

1 **FOR PUBLICATION**

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3
4 UNITED STATES BANKRUPTCY COURT
5 EASTERN DISTRICT OF CALIFORNIA
6

7 In re:) Case No. 12-32118-C-9
8 CITY OF STOCKTON, CALIFORNIA,) DC No. OHS-5
9 Debtor.)
10)
11)

12 **OPINION REGARDING APPLICABILITY OF
13 FEDERAL RULE OF BANKRUPTCY PROCEDURE 9019**

14 Before: Christopher M. Klein
15 United States Bankruptcy Judge

16 Marc A. Levinson (argued), Patrick Bocash, John W. Killeen,
17 Orrick, Herrington & Sutcliffe LLP, Sacramento, California, for
18 Debtor.

19 William W. Kannel (argued), Mintz Levin Cohn Ferris Glovsky and
20 Popeo P.C., Boston, Massachusetts, for Wells Fargo Bank National
21 Association, as Indenture Trustee.

22 Matthew M. Walsh (argued), Winston & Strawn LLP, Los Angeles,
23 California, for National Public Finance Guarantee Corporation.

24 Jeffrey Bjork (argued), Sidley Austin LLP, Los Angeles,
25 California, for Assured Guaranty Corp. and Assured Guaranty
26 Municipal Corp.

27 James O. Johnston (argued), Jones Day, Los Angeles, California,
28 for Franklin High Yield Tax Free Income Fund and Franklin
California High Yield Municipal Fund.

Michael J. Gearin (argued), K&L Gates LLP, Los Angeles,
California, for California Public Employees' Retirement System.

2 The Bankruptcy Act of 1898 provided that the trustee, with
3 approval of the court, could compromise any controversy in the
4 best interests of the estate.¹ And, until supplanted when
5 Bankruptcy Rules issued pursuant to 28 U.S.C. § 2075 first took
6 effect in 1974, the statute also designated the notice required
7 for such a motion.²

8 After 1974, Bankruptcy Rule 919, on which the current Rule
9 9019 was modeled, provided for a noticed application seeking
10 approval of a compromise or settlement.³

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12 ¹The former Bankruptcy Act provided:

13 Sec. 27. The receiver or trustee may, with the approval of
14 the court, compromise any controversy arising in the
15 administration of the estate upon such terms as he may deem
for the best interests of the estate.

16 Bankruptcy Act of 1898, § 27, Act of July 1, 1988, 30 Stat. 553-
17 54, as amended, Chandler Act, § 27, Act of June 22, 1938, 52
Stat. 855, repealed 1979.

18 ²The required notice was:

19 Sec. 58. (a) Creditors shall have at least 10 days' notice
20 by mail, to their respective addresses as they appear in the
21 list of creditors of the bankrupt or as afterward filed with
22 the papers in the case by the creditors, of ... (6) the
proposed compromise of any controversy in which the amount
claimed by any party in money or value exceeds \$1000.

23 Bankruptcy Act of 1898, § 58(a)(6), Act of July 1, 1988, 30 Stat.
24 553-54, as amended, Chandler Act, § 58, Act of June 22, 1938, 52
Stat. 855, repealed 1979.

25 ³Rule 919 provided, in relevant part:

26 (a) Compromise. On application by the trustee or receiver
27 and after hearing on notice to the creditors as provided in
Rule 203(a) and to such other persons as the court may

1
2 But Bankruptcy Act § 27 and § 58 did not apply in chapter IX
3 municipal debt adjustment cases. There was no estate, nor a
4 trustee, nor a receiver. The court was barred from interfering
5 with property or revenues of the municipality. And from the time
6 chapter IX was made permanent in 1946 until 1976, only securities
7 debts could be modified in a chapter IX plan.⁴

8 And the Bankruptcy Rules issued in 1974 (replacing the
9 former General Orders in Bankruptcy issued by the Supreme Court)
10 included special chapter IX rules that made clear that Rule 919
11 regarding settlements did not apply. The chapter IX rules were
12 explicit about which of the general Bankruptcy Rules applied and
13 omitted Rule 919 from the list of incorporated rules.⁵

14 In short, the argument that a municipality must obtain court
15 approval of settlements would have seemed dubious in 1978.

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19 designate, the court may approve a compromise or settlement.
20 Bankruptcy Rule 919(a).

