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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re:	Case No. 2012-32118
CITY OF STOCKTON, CALIFORNIA,	D.C. No. OHS-5
Debtor.	Chapter 9

CITY OF STOCKTON'S RESPONSE TO SUPPLEMENTAL BRIEF OF CAPITAL MARKETS CREDITORS REGARDING THE CITY'S MOTION FOR AN ORDER RULING THAT APPROVAL OF SETTLEMENT AGREEMENT IS NOT REQUIRED UNDER BANKRUPTCY RULE 9019

Date: January 30, 2013
Time: 10:00 a.m.
Dept: C, Courtroom 35
Judge: Hon. Christopher M. Klein

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The City of Stockton, California (the "City") hereby submits this response ("Supplemental Response") to the Supplemental Brief Of Capital Markets Creditors Regarding The City Of Stockton's Motion For Order Ruling That Approval Of Settlement Agreement Is Not Required Under Rule 9019 Of The Federal Rules Of Bankruptcy Procedure (the "CMC Supplemental Brief" or "CMC Supp. Br."). This Supplemental Response also addresses questions raised by the Court at the November 20, 2012 hearing on the City's Motion For Order (1) Ruling That Approval Of Settlement Agreement Is Not Required Under Rule 9019 Of The Federal Rules Of Bankruptcy Procedure; Or Alternatively (2) Approving Settlement Agreement Pursuant To 9019 (the "9019 Motion"; Dkt. No. 585).

I. INTRODUCTION

The question before the Court is whether it has the authority in a chapter 9 case to require the City to submit settlements or compromises of claims for its approval pursuant to Rule 9019 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules").[1] The answer is a definitive "no." As a procedural rule, Rule 9019 cannot create a substantive requirement on its own, and instead must depend on the Bankruptcy Code to provide the source and define the scope of its application. The Bankruptcy Code, however, excludes 11 U.S.C. § 363 – which provides the substantive basis for requiring bankruptcy court approval of settlements and compromises – from application in chapter 9. *See* 11 U.S.C. § 901(a)[2]. Furthermore, § 904 expressly prohibits the bankruptcy court from interfering in any way with a chapter 9 debtor's control of its property and revenues or with its ability to govern itself, powers which are clearly implicated by a municipality's settlement of claims against it. In fact, chapter 9 as a whole is deliberately structured to ensure that the powers of the federal bankruptcy courts do not conflict with the sovereign rights reserved to the states by the Tenth Amendment.

The Capital Markets Creditors perhaps intentionally fail to grasp this fundamental difference between chapter 9 cases and cases brought under the other chapters of the Bankruptcy Code. The nature of the Tenth Amendment and of the delicate relationship between the

[1] Unless otherwise specified, a reference to a "Rule" is a reference to a Bankruptcy Rule.
[2] Unless otherwise specified, all statutory references are to the 11 U.S.C. § 101 *et seq.* (the "Bankruptcy Code").

bankruptcy courts and the states necessarily requires that the powers of bankruptcy courts in chapter 9 cases are limited as compared with those in cases brought under other chapters of title 11. This is because the Tenth Amendment, as well as § 904, which implements it, requires that a municipality in chapter 9 must continue to be free to perform the basic acts of government, even as its bankruptcy case is ongoing – a principle made clear both by the structure of the Bankruptcy Code, and by this Court's own rulings. *See In re City of Stockton, California*, 478 B.R. 8, 20 (Bankr. E.D. Cal. 2012) ("*ARECOS*").

Rather than address the unique nature of a chapter 9 case, the Capital Markets Creditors cite to a litany of unrelated Bankruptcy Code sections in an attempt to paint Rule 9019 as a linchpin of the claims allowance process. However, this line of reasoning is unsupported by the sections cited (which do not implicate settlements or compromises) and in fact stands in direct contradiction to the fundamental purpose of § 904, which is to prevent court intrusion on issues of governance. The CMC Supplemental Brief also attempts to draw non-existent distinctions between a City's "government" functions and "bankruptcy" functions in the hope that court approval of settlements can be brought outside the scope of those judicial actions prohibited by § 904. This argument ignores the plain reality that there are many instances in which a court's bankruptcy authority, if left unchecked, would encroach upon the debtor municipality's sovereign powers.

