evidence that Franklin was misled regarding its collateral. The Court also stated that "[t]here is no evidence suggesting that Franklin was misled about the quality of its collateral when it acquired the bonds."[119] This too is false.

Franklin's expert (Frederick Chin) specifically opined that the Official Statement for Franklin's Bonds misrepresented the value of Franklin's collateral: "[T]he City and RBC [the underwriters] misstate and misuse the Appraisal Report, and mislead readers of the Official Statement to believe that independent market valuations have been performed on the properties by American Appraisal. Absent a review of the Appraisal Report and with reliance only on the Official Statement, a reader could easily be misled to believe that the market value of the Subject

[119] Op. at 53.

Properties had been independently derived and substantiated."[120] Mr. Chin concluded that the collateral valuation in the Official Statement was "*flawed, misleading and erroneous* for any lending or extension of credit purpose."[121] The Court ignored this unrebutted expert testimony.

B. The Court Erred In Concluding That The Plan Properly Classified And Treated Franklin's Unsecured Claim.

Section 1129(b) of the Code empowers a court to confirm a plan over the objection of a dissenting class only if the plan "does not discriminate unfairly." 11 U.S.C. § 1129(b)(1). No one seriously disputes that, had Franklin's unsecured claim been placed into its own class, the Plan would have run afoul of the statutory prohibition on unfair discrimination. As shown in Section VI.B.4, relevant case law uniformly condemns discrimination far less material than the Plan's disparity between 1% payment on Franklin's unsecured claim and 52%-100% payments on other unsecured claims.

In an effort to dodge the issue, the City rigged the classification scheme so that Franklin's unsecured claim would be placed in an impaired class that accepted the Plan, classifying Franklin with 1,100 retirees who voted yes because the City agreed to pay their pensions in full. The Court endorsed that gerrymander, disregarded the Plan's favoritism of retiree claims within Franklin's class, and

[120] ER598 (Chin Report).

[121] ER589, 598 (Chin Report) (emphasis added).

never addressed the unlawful discrimination against Franklin, concluding that "there was no need to get to the . . . standard of Section 1129(b) 'cramdown.'"[122] The Court erred as a matter of law in all three respects.

1. Sections 1122, 1123(a)(4), And 1129(b) Ensure Equality Of Distribution.

As noted above, "[e]quality of distribution among creditors is a central policy of the Bankruptcy Code." *Begier*, 496 U.S. at 58. Sections 1122, 1123(a)(4), and 1129(b) of the Code – which forbid classification of dissimilar claims together, require the same treatment of claims within a class, and prohibit unfair discrimination against a dissenting class – operate together to implement that policy.

Thus, the appropriateness of classification in a particular case is determined with reference to the Code's prohibition of unfair discrimination. *See, e.g.*, *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 455 (Bankr. E.D. Cal. 1999) ("in determining whether a separate classification under § 1122(a) . . . is appropriate, courts must be guided by the mandate of § 1129(b)(1) that the plan not discriminate unfairly"); *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 . . . ."). As COLLIER notes:

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[122] ER475 (1/20/15 Tr.).

> *[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 . . . .

7 COLLIER, *supra*, ¶ 1122.03[3][a] (emphasis added) (citation omitted); *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.").

2. The Plan Improperly Classified Franklin's Unsecured Claim.

The Plan's classification scheme is convoluted and inherently suspect. The Plan separately classified, into *twenty* different classes, virtually every major claim against the City that had not already been paid during the bankruptcy case. Among other things, unsecured claims for each of the City's bond issues other than

Franklin's Bonds were placed into *separate* individual classes.[123] All other material unsecured claims similarly were placed into their own separate classes.[124]

In contrast, the Plan classified Franklin's unsecured claim into Class 12, which contained *two* distinct categories of claims: Franklin's $30.5 million unsecured claim and the health benefit claims asserted by 1,100 retirees. (There were no other material claims in Class 12 because the City paid all of its prepetition trade debt, which it never had any intention of impairing.) This classification was inappropriate for two independent reasons.

a. The Plan Gerrymandered Franklin's Claim.

First, section 1122(a) permits 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. *In re Barakat*, 99 F.3d 1520, 1526 (9th Cir. 1996). This rule applies in chapter 9. *Corcoran Hosp.*, 233

[123] Class 1 (2003 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).

[124] Class 7 (DBW claims); Class 8 (SCC 16 claims); Class 9 (Thunder claims); Class 11 (special tax claims); Class 14 (tort claims); Class 15 (pension claims); Class 16 (equipment leases); Class 17 (workers' compensation); Class 18 (SPOA claims); and Class 19 (Price claims).

B.R. at 455 ("there must be a business or economic justification for separate classification of unsecured claims").

In particular, "[s]eparate classifications for unsecured creditors are only justified where the legal character of their claims is such as to accord them a status different from the other unsecured creditors." *Tucson Self-Storage*, 166 B.R. at 897 (quotations omitted). "[U]nsecured claims will, generally speaking, comprise one class, whether trade, tort, publicly held debt or a deficiency of a secured creditor, because they are claimants of equal legal rank entitled to share *pro rata*." *Id.* (quotation omitted).

This rule is intended to prevent abuse like that which occurred in this case: "[T]here must be some limit on a debtor's power to classify creditors. . . . The potential for abuse would be significant otherwise. If the plan unfairly creates too many or too few classes, if the classifications are designed to manipulate class voting, or if the classification scheme violates basic priority rights, the plan cannot be confirmed." *Id.* (quotations omitted). One rampant type of abuse – classification designed to manipulate voting – has led to what the Ninth Circuit described as "one clear rule": "thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan." *Barakat*, 99 F.3d at 1525 (quotations omitted).