21 ⁴This was accomplished through the definition of creditor:
22 "The term 'creditor' means the holder of a security or
23 securities." § 82, Act of July 1, 1946, 60 Stat. 409.

24 ⁵The pertinent rule was Rule 9-40 ("Applicability of Federal
25 Rules of Civil Procedure and Bankruptcy Rules"):

26 (b) Bankruptcy Rules. Bankruptcy Rules 508, 903, 904,
27 906(e), 907-909, 911, 912, 915, 918, 927, and 928 apply in
28 chapter IX cases, except that the reference in Rule 915 to
Rule 112 shall be read as a reference to Rule 9-10.

Bankruptcy Rule 9-40(b).

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2 The 1978 Bankruptcy Code reinvigorated in modern code form a
3 statute that had become unsteady in its old age.

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6 The Bankruptcy Code omitted former Bankruptcy Act provisions
7 deemed more procedural than substantive or too well-established
8 as doctrines to warrant repetition, not because the procedures or
9 doctrines would no longer apply, but because rules of procedure
10 or settled nonstatutory or interpretive doctrines were adequate
11 to the task.

12 For that reason, the Supreme Court adopted a rule of
13 construction for the Bankruptcy Code that doctrines established
14 under the former Bankruptcy Act are presumed to have been carried
15 forward except to the extent Congress indicated a contrary
16 intent. E.g., Midlantic Nat'l Bank v. New Jersey Dep't of Evntl.
17 Prot., 474 U.S. 494, 501 (1986); Kelly v. Robinson, 479 U.S. 36,
18 47 (1986).

19 Basic bankruptcy settlement doctrine was carried forward
20 into the Bankruptcy Code even though the express statutory
21 command was deleted from statute. Over time, bankruptcy
22 settlement doctrine had matured through Supreme Court decisions
23 beyond the confines of the 1898 narrow "best interest" statute
24 into a broader "fair and equitable" doctrine that, for example,
25 in reorganization contexts overlapped plan confirmation issues.
26 E.g., Protective Comm. for Indep. Stockholders of TMT Trailer

1 Ferry, Inc. v. Anderson, 390 U.S. 414, 424-41 (1968) ("TMT
2 Trailer Ferry").

3 Although Congress may have elected to sidestep a complicated
4 drafting problem because of the maturity of Supreme Court
5 doctrine, coupled with the practicality that bankruptcy trustees
6 saddled with fiduciary obligations naturally gravitate to the
7 safety of a court order whenever a debatable settlement is at
8 hand, it is beyond cavil that Congress did not indicate a
9 contrary intent regarding settlements.

10 Hence, Congress left settlement procedure to a combination
11 of procedural rule and nonstatutory judicial doctrine. Rule
12 9019, modeled on former Rule 919, regarding compromise or
13 settlement, was adopted to prescribe a procedure. Fed. R. Bankr.
14 P. 9019. As to substantive standards, courts have consistently
15 followed the settlement precedents established under the
16 Bankruptcy Act decisions requiring that settlements be "fair and
17 equitable." E.g., Martin v. Kane (In re A & C Props.), 784 F.2d
18 1377, 1380-81 (9th Cir. 1986), following TMT Trailer Ferry, 390
19 U.S. at 424-41.

20 It follows, then, that if judicial scrutiny of compromises
21 was not required in chapter IX cases, then none is required in
22 chapter 9 cases under the Bankruptcy Code.

23 The fact that the rules issued under the 1978 Bankruptcy
24 Code abandoned the prior format of separate rules for separate
25 chapters does not constitute a change in substantive law. See
26 Preface to Comments of the Advisory Committee on Bankruptcy Rules
27 Accompanying August 9, 1982, Transmittal of Preliminary Draft of
28

1 Federal Rules of Bankruptcy Procedure. Nor, as a matter of law,
2 could Rule 9019 trump § 904. Hence, Rule 9019 applies in chapter
3 9 cases only if the debtor elects to "consent" per § 904 to have
4 the court consider approval of a compromise.

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7 The conclusion that Rule 9019 review of compromises or
8 settlements in chapter 9 cases is not mandatory also is to be
9 inferred from the structure and terms of the Bankruptcy Code.