Ultimately, the Capital Markets Creditors' arguments must fail because they refuse to acknowledge one basic fact: cases brought under chapter 9 are different than those brought under other chapters. This is evident from the structure of chapter 9, the explicit limitations of § 904, and the overarching constitutional limits imposed by the Tenth Amendment. The City must be allowed to continue to govern itself throughout its chapter 9 case, free from interference by the Court. Because the authority to approve or reject the City's settlements would impinge upon the City's sovereignty, such authority is denied to the Court.

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II. THERE IS NO SUBSTANTIVE REQUIREMENT THAT CHAPTER 9 DEBTORS SEEK THE COURT'S APPROVAL OF SETTLEMENTS OR COMPROMISES.

A. Rule 9019 Is Purely Procedural, And Does Not Create A Substantive Requirement Of Court Approval Of Settlements In Chapter 9.

The Bankruptcy Rules cannot "abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2075. As a rule of procedure, Rule 9019 "cannot create a substantive requirement for court approval that does not exist in the Code itself." *In re Telesphere Communications, Inc.*, 179 B.R. 544, 551-52 (Bankr. N.D. Ill. 1994); *see also In re Dow Corning Corp.*, 198 B.R. 214, 246 (Bankr. E.D. Mich. 1996) (Rule 9019 is "merely a rule, [it] can do no more than establish a procedural mechanism for exercising statutory power."). Rule 9019 thus does not apply to all cases under title 11 "by its terms," as the Capital Markets Creditors argue. *See* CMC Supp. Br., p. 1. Instead, Rule 9019 applies only where the Bankruptcy Code itself provides the substantive underpinning.

Recognizing Rule 9019's lack of substantive import, multiple courts in bankruptcy cases brought under chapters other than chapter 9 have held that the substantive requirement to seek court approval of compromises and settlements is provided by § 363, which permits the "use" or "sale" of property of the estate only after "notice and a hearing." *See Northview Motors, Inc. v. Chrysler Motors Corp.*, 186 F.3d 346, 351 n. 4 (3d Cir. 1999) ("[A]s a matter of law, Bankruptcy Rule 9019(a), a rule of procedure, cannot, by itself, create a substantive requirement of judicial approval of [a] settlement . . . Section 363 of the Code is the substantive provision requiring court approval."); *In re Sparks*, 190 B.R. 842, 844 (Bankr. N.D. Ill. 1996) (holding that Rule 9019 itself did not provide a basis for a Court's refusal to enforce a settlement it did not approve, but that such basis could be found in § 363); *In re Dow Corning Corp.*, 198 B.R. 214, 246 (Bankr. E.D. Mich. 1996) (holding that "Rule 9019, being merely a rule, can do no more than establish a procedural mechanism for exercising a statutory power," while also finding that section 363 "is certainly broad enough to include a trustee's alienation of a chose in action through compromise/settlement."). The Bankruptcy Appellate Panel for the Ninth Circuit has confirmed that the requirement of court approval of compromises derives from § 363. In *In re Mickey Thompson Entm't Group, Inc.*, the BAP held that "the disposition by way of 'compromise' of a

claim that is an asset of the estate is the equivalent of a sale of the intangible property represented by the claim, which transaction simultaneously implicates the 'sale' provisions under section 363 as implemented by Rule 6004 and the 'compromise' procedure of Rule 9019(a)." 292 B.R. 415, 421 (B.A.P. 9th Cir. 2003) (*citing Myers v. Martin (In re Martin)*, 91 F.3d 389, 394-95 (3d Cir. 1996)); *see also* 10 COLLIER ON BANKRUPTCY ¶ 6004.01 ("[a] compromise of a claim of the estate is in essence the sale of that claim to the defendant.") (citing *Mickey Thompson Entm't Group*).

Section 363, however, is not applicable in chapter 9 cases. 11 U.S.C. § 901(a). Thus, as Rule 9019 implicates no substantive requirement for seeking court approval of a settlement, and as the Bankruptcy Code section that provides that requirement is inapplicable to a chapter 9 debtor, the Bankruptcy Code does not require the City to seek the Court's approval of its settlement agreement with Christopher Hallon (the "Settlement Agreement" or "Hallon Settlement").