That is exactly what the City did. The Plan, in fact, turns the general rule of joint classification of unsecured claims on its head. The City *separately* classified every material category of unsecured claims except the retiree health benefit claims and Franklin's unsecured claim, which the City inexplicably classified together. This is facially suspect. *See, e.g.*, *In re AOV Indus.*, 792 F.2d 1140, 1151 (D.C. Cir. 1986) ("while there is no restriction on the total number of classifications, logistics and fairness dictate consolidation rather than proliferation of classes").

The City's effort to avoid section 1129(b) by placing Franklin in a class with the retirees 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.") (quotations omitted); *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"). As one commentator observed about this case, "Stockton clearly engineered its classes to obtain a desirable voting outcome within each class. . . . *Stockton . . . sought to evade the unfair discrimination standard by abusing its power to classify claims*." *Fair and Unfair Discrimination*, *supra*, at 30, 68 (emphasis added).

The City proved no "legitimate business or economic justification" for the Plan's balkanized classification. The Court said nothing about the issue, and it erred in approving the Plan's rigged classification scheme.

b. The Plan Classified Franklin's Unsecured Claim With Dissimilar Claims.

Second, even absent the effort to evade section 1129(b), the classification scheme was inappropriate because Franklin's unsecured claim was not substantially similar to the retiree health benefit claims classified with it.

As explained above, Franklin's claim was payable at least in part from restricted PFFs. This Court has held that "a third-party source for payment" on an unsecured claim renders the claim dissimilar from unsecured claims without an additional avenue of recovery and *requires* separate classification. *Loop 76*, 465 B.R. at 541 (unsecured claim with third-party guarantee dissimilar and must be separately classified from general unsecured claims) (citing *In re Johnston*, 21 F.3d 323, 328 (9th Cir. 1994)). The Ninth Circuit similarly held that the ability of a creditor to recover from collateral of a third party renders the creditor's unsecured claim against the debtor dissimilar from other unsecured claims. *Johnston*, 21 F.3d at 328.

When attempting to justify separate classification of the unsecured Pension Obligation Bonds, the City agreed that unsecured claims that may (but need not) be paid from restricted funds have a different "legal character" from other unsecured

claims and thus are not substantially similar within the meaning of section 1122(a).[125] The same reasoning applies to Franklin's unsecured claim, which may be paid from restricted fund PFFs.

The City thus cannot have it both ways. Either the ability to pay from restricted funds required separate classification of Franklin's unsecured claim (just like the Pension Obligation Bonds), or *all* unsecured claims (including the Pension Obligation Bonds) should have been classified together because there was no business or economic justification for separate classification. The Court ignored this rudimentary point.

3. The Plan Provided Different Treatment To Claims Within Franklin's Class.

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.

Regarding Class 12 (the class into which the retiree health benefit claims and Franklin's unsecured claim were lumped together), the Court gave short shrift to this "same treatment" requirement: "One has to read it carefully to confirm there is equal treatment, but there is equal treatment with respect to all of the

[125] DI1243 (City conf. memo.) at 7.

claims that are general unsecured claims . . . . So I conclude that Section 1123(a)(4) has been satisfied."[126] *That tautology was the Court's entire assessment of the issue*. Because the Court ignored the Plan's superior treatment of retiree claims within Franklin's class, this is yet another error of law.

To be sure, the Plan's treatment of Class 12 claims superficially is the same – a meager payment of less than one penny on the dollar. In fact, however, the 1,100 retirees whose health benefit claims were classified into Class 12 received much better overall treatment on their unsecured claims for retirement benefits. Specifically, the retirees also received *100% payment* of the City's unfunded pension obligations to them. Considering the City's *total* liability (pension and health benefits), retirees with claims classified into Class 12 received between 53% and 70% for their unsecured and unfunded retirement benefits.[127] In contrast, Franklin received a *total* recovery of less than 1% on its unsecured claim.

Below, the City attempted to draw a distinction between retiree claims for health benefits and for pensions. Those claims, however, are part and parcel of the City's *single obligation* to retirees for retirement benefits. The benefits arose from the *same contracts* and served as compensation for the *same service* provided by retirees. Each retiree's claim for retirement benefits is a single claim that cannot

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[126] ER434 (10/30/14 Tr.).

[127] When the amount of the retiree claims is calculated correctly, as described in Section VI.C, retirees achieved an even *greater* percentage recovery.

be split into two in order to assist the City's gerrymandered classification scheme. *See* 11 U.S.C. § 507(a)(5) (affording single priority for claims under an "employee benefit plan"); H.R. Rep. No. 95-595, at 187 (1977) (priority covers "health insurance programs, life insurance plans, pension funds, and all other forms of employee compensation that [are] not in the form of wages"); *Howard*, 547 U.S. at 664 (considering "[e]mployer-sponsored pension plans, and group health or life insurance plans," together for purposes of priority); *see also Bethea v. Robert J. Adams & Assocs.*, 352 F.3d 1125, 1128 (7th Cir. 2003) ("One contract . . . gives rise to one claim, meaning a 'right to payment, whether or not such right is . . . fixed, contingent, matured [or] unmatured.' 11 U.S.C. § 101(5).").[128]