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11 a

12 The extent to which bankruptcy settlement doctrine applies
13 in the chapter 9 context is a puzzle because much of the
14 Bankruptcy Code does not apply. Only chapters 1 and 9, together
15 with the select provisions from chapters 3, 5, and 11 designated
16 in § 901, apply in a chapter 9 case. 11 U.S.C. §§ 103(f) & 901.

17 The patchwork chapter 9 incorporation of only portions of
18 otherwise generally applicable provisions of the Bankruptcy Code
19 necessitates caution whenever thinking about bankruptcy concepts
20 that are virtually axiomatic in cases under other chapters.
21 Context necessarily shifts once one steps into the chapter 9
22 arena, and context can be crucial in municipal debt adjustment
23 cases. So it is with compromises.

24
25 b

26 One dramatic difference of chapter 9 from other bankruptcy
27 cases is that § 904 limits the jurisdiction and powers of the

1 court over the municipal debtor:

2 Notwithstanding any power of the court, unless the debtor
3 consents or the plan so provides, the court may not, by any
4 stay, order, or decree, in the case or otherwise, interfere
with -

4 (1) any of the political or governmental powers of the
debtor;

5 (2) any of the property or revenues of the debtor; or

6 (3) the debtor's use or enjoyment of any income-producing
property.

7 11 U.S.C. § 904.

8 As explained previously in this case, § 904 is a keystone in
9 the constitutional arch between federal bankruptcy power and
10 state sovereignty. Ass'n of Retired Employees of the City of
11 Stockton v. City of Stockton, Ca. (In re City of Stockton, Ca.),
12 478 B.R. 8, 16-20 (Bankr. E.D. Cal. 2012) (Stockton II).

13 Indeed, the first federal municipal debt adjustment statute
14 was held to be unconstitutional in part because the precursor of
15 § 904 qualified the prohibition on federal judicial interference
16 with municipal property or revenues to revenues "necessary in the
17 opinion of the judge for essential governmental purposes."⁶
18 Ashton v. Cameron Cnty. Water Improvement Dist. No. 1, 298 U.S.

21 ⁶The statute provided:

22 The judge ... (11) shall not, by any order or decree,
23 in the proceeding or otherwise, interfere with (a) any of
24 the political or governmental powers of the taxing district,
25 or (b) any of the property or revenues of the taxing
district necessary in the opinion of the judge for essential
governmental purposes, or (c) any income-producing property,
unless the plan of readjustment so provides.

26 Bankruptcy Act § 80(c)(11), Act of May 24, 1934, 48 Stat. 801
27 (emphasis supplied).

1 513, 532 (1936) (emphasis supplied).

2 Congress reacted to Ashton by enacting a slightly revised
3 statute that deleted the phrase "in the opinion of the judge"
4 from the limitation on judicial authority. The Supreme Court
5 ruled it was constitutional. United States v. Bekins, 304 U.S.
6 27 (1938).

7 In 1976, Congress deleted the phrase "necessary for
8 essential governmental services" from the prohibition of judicial
9 interference with the municipality's property or revenues. Act
10 of April 8, 1978, Pub. L. 94-260, 90 Stat. 315.

11 The historical facts of the relationship of Ashton and
12 Bekins, and of the 1976 revision of chapter IX to the deletion of
13 the qualification "necessary in the opinion of the judge for
14 essential governmental purposes" from what is now § 904, compel
15 the conclusion that the bankruptcy court cannot prevent a chapter
16 9 debtor from spending its money for any reason, even foolishly
17 or in a manner that disadvantages other creditors, unless the
18 municipality consents to such judicial oversight. Stockton II,
19 478 B.R. at 20. The power to approve a compromise implies the
20 power to disapprove a compromise. And the power to disapprove is
21 the power to interfere. And the power to interfere without
22 consent with property or revenues is precisely what Congress has
23 withheld in chapter 9 cases. 11 U.S.C. § 904.

24 Hence, § 904 means that the City can expend its property and
25 revenues during the chapter 9 case as it wishes. It can pay any
26 debt in full without permission from this court. If it wishes to
27 spend \$55,000 settling a lawsuit, it is entitled to do so without

1 needing a permission from this court; such permission would imply
2 a power to disapprove and thereby to interfere with the City's
3 property or revenues that would offend § 904.

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5 3

6 What then of actual examples from other chapter 9 cases of
7 Rule 9019 motions seeking court approval of settlements? The
8 answer lies in "consent" and does not undermine the conclusion
9 that judicial approval is not mandatory.