B. <u>The Capital Markets Creditors Fail To Cite Any Legitimate Alternative Source For A Substantive Requirement For Court Approval Of Settlements.</u>

The CMC Supplemental Brief all but ignores the City's arguments regarding Rule 9019's dependence on section 363's substantive requirement. It fails to discuss *Mickey Thompson Entm't Group*, *Northview Motors*, *In re Sparks*, or *In re Dow Corning Corp.*[3] and instead offers only a footnote with the bald, unsupported assertion that "Rule 9019 has a myriad of statutory bases," including sections 502, 943, and 1129. CMC Supp. Br., p. 5 n. 3. The Capital Markets Creditors give no explanation as to why the holding in *Mickey Thompson* – which expressly links Rule 9019 and the "use" and "sale" provisions of section 363 – is not decisive, and fail to cite a single case identifying any of these alternative Code sections as a source of the substantive requirement underlying Rule 9019.

[3] The Capital Markets Creditors also appear to have abandoned the argument that these cases are distinguishable on the grounds that they involved settlement of claims held *by* the City as opposed to claims *against* the City. *See* Limited Objection Of Capital Markets Creditors To The City Of Stockton's Motion For Order (1) Ruling That Approval Of Settlement Agreement Is Not Required Under Rule 9019 Of The Federal Rules Of Bankruptcy Procedure; Or Alternatively (2) Approving Settlement Agreement Pursuant To Rule 9019 ("Limited Objection") [Dkt. No. 605], p. 2.

In fact, the only case cited by the CMC Supplemental Brief on the subject, *In re Columbia Gas Systems*, does nothing more than recite that the settlement motion at issue was "brought pursuant to Sections 105 and 502 of the Bankruptcy Code, and Bankruptcy Rule 9019." Case No. 91-803, 1995 Bankr. LEXIS 936, at *1 (Bankr. D. Del. June 16, 1995). *Columbia Gas* neither discusses any relationship between section 502 and Rule 9019 nor considers the character of Rule 9019 as a purely procedural rule. Moreover, none of the alternative Bankruptcy Code sections invoked in the CMC Supplemental Brief pertains to the settlement or compromise of claims. *See* Section IV, *infra* (discussing alternative Bankruptcy Code sections raised by the Court and the CMC Supp. Br.). Section 363 of the Bankruptcy Code is the only recognized source of a substantive requirement for court approval of settlements and compromises, and it is inapplicable in chapter 9. Thus, the City is not required to seek the Court's approval of its settlements.

C. The Decision By Other Debtors To Consent To Court Approval Of The Settlement Of Claims Has No Bearing On the Application Of Rule 9019.

The Capital Markets Creditors renew their argument, originally raised in the Limited Objection, that because debtors in other chapter 9 cases have opted to seek court approval of settlements and compromises, Rule 9019 must necessarily apply in all chapter 9 cases. *See* CMC Supp. Br., pp. 3-4. In support, the CMC Supplemental Brief cites to the same examples as the Limited Objection (including several motions filed in *In re City of Vallejo* and *In re Corcoran Hospital District*, 233 B.R. 449 (Bankr. E.D. Cal. 1999)) and to one additional case, *In re Jefferson County*, 11-05736(TBB9) [Dkt. Nos. 1450, 1537] (Bankr. N.D. Ala Nov. 27, 2012).

None of these cases has any bearing on the 9019 Motion. As discussed in the City's Reply In Support Of Its 9019 Motion [Dkt. No.613], the City of Vallejo's independent decision to seek court approval is completely irrelevant to the question of whether Rule 9019 is applicable to chapter 9 debtors. The City of Vallejo may have had any number of reasons to seek court approval, whether as part of an agreement with its creditors or simply out of an abundance of caution. Moreover, because these settlements occurred near the end of Vallejo's chapter 9 case, there was little incentive not to seek court approval, thereby consenting pursuant to § 904 to the resolution of the issue by Judge McManus. On the other hand, the City hopes to avoid the

substantial costs and delays that would result from litigating challenges to each and every one of its settlements throughout the course of its own chapter 9 case, and thus does not consent to the Court's determination of the Hallon Settlement.

Vallejo's decision carries no precedential weight, and court approval of Vallejo's settlements in no way shows that such approval was *required*. Judge McManus in *Vallejo* was not asked to determine, nor did he discuss, the necessity of seeking his approval for these settlements, either in the context of Rule 9019, section 363, or any of the other Bankruptcy Code sections cited in the CMC Supplemental Brief. The same is true of *In re Corcoran Hospital District* and *In re Jefferson County*. In both cases, court approval of a settlement was sought and granted, but in neither case did the court consider whether court approval was in fact required or make any reference to a potential source of such a requirement. Again, as noted above, section 904 allows a debtor municipality to consent to the court's exercise of otherwise prohibited powers, which would include the power to review and approve settlements. The decision by other municipalities to consent to court review of a settlement is thus not contrary to the notion that section 904 bars such review *absent* that consent.