The City's settlement with retirees makes this crystal clear. The settlement was a "package deal" – retirees voted in favor of the Plan notwithstanding 1% payment on health benefits *because* the Plan provided for full payment of pensions. The Plan's treatment of retiree liabilities was a single, unified treatment despite the manufactured separate classification of the two components of retiree

[128] The City recognized that treatment of retiree claims must account for both health benefits *and* pensions: "In determining how to restructure its obligations, City management . . . developed a proposal which tries to strike an equitable balance with respect to retiree obligations and keeps the City a competitive employer. Specifically the City has elected to target retiree medical costs for restructuring, but to attempt [to] preserve pension funding for current retirees and current employees who will retire under the CalPERS system." ER541 (Ask).

claims.[129] It is inconceivable that any retiree would have voted in favor of a plan that discharged health benefit claims for a cent on the dollar in the absence of a promise of an unimpaired pension.

The treatment of the City's retiree obligations (pension and health) was inexorably joined. Accordingly, under "Stockton's circumstances, the current and former workers are receiving more than a fraction of a percent on their healthcare claims, it is just that as a formal matter, some of the compensation is paid in the form of a greater recovery on their pensions." *Fair and Unfair Discrimination*, *supra*, at 65-66. This plainly violates the "same treatment" requirement of section 1123(a)(4).

Several cases are instructive in this regard. The first is the Supreme Court's decision in *Avon Park*, a municipal restructuring case decided before Congress made the "same treatment" requirement explicit in the statute. In *Avon Park*, the Court reversed confirmation of a plan that provided for the debtor to pay one bondholder (the fiscal agent) additional amounts for assistance in facilitating the restructuring. *Avon Park*, 311 U.S. at 141. The Court held that the additional consideration, which was not available to other bondholders in the same class, violated principles of equality:

[129] ER843-46 (Retiree Committee letter); ER847-50 (Retiree Committee responses); ER871-76 (newsletter); ER877-81 (newsletter); DI1657 (City post-trial br.) at 22 ("any impairment of pensions would also unravel . . . [the] penny on the dollar settlement with the Retirees Committee").

> [T]he general rule of "equality between creditors" [is] 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 [agent] were reasonable, measured by the services rendered, *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*.

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

Congress codified *Avon Park* in section 1123(a)(4), and courts have applied its teachings in analogous situations. In *Adelphia*, for example, the district court concluded that the bankruptcy court likely erred in confirming a plan that granted releases to some class members in exchange for ballots accepting the plan:

> 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)*. . . .
>
> 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 . . . [T]here 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); *see also In re New Century TRS Holdings, Inc.*, 407 B.R. 576, 592 (D. Del. 2009) (plan violated section 1123(a)(4) by providing certain claimants a greater distribution on account of claims classified

into other classes); *In re The Finova Grp., Inc.*, 304 B.R. 630, 637 (D. Del. 2004) (plan violated section 1123(a)(4), despite nominally same treatment, where some creditors had a greater portion of their claims recognized than others).

The Court did not address any of this compelling authority, instead ignoring the City's artificial distinction between retiree health benefit and pension liabilities. The Court plainly erred in this regard. As in *Finova*, the Plan's treatment of retirees as having separate, unrelated claims – one entitled to 100% payment and another to 1% payment – "elevate[d] form over substance and violate[d] the equal treatment mandate" of section 1123(a)(4). *Id*; *see Fair and Unfair Discrimination*, *supra*, at 30 (by favoring retirees, the Plan "does not in fact treat members of [Franklin's] class equally") and 66 (decision below is "surprising given that [the Court] clearly understood that creditors are willing to sacrifice a return on one claim in order to bargain for a [higher] return on another").

4. The Plan Unfairly Discriminated Against Franklin's Unsecured Claim.

With proper classification, Franklin's class would have rejected the Plan and triggered 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). There is no question that the Plan violates that statutory command.

As shown in Table 2 above, the City made distributions on unsecured claims that are as discriminatory as possible, ranging from less than 1% on Franklin's

unsecured claim to 52%-100% on other unsecured claims. On top of that, the City paid all $4 million of prepetition trade claims that would have qualified as "General Unsecured Claims" in Class 12 had the City not unilaterally exempted them from the restructuring process.

This plainly violates section 1129(b)'s prohibition on unfair discrimination, which 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 ("Courts have denied confirmation of Chapter 11 plans that proposed widely disparate treatment of similarly situated creditors as unfairly discriminatory.").

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 discrimination." *Ambanc*, 115 F.3d at 656. The relevant inquiry focuses on "the disparity of treatment proposed in the plan, and whether such disparity can be justified under the Code." 7 COLLIER, *supra*, ¶ 1129.03[3][a].

"Courts considering the issue of unfair discrimination have roundly rejected plans proposing grossly disparate treatment (50% or more) to similarly situated

creditors." *In re Tribune Co.*, 472 B.R. 223, 243 (Bankr. D. Del. 2012); *see, e.g.*, *Tucson Self-Storage*, 166 B.R. at 898 (confirmation denied where plan provided 100% recovery for unsecured trade creditors and 10% to unsecured deficiency claims); *In re Greate Bay Hotel & Casino, Inc.*, 251 B.R. 213, 231 (Bankr. D.N.J. 2000) ("Courts which have rejected confirmation on the basis of unfair discrimination have confronted plans proposing grossly disparate treatment (50% or more) to similarly situated creditors."); *In re Sentry Operating Co.*, 264 B.R. 850, 863-64 (Bankr. S.D. Tex. 2001) (100% v. 1%); *In re Crosscreek Apartments, Ltd.,* 213 B.R. 521, 538 (Bankr. E.D. Tenn. 1997) (100% v. 50%); *Barney & Carey*, 170 B.R. at 25-26 (100% v. 15%); *In re Cranberry Hill Assocs., L.P.*, 150 B.R. 289, 290-91 (Bankr. D. Mass. 1993) (100% v. 50%); *In re Aztec Co.*, 107 B.R. 585, 591 (Bankr. M.D. Tenn. 1989) (100% v. 3%).