10 The language of § 904 provides that the debtor may consent
11 to judicial interference: "unless the debtor consents or the plan
12 so provides, the court may not, ..., interfere with - ... (2) any
13 of the property or revenues of the debtor." 11 U.S.C. § 904.

14 When a chapter 9 debtor files a Rule 9019 motion to have the
15 court approve a compromise or settlement, the municipality
16 "consents" for purposes of § 904 to judicial interference with
17 the property or revenues of the debtor needed to accomplish the
18 proposed transaction. 11 U.S.C. § 904.

19 There are a number of plausible reasons why a municipality
20 may choose to consent to judicial approval. A counterparty may
21 insist on Rule 9019 judicial approval as a condition precedent to
22 the settlement. The municipality may wish to obtain judicial
23 approval as part of a strategy of transparency designed to
24 forestall later challenges to plan confirmation. The fact of
25 judicial approval may satisfy some requirement of a nonbankruptcy
26 law with which the municipality also must comply.

27 If, for any reason, a chapter 9 debtor decides that its
28

1 interests would be served by consenting to submit to a judicial
2 approval under bankruptcy settlement-review standards, it is free
3 to make that § 904 consent in the form of filing a Rule 9019
4 motion or by including such a review as a plan provision. 11
5 U.S.C. § 904.

6
7 II

8 If the court cannot prevent or disapprove a settlement or
9 compromise, what are the limiting principles? The answer lies in
10 an appreciation of the plan confirmation process and a
11 recognition that overreaching may make it difficult to confirm a
12 plan.

13 If and when an order for relief is entered, the next task in
14 a chapter 9 case is the filing and confirmation of a plan of
15 adjustment. Since a chapter 9 debtor has the exclusive right to
16 propose a plan, it follows that the burden of proving the
17 essential elements for confirmation is on the debtor in its
18 capacity as plan proponent.

19 The capital market creditors argue that unconstrained
20 settlements amount to a creeping plan of arrangement. Perhaps
21 so. Perhaps such a creep is legitimate and sensible. Perhaps
22 nefarious. But, in any event, the day of reckoning comes at the
23 plan confirmation hearing.

24 If any impaired class of claims does not accept the plan,
25 then confirmation will require a so-called cramdown pursuant to
26 § 1129(b)(1) in which the City must prove that the plan "does not
27 discriminate unfairly," and is "fair and equitable" with respect
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1 to that non-accepting, impaired class. 11 U.S.C. § 1129(b)(1),
2 incorporated by 11 U.S.C. § 901(a). It is not difficult to
3 imagine arguments that evidence of untoward settlements could be
4 probative of § 1129(b)(1) issues.

5 Similarly, the plan must have "been proposed in good faith
6 and not by any means forbidden by law." 11 U.S.C. § 1129(a)(2),
7 incorporated by 11 U.S.C. § 901(a). If an objection to
8 confirmation of a chapter 9 plan is filed, evidence must be
9 presented on the § 1129(a)(2) issues. Fed. R. Bankr. P.
10 3020(b)(2). It is not difficult to imagine arguments that
11 evidence of untoward settlements could be probative of
12 § 1129(a)(2) issues.

13 Although the parties have debated in their briefs whether
14 various other plan confirmation elements might be affected by
15 evidence of the history and terms of prior settlements, further
16 speculation is not necessary.

17 In short, the capital market creditors have, in effect,
18 given notice that they reserve the right to litigate the debtor's
19 conduct and management and spending choices during the case at
20 the time of plan confirmation. That is the limiting principle
21 and the protection to which they are entitled.

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23 ***

24 For the foregoing reasons, the City's motion will be granted
25 to the extent that it seeks a ruling that it is not required to
26 seek approval of compromises pursuant to Rule 9019. Any such
27 motion that it does make will be deemed to constitute "consent"

1 for purposes of § 904 that would permit the court to assess
2 whether the proposed compromise is "fair and equitable" under
3 bankruptcy settlement standards. This ruling renders moot the
4 remainder of the motion - seeking approval of the \$55,000
5 compromise only if the court rules that such approval is
6 mandatory - which shall be dismissed.

7 Dated: February 5, 2013.

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UNITED STATES BANKRUPTCY JUDGE

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DEPUTY CLERK

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