III. BANKRUPTCY CODE § 904 PROHIBITS THE COURT FROM EXERCISING CONTROL OVER THE CITY'S PROPERTY AND REVENUES BY REQUIRING APPROVAL OF SETTLEMENTS.

A. Section 904 Bars The Court From Requiring Approval Of Settlements And Compromises.

Section 904 imposes clear limitations on the Court's power to control or affect the City's ability to govern itself. Specifically, it provides that a bankruptcy court, absent the debtor's consent or a plan provision to the contrary, "may not, by any stay, order, or decree . . . interfere with - (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property." These restrictions on the authority of the bankruptcy court are wide-reaching. As this Court recently held, "§ 904 performs the role of the clean-up hitter in baseball. Its preambular language . . . is so comprehensive that it can only mean that a federal court can use no tool in its toolkit – no inherent authority power, no implied equitable power, no Bankruptcy Code § 105 power, no

writ, no stay, no order—to interfere with a municipality regarding political or governmental powers, property or revenues, or use or enjoyment of income-producing property." *ARECOS*, 478 B.R. at 20.

Requiring the City to seek the Court's approval of settlements would interfere with the City's control of its property and revenues, as well as its basic government functions, in violation of § 904. This Court has held that "[t]he contents of the City treasury are 'property and revenues' within the meaning of § 904(2)." 478 B.R. at 21. Because the City's settlements necessarily implicate the City's treasury, imposing a requirement of court approval of such settlements would therefore constitute impermissible court control over the City's property and revenues. For one, any payments made by the City pursuant to a settlement – such as the $55,000 payment to Hallon – will come from the City treasury. Moreover, the expenses incurred while litigating the validity of a settlement, or while litigating the underlying claims if a settlement is rejected, also will be paid from the City treasury. Thus, requiring the City to seek the Court's approval of a settlement – with the result that the Court has the power to *deny* such approval or to dictate the amount to be paid in a given settlement – would be a clear violation of the section 904 prohibition of court control of a municipality debtor's property and revenues.

By the same token, requiring court approval of settlements also would give courts de facto control over a municipality debtor's core government functions, particularly where a settlement involves a labor contract between the debtor and one or more of its unions. Releases of claims by both parties are a standard part of labor agreements, and frequently involve carefully negotiated trade-offs that form the very foundation of the labor agreement. These include decisions and compromises regarding wages and benefits that, as the Court has previously held, lie at the core of a city's municipal powers.

One notable example of this is the City's recent agreement with the Stockton Police Officers Association ("SPOA"). This agreement settles all of the claims of SPOA members against the City stemming from the City's prebankruptcy decision to unilaterally impose compensation reduction measures under two fiscal emergencies aimed at keeping the City out of bankruptcy court. The agreement with SPOA was not some "secret settlement" designed to buy

off a favored creditor, as the Capital Markets Creditors claim. *See* CMC Supp. Br., p. 2. To the contrary, the City's settlement with SPOA was publicly noticed prior to approval thereof by the City Council[4] and was achieved only through the diligent efforts of Judge Elizabeth Perris, who brokered the deal through the mediation process ordered by this Court.

If the City is forced to litigate the approval of the Hallon Settlement, the SPOA agreement and other settlements, it not only will be compelled to commit significant resources to defending its settlements, but will also be at risk of forfeiting its governmental powers if the Court determines that the City must renegotiate its deals, including its labor contracts. In such an instance, the Court essentially would be dictating to the City what it should pay its employees and what benefits it is permitted to offer to the members of its labor unions. Such a result would be a clear violation of *ARECOS*. Indeed, in *ARECOS*, the Court held that section 904 barred the Court from interfering in the City's decision to unilaterally reduce retiree health benefit payments. Thus, despite the Court having determined that it could not intervene in the City's decision to reduce or eliminate healthcare benefits for City retirees, the Capital Markets Creditors argue that the Court should be able to dictate the *terms* of the City's labor contracts by subjecting the settlements containing those terms to Court review. This would be an even greater intrusion than the one rejected in *ARECOS*.