The City put on no evidence regarding any of the *Ambanc* criteria, and the Court ignored them. The evidence that is in the record clearly shows that the Plan discriminates unfairly against Franklin's unsecured claim. To wit, in contrast to the 1% payment on Franklin's unsecured claim, other similarly-situated unsecured claims received far more:

- Pension Obligation Bonds. The Plan promised future payments on unsecured Pension Obligation Bonds having a present value of at least 52%, *plus* the "Contingent General Fund Payments" (the Court's

"sweetener fund"). Franklin's unsecured claim had identical rights against the City but received only 1%. This is the epitome of unfair discrimination. By providing a materially-greater recovery on *wholly-unsecured* general fund debt (the Pension Obligation Bonds) than on Franklin's *partially-secured* general fund debt, the Plan also turned a basic precept of bankruptcy distribution on its head.

- Other bonds. Because the City did not value any of the collateral securing its other bonds, there is no evidence of the size of the unsecured deficiency claims on those obligations (which had the *same underlying rating* as Franklin's Bonds). To the extent the bonds were not fully secured (or nearly so), those unsecured deficiency claims would have the same legal rights as Franklin's unsecured deficiency claim. The Plan, however, provided payments up to 100% on those other claims.

- Retirees. The Plan provided recoveries of between 53% and 70% to retirees on account of their unsecured retirement benefits (and 100% to retirees with pensions but no health benefits). Compared to Franklin's 1% recovery on its unsecured claim with identical legal rights against the City, such treatment is unfairly discriminatory.

As recently observed in *Detroit*, the prohibition on unfair discrimination prohibits categorical value judgments of the sort made by the City, which simply

declared that retirees, trade creditors, and others were more sympathetic and deserving than Franklin:

> [T]he Court must judge the fairness of the discrimination not in the abstract, but informed by the goals and purposes of the chapter 9 case. This judgment, therefore, necessarily excludes the relative needs of the creditors in the disparately treated classes . . . *[N]o case law in any of the rehabilitative chapters suggests that creditors' needs are an appropriate consideration in determining whether a plan unfairly discriminates*.

In re City of Detroit, 524 B.R. 147, 258 (Bankr. E.D. Mich. 2014) (emphasis added); *Fair and Unfair Discrimination*, *supra*, at 27 ("*[B]ankruptcy's unfair discrimination standard prevents a municipality from granting workers and retirees a greater recovery than an objecting class of disfavored creditors*. Although political considerations may induce a court to construe that standard to permit a municipal reorganization plan to favor workers and retirees, *current law does not allow it*.") (emphasis added).

The Court refused to consider any of this because it erroneously concluded that the unfair discrimination standard was inapplicable. The gross disparity in treatment of Franklin's unsecured claim amounted to unfair discrimination and should have prevented confirmation of the Plan.

C. The Court Erred In Not Discounting Retiree Health Benefit Claims To Present Value.

Under the Plan, Franklin's unsecured claim was classified into Class 12. Class 12 claims received a payment equal to the "Unsecured Claim Payout

Percentage," defined to be "the percentage paid on account of the Retiree Health Benefit Claims."[130] The Plan specified that, "unless the amount of the Retiree Health Benefit Claims changes, that percentage will be equal to 0.93578%, *i.e.*, $5,100,000 divided by $545,000,000."[131]

Under this formula, the *higher* the amount of health benefit claims the *lower* the payment on Franklin's unsecured claim. Because the City agreed to pay a fixed amount in respect of the health benefit claims *regardless of their allowed amount*,[132] the City had the perverse incentive to *inflate* the health benefit liability in order to reduce the "Unsecured Claim Payout Percentage" and thus minimize payment to Franklin.

That is exactly what the City did. Pursuant to the Retirees Settlement, the City allowed the Retiree Health Benefit Claims in an aggregate amount of $545 million.[133] That amount represents projected health benefit costs over the expected lifespan of each of the 1,100 retirees (and their respective dependent)

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[130] ER766-67 (Plan §§ I.A.198, IV.M.2).

[131] ER766 (Plan § I.A.198).

[132] ER684-85 (5/13/14 Tr.) (Goodrich). "[T]he City doesn't care whether or not [the allowed claim amount] is higher or lower. . . . There was not a relationship between the [$]5.1 million and the [$]546 million, now or ever." ER905-06 (Milnes).

[133] ER676 (5/13/14 Tr.) (Goodrich).

who had been promised retirement health benefits.[134] *It is simply the sum total of payments the City might have had to make over the next eighty years, without discounting to present value.*[135]

This simplistic calculation resulted in huge individual claims (averaging nearly $500,000 across 1,100 retirees, with 67 claims of more than $1 million)[136] and vastly overstated the City's actual liability. Franklin objected and established that the City's real liability was approximately $261.9 million – the discounted amount reflected in its audited financial statements.[137] Had the City stipulated to that amount instead (which would not have reduced the payment to retirees), the "Unsecured Claim Payout Percentage" would have been 1.94731% ($5,100,000 divided by $261,900,000) – more than *double* what Franklin actually received.

In ruling on the Plan, the Court mistakenly believed that there was no dispute regarding the amount of the City's liability.[138] After being informed that there was a live dispute, the Court made an immediate "determination" – without benefit of argument or review of the briefs – that the health benefit claims would be allowed in the full non-discounted amount of $545 million proposed by the

[134] ER677-78 (5/13/14 Tr.) (Goodrich); ER636-41 (Zadroga-Haase).

[135] ER679-80 (5/13/14 Tr.) (Goodrich); ER636-41 (Zadroga-Haase).

[136] ER549-76 (amended list of creditors).

[137] DI1273 (Franklin conf. obj.) at 60-63; DI1377 (Franklin supp. conf. obj.) at 40-44; DI1689 (Franklin post-trial br.) at 40 n.121.

[138] ER447 (10/30/14 Tr.).

City.[139] The Court, however, stated that this snap judgment was "fair game for a Rule 52(b) Motion to try to get me to adjust that number. So I'll take a harder look at it, full and fair harder look at that question if an appropriate motion is made."[140]

Franklin therefore moved to have the Court alter and amend its findings.[141] After additional briefing and argument, the Court concluded without further analysis: "as I do look at the cases and the problems of the statute and the language of Section 502, in the context of Chapter 9, I am persuaded that I am not required to discount the employee claims to present value and they are not required to be done."[142] The Court did not elaborate on what "cases" had been reviewed or what "the problems of the statute" might be. The Court did acknowledge, however, that "[i]t's a close question. I can imagine the Court of Appeals or the Supreme Court saying it must be discounted."[143] This rudimentary ruling cannot survive scrutiny.

1. Accounting Rules Require Discounting.

To start, the City's calculation conflicted with its own audited financial statements, which reflected the *discounted* present value of the retiree health

[139] ER448 (10/30/14 Tr.).

[140] ER448 (10/30/14 Tr.).

[141] DI1779 (Franklin rule 52(b) motion).

[142] ER464-65 (12/10/14 Tr.).

[143] ER465 (12/10/14 Tr.).

benefit liability, not the sum total of all future amounts the City might have to pay to satisfy its unfunded benefit promises. As a result, the financial statements indicated that the City's petition date liability for retiree health benefits was $261.9 million,[144] less than half the liability to which the City stipulated.

The prepetition discounting was not calculated by accident. The Governmental Standards Accounting Board requires that a municipality's liability for retiree health benefits be discounted to present value in its financial statements:

> The actuarial present value of total projected benefits as of the valuation date is the present value of the cost to finance benefits payable in the future *discounted to reflect the expected effects of the time value (present value) of money* and the probabilities of payment. Expressed another way, it is *the amount that would have to be invested on the valuation date so that the amount invested plus investment earnings will provide sufficient assets to pay total projected benefits when due.*[145]

Franklin's expert explained that, as a matter of basic economics, "it makes no sense simply to tally up projected future health care expenses payable over the next thirty years or more. The payment of a claim thirty years from now obviously is less of a burden than the payment of the same claim today. This is why generally accepted accounting principles dictate that future liabilities like retiree

[144] ER852-54 (FY2011-12 financials); ER680-81 (5/13/14 Tr.) (Goodrich); ER910 (Zadroga-Haase).

[145] ER891 (GASB No. 45) (emphasis added); *see id.* at 882-90, 892-98; ER610-12 (Moore Report).

health care benefit costs be discounted to present value in order to provide an accurate representation of the liability in an entity's financial statements."[146]

The City's witnesses provided no credible explanation of why the City abandoned its pre-bankruptcy practice of discounting health benefit liabilities to present value.[147] *See Fair and Unfair Discrimination*, *supra*, at 67 ("Failing to discount future claims would be an obvious violation of bankruptcy norms, raising the question of why the city would do this."). It was clear the City did so for one reason – to reduce payment on Franklin's unsecured claim by more than half.

2. The Code Requires Discounting.

Whatever its motivation, the City's failure to discount the health benefit claims plainly violated section 502(b) of the Code.

Section 502(b) requires the court to "determine the amount of [a] claim . . . as of the date of the filing of the petition." 11 U.S.C. § 502(b). "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*." *In re CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293, 1300 (10th Cir. 1998) (emphasis added). "*Discounting is consistent with the fundamental goal of treating similar claims in*

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[146] ER611 (Moore Report); *see also* ER731-38 (5/14/14 Tr.) (Moore).

[147] ER681-84 (5/13/14 Tr.) (Goodrich); ER910-11 (Zadroga-Haase).

the same manner, and *reflects the economic reality that a sum of money received today is worth more than the same amount received tomorrow*." *In re Trace Int'l Holdings*, 284 B.R. 32, 38 (Bankr. S.D.N.Y. 2002) (emphasis added) (citations omitted).

Thus, courts routinely discount claims for future employment-related benefits like retiree health benefits. *See, e.g., 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 discounted to present value); *Trace*, 284 B.R. at 38 ("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); *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. June 7, 1993).[148]

The City asserted that this authority was wrongly decided, arguing that section 502(b) forbids discounting because it "requires the court to determine the '*amount*' of a claim," in contrast to other sections of the Code that "ask courts to 'determine the *value*' as of a specific date."[149] Section 502(b), however, expressly commands the court to "determine the amount" of claims "as of the date of the filing of the petition," not some payment date in the future.

Moreover, the City drew a false distinction. The other sections it cited – *e.g.*, 11 U.S.C. §§ 1129(a)(7),(9),(15) – concern the value of *property* distributed *by* the debtor. In those instances, Congress spoke of present "value" of the property to be distributed. In contrast, section 502 involves *claims* asserted *against*

[148] *See also In re Wisconsin Engine Co.*, 234 F. 281, 282-83 (7th Cir. 1916) (non-interest bearing promissory notes discounted to present value); *In re O.P.M. Leasing Servs.*, 79 B.R. 161, 167 (S.D.N.Y. 1987) ("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 omitted); *In re Loewen Grp. Int'l*, 274 B.R. 427, 437-38 (Bankr. D. Del. 2002) ("where a claim has been asserted in respect to a future liability of the debtor payable post-petition, the claim must be discounted to present value as of the petition date").

[149] DI1803 (City obj.) at 2 (emphasis in original).

the debtor. In that context, it makes no sense to speak of "value" of a debtor's liabilities. Rather, Congress directed courts to determine the petition date "amount" of liabilities that may be allowed against the bankruptcy estate.

Here, the "amount" of retiree health benefit claims is the City's projected expense of providing health care benefits through the *year 2095*, discounted to account for the fact that the City would not incur a huge portion of that liability until decades into the future. That is the liability reflected in the City's financial statements, which accurately reflect what retirees could have received outside of bankruptcy under the basic rule of future damages. *See, e.g.*, CAL. CIV. CODE § 1951.2 (landlord must discount future rent).

The City also argued that "the Bankruptcy Code accelerates the maturity of future obligations to the petition date."[150] A bankruptcy petition, however, only "operates as the acceleration of the *principal amount* of all claims against the debtor." H.R. Rep. No. 95-595 at 353-54 (1977) (emphasis added). There is no "principal amount" of the health benefit claims – only a promise to provide future benefits – and thus nothing to accelerate.

Finally, the City cited *In re Oakwood Homes Corp*., 449 F.3d 588 (3d Cir. 2006), a case that holds in Franklin's favor. In *Oakwood Homes*, the Third Circuit concluded that claims for repayment of principal on *interest-bearing*

[150] DI1803 (City Obj.) at 3.

obligations should not be discounted because "the interest has already been disallowed pursuant to § 502(b)(2)." *In re Oakwood Homes Corp*., 449 F.3d 588, 600 (3d Cir. 2006). The Circuit distinguished between *interest-bearing* obligations (not discounted) and *non-interest bearing* obligations (discounted), using the example of two 10-year notes for $1,000 (one with 5% interest; one without):

> 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 – 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 $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 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 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 (underlining added) (italics in original).

Oakwood thus *endorsed* discounting of *non-interest bearing claims* (like the health benefit claims). In fact, the Circuit specifically held that "*future liabilities must be reduced in some way to reflect the time value of money*." *Id.* (emphasis added); *see id.* at 598 ("money received today is more valuable than money negotiated to be received in the future, and reduction in recognition of that basic economic fact may sometimes be appropriate").

Accordingly, the Court erred as a matter of law in not discounting retiree health benefit claims. Undiscounted, the stipulated claim amount vastly overstated the City's liability and cut Franklin's unsecured claim recovery by more than half.

D. The Court Erred In Concluding That The Plan Was Proposed In Good Faith.

Section 1129(a)(3) of the Code requires the plan proponent to prove that the plan "has been proposed in good faith." 11 U.S.C. § 1129(a)(3). The Court concluded that the Plan satisfied this requirement, apparently because the City was able to reach settlements with its other creditors.[151]

The Court ignored the Plan's punitive, discriminatory treatment and failed to consider six facts that collectively demonstrate bad faith toward Franklin:

1. The City failed to apply any future revenues (including PFFs) to repayment of Franklin's claim even though Franklin's Bonds were intended to be repaid from PFFs, PFFs could not be used to repay other creditors, and the City admitted it would be "a sign of bad faith" if PFFs were not used to pay Franklin.

2. The City inflated retiree health benefit claims for no reason other than to reduce the distribution on Franklin's unsecured claim.

3. The City gerrymandered the Plan to avoid the "unfair discrimination" standard.

[151] ER436-37 (10/30/14 Tr.).

4. The City improved recoveries for all other creditors from those proposed in the pre-bankruptcy Ask, while dramatically reducing Franklin's recovery from what had been offered before bankruptcy.

5. The City made only *de minimis* payment on Franklin's unsecured claim while refusing to restructure its largest unsecured liability (unfunded pensions).

6. The City frivolously asserted that Franklin's claim should be capped pursuant to section 502(b)(6) of the Code.

Good faith requires, at a minimum, that a proposed chapter 9 plan "treat *all* interested parties fairly and that the efforts used to confirm the plan [] comport with due process." *Mount Carbon*, 242 B.R. at 39 (emphasis added). This requirement of good faith is, and has always been, a critical component of municipal restructuring. *See Avon Park*, 311 U.S. at 144-46 (reversing confirmation due to lack of good faith); *Town of Belleair v. Groves*, 132 F.2d 542, 543 (5th Cir. 1942) (same); *Kaufman Cnty. Levee Improvement Dist. No. 4 v. Mitchell*, 116 F.2d 959, 960 (5th Cir. 1941) (same).

Thus, modern courts have denied confirmation in chapter 9 where the municipal debtor abused the restructuring process or sought results inconsistent with the purposes of the Code. *See, e.g.*, *In re Wolf Creek Valley Metro. Dist. No. IV*, 138 B.R. 610, 618-19 (D. Colo. 1992) (reversing confirmation where plan

singled out landowner for discriminatory treatment); *Pierce Cnty.*, 414 B.R. at 719-20 (confirmation denied where plan was not "a sincere attempt by the Debtor to readjust its debts by *maximizing the creditors' recovery*") (emphasis added); *Mount Carbon*, 242 B.R. at 39-42 (confirmation denied where plan was inconsistent with purpose of chapter 9).

One early case – *Wright v. City of Coral Gables*, 137 F.2d 192 (5th Cir. 1943) – is instructive. In *Wright*, the Fifth Circuit reversed confirmation of a plan that had been accepted by 94% of bondholders. The Circuit concluded that the debtor lacked good faith as to the objecting bondholder because it tried "to bludgeon into submission those with whom the city had not been able to make settlements satisfactory to itself." *Id.* at 195.

That is an apt description of the City's conduct with respect to Franklin. Unable to reach what it deemed to be a satisfactory settlement, the City bludgeoned Franklin through the Plan. The City did not attempt to maximize Franklin's recovery. It did the opposite. It deliberately *minimized* Franklin's recovery by refusing to use future revenues (including PFFs) to pay the Bonds and doubling the amount of retiree health benefit claims in order to reduce the already tiny distribution on Franklin's unsecured claim. The City punished Franklin by taking away what had been offered before bankruptcy and gerrymandering the Plan to evade its patently discriminatory treatment.

This is not the good faith required by the Bankruptcy Code. "Knowingly sacrificing prospectively significant value demonstrates a lack of good faith within the totality-of-circumstances analysis of 1129(a)(3)." *In re Val-Mid Assocs.*, Case No. 4:12-bk-20519-EWH, 2013 Bankr. LEXIS 2521, at *9 (Bankr. D. Ariz. June 14, 2013); *see, e.g.*, *In re Multiut Corp.*, 449 B.R. 323, 342 (Bankr. N.D. Ill. 2011) (failure to maximize value for creditors "directly bears on the Plan's good faith"); *Pierce Cnty.*, 414 B.R. at 719-20 (same).

The City's wholesale assumption of its largest liability – unfunded pensions – is additional evidence of bad faith. If the City truly desired to "treat all interested parties fairly" and "provide creditors the potential for the greatest economic return from its assets," it would not have assumed pensions while professing inability to pay any more on Franklin's unsecured claim. There is, of course, nothing wrong with a distressed municipality deciding that it has enough money to pay its debts. If it decides to do so, however, it must pay *all* liabilities, not just claims held by creditors that it favors.

Finally, the City's attempt to cap Franklin's claim at less than $9 million demonstrates bad faith. Franklin was singled out for this treatment even though the Bonds had "a similar structure" and the same underlying rating as the City's other bonds. Then, after compelling Franklin to spend substantial resources

fending off that discriminatory attack, the City abandoned its frivolous argument and stipulated that Franklin was entitled to a full claim.

Despite all this, the Court seemed to believe that Franklin somehow deserved discriminatory treatment because it had not settled with the City, had "elected to just not come to the table and deal, and . . . instead chose to challenge confirmation of the plan."[152] That is simply not reflective of factual or legal reality. For one thing, there is *no evidence* to support the Court's unfounded speculation that Franklin did not "come to the table." The *evidence* is to the contrary. Franklin was the only bondholder to make a counterproposal before bankruptcy ("which the City concedes was made in good faith"),[153] and Franklin engaged in more than a year of postpetition mediation. Franklin was ready, willing and eager to "deal."

More importantly, the City had no right to "bludgeon" Franklin because a settlement was not achieved. A creditor who fails to compromise with a debtor – for whatever reason – is entitled to the fair and nondiscriminatory treatment required by the Code. The City never even tried to provide that treatment. The City did not act with good faith toward Franklin in proposing and confirming the Plan, and the Court erred in concluding otherwise.

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[152] ER474-75 (1/20/15 Tr.).

[153] *Stockton*, 493 B.R. at 783.

E. The Court Erred In Excusing The City From Disclosure Or Approval Of Professional Fees.

Section 943(b)(3) of the Code requires the court to find that "all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable." 11 U.S.C. § 943(b)(3).

Notwithstanding that requirement, the City did not disclose or seek approval of approximately $20 million it apparently paid to its professionals during the bankruptcy case[154] – *more than four-and-a-half times the amount the City deigned to pay Franklin's claim*. The City refused to produce invoices of its professionals and argued that section 943(b)(3) applies only to "fees that *will* be paid in the future" and not to "fees that *have been* paid during the course of the case."[155]

Although Franklin objected to the City's failure to disclose and seek approval of fees,[156] the Court completely overlooked the issue. In issuing its oral ruling on confirmation, the Court incorrectly stated that "nobody has contended

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[154] In June 2014, the City filed a one page sheet listing more than $13.8 million in "bankruptcy-related fees" it had incurred during the two-years of bankruptcy proceedings through May 20, 2014. ER756-59 (chapter 9 costs). The City did not disclose any of its fees incurred in the nine months between May 20, 2014, and the effective date of its Plan. Given its prior run rate, it is safe to assume that the City's total bankruptcy fees approached, if not exceeded, $20 million.

[155] DI1309 (City supp. conf. br.) at 41-42 (emphasis in original).

[156] DI1273 (Franklin conf. obj.) at 57-59; DI1377 (Franklin supp. conf. obj.) at 38-39.

that [section 943(b)(3)] has not been satisfied."[157] After being reminded of Franklin's objection, without reviewing the briefing or otherwise informing itself about the issue, the Court simply declared that section 943(b)(3) "is not retrospective."[158] That unreasoned decision represents one final error.

The 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." 6 COLLIER, *supra*, ¶ 943.03[3]. Congress did not intend for municipal debtors to evade that "monitoring" function by paying professionals during the case – without any disclosure – leaving nothing left "to be paid" at the time of confirmation. As recently noted in *Detroit*, "to determine the reasonableness of unpaid fees but not paid fees creates an arbitrary line that the parties can readily manipulate to avoid judicial review of their fees." *Detroit*, 524 B.R. at 209. There is no logical basis for the artificial distinction drawn by the Court.

To the contrary, fulsome disclosure of professional fees has always been a required component of municipal restructuring. In *Avon Park*, for example, the

[157] ER439 (10/30/14 Tr.).

[158] ER453 (10/30/14 Tr.).

Supreme Court reversed confirmation precisely because the debtor had not disclosed amounts it paid to the fiscal agent in connection with the plan. *Avon Park*, 311 U.S. at 145, 147. "[T]he Supreme Court's mandate to review professional fees was surely not so spineless as to permit an exception for paid fees. Rather, *the Court's mandate is an important and powerful one, to be observed with the greatest consideration and care. It simply cannot be obeyed by reviewing only unpaid fees*." *Detroit*, 524 B.R. at 210 (emphasis added).

Until now, courts have taken that mandate seriously, examining *all* of the debtor's fees and expenses in a chapter 9 case regardless of whether or not previously paid. *See, e.g.*, *Detroit*, 524 B.R. at 208 (noting "the responsibility to determine the reasonableness of all of the professional fees incurred by the City, whether paid or unpaid at the point of confirmation"); *Barnwell Cnty.*, 471 B.R. at 868; *See also In re City of Colo. Springs Spring Creek Gen. Improvement Dist.*, 187 B.R. 683, 685-86 (Bankr. D. Colo. 1995); *In re Colorado Centre Metro. Dist.*, 139 B.R. 534, 535 (Bankr. D. Colo. 1992); *see also In re Castle Pines N. Metro. Dist.*, 129 B.R. 233, 235 (Bankr. D. Colo. 1991) (committee fees).

The Court below disregarded its "important and powerful" statutory mandate. It erred as a matter of law, allowing the City to evade oversight of $20 million in fees paid during the case with funds that otherwise could have been used to pay part of Franklin's unsecured claim.

VII. CONCLUSION

The Bankruptcy Court erred in confirming an unfairly discriminatory Plan over Franklin's objection. Franklin requests that this Court reverse and remand with directions that the City provide fair, reasonable, and nondiscriminatory treatment to Franklin's unsecured claim. The Bankruptcy Court concluded that such relief would be available upon reversal without disturbing the balance of the City's Plan, and justice demands that it be ordered here.

Respectfully submitted,

March 23, 2015

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TYPE-VOLUME CERTIFICATION

Pursuant to Rule 8015(a)(7)(C) of the Federal Rules of Bankruptcy Procedure, this brief complies with the type-volume limitations of Rule 8015(a)(7)(B) of the Federal Rules of Bankruptcy Procedure, as modified by the Court's Order dated January 12, 2015, as follows:

(1) Exclusive of the portions exempted by Rule 8015(a)(7)(B)(iii) of the Federal Rules of Bankruptcy Procedure, the brief contains 19,384 words, according to the count of Microsoft Word.

(2) The brief was prepared using Microsoft Word in 14-point Times New Roman, a proportionally-spaced font.

March 23, 2015

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CERTIFICATION REQUIRED BY BAP RULE 8015(a)-1(b)

BAP CASE NO. EC-14-1550
In re City of Stockton, California

The undersigned certifies that the following parties have an interest in the outcome of this appeal. These representations are made to enable judges of the Plan to evaluate possible disqualification or recusal:

1. City of Stockton, California.
2. Franklin High Yield Tax-Free Income Fund
3. Franklin California High Yield Municipal Fund
4. Official Committee of Retirees
5. California Public Employees' Retirement System
6. Stockton Police Officers Association
7. Stockton Police Managers Association
8. Stockton City Employees Association
9. Stockton Professional Firefighters – Local 456
10. Operating Engineers Local No. 3
11. Assured Guaranty Corp.
12. Assured Guaranty Municipal Corp.
13. National Public Finance Guarantee Corporation
14. Wells Fargo Bank, National Association, as Indenture Trustee

March 23, 2015

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CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the Bankruptcy Appellate Panel for the Ninth Circuit by using the appellate CM/ECF system on March 23, 2015.

Participants in the case who are registered CM/ECF users will be served by the appellate CM/ECF system.

I further certify that some of the participants in the case are not registered CM/ECF users. I have mailed the foregoing document by First-Class Mail, postage prepaid, to the following non-CM/ECF participants:

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