The Capital Markets Creditors claim that Rule 9019 does not conflict with § 904 or the Tenth Amendment based on an illusory distinction between the City's "provision of services and benefits," and "matters involving adjustment of the debtor-creditor relationship." CMC Supp. Br., p. 6. Thus, "the resolution, allowance, and adjustment of a disputed prepetition claim . . . is not a governmental function – it is a bankruptcy function." *Id.* This line of reasoning, however, ignores the fact that the City's provision of services and its resolution of claims are irrevocably intertwined on a practical level. The City's settlement of claims by its police officers, for

[4] In fact, the exhibit filed in support of the CMC Supp. Brief [Dkt. No. 657] is taken from the City's website, as the SPOA agreement and the staff report recommending City Council approval thereof were published prior to the Council meeting as required by the City Charter. *See* Concurrent Agenda for December 11, 2012 Meeting of Stockton City Council, *available at http://www.stocktongov.com/clerk/granicusagendas/citycouncil/20121211.pdf.* Despite the publication of the agenda prior to the Council meeting, the Capital Markets Creditors did not object to the SPOA settlement at the Council meeting.

example, implicates *both* the resolution of the union members' claims and the level of services provided by the City. The City's Memoranda of Understanding with its labor unions simultaneously resolve both claims issues (such as grievances, unfair labor practices, and litigation) while also containing numerous non-claim provisions that affect the compensation and services offered by the City (including terms and conditions relating to, among other things, pay rates, overtime rates and limitations, grievance procedures, response times to return to work, use of City buildings and time off for union business, the number and types of health plans available, procedures for changing health insurance, dues deductions, and appeals of disciplinary decisions). Moreover, the MOUs often involve carefully negotiated trade-offs between these various considerations. The resolution, allowance, and adjustment of disputed prepetition claims thus plainly impacts the City's exercise of government functions, and the separation the Capital Markets Creditors attempt to create between these concepts is therefore a false one.

Section 904 expressly forbids the Court from "interfer[ing] with a municipality regarding political or governmental powers, property or revenues, or use or enjoyment of income-producing property," *ARECOS*, 478 B.R. at 20, which clearly would be in conflict with any attempt to impose a settlement approval requirement pursuant to Rule 9019. Where there is a conflict between the Bankruptcy Code and the Bankruptcy Rules, that conflict "must be settled in favor of the code." *In re Pac. Atl. Trading Co.*, 33 F.3d 1064, 1066 (9th Cir. 1994). This is because 28 U.S.C. § 2075, which confers power on the Supreme Court to prescribe the Bankruptcy Rules, expressly states that "[s]uch rules shall not abridge, enlarge, or modify any substantive right." A Bankruptcy Rule "cannot create an exception to the Bankruptcy Code." *In re Jastrem*, 253 F.3d 438, 441 (9th Cir. 2001); *see also In re Cisneros*, 994 F.2d 1462, 1465 (9th Cir. 1993) (where Bankruptcy Code and Bankruptcy Rules conflict, the statute must take precedence). Rule 9019, therefore, cannot abridge the City's substantive rights under section 904, nor can it create a substantive requirement where none exists. *See* Section I, *supra*. Thus, under a plain reading of section 904, the City is not required to seek the Court's approval of settlements and compromises.

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B. The History Of Section 904 Illustrates A Trend Towards Greater Limitations On The Court's Authority.

As discussed in detail in *ARECOS*, the history of section 904 amply demonstrates that Congress has consistently sought to limit judicial interference with a debtor municipality's basic governmental functions due to Tenth Amendment concerns. Further, the successive amendments to section 904 illustrate a trend towards *greater* limitations on the Court's powers in this regard.

In its original form in 1934, the predecessor of current section 904 read:

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

Bankruptcy Act § 80(c)(11), Act of May 24, 1934, 48 Stat. 801; s*ee ARECOS*, 478 B.R. at 17. The Supreme Court ruled this version of the statute unconstitutional in *Ashton v. Cameron Cty. Water Improvement Dist. No. 1*, 298 U.S. 513 (1936), on the grounds that, first, municipal bankruptcy was an impossible contradiction of federalism, and second, that the terms of the statute would allow the federal government, through the courts, to impose its will on a sovereign state. *ARECOS*, 478 B.R. at 17-18 (noting that while the first rationale was later rejected in *United States v. Bekins*, 304 U.S. 27 (1938), the Supreme Court's concern with the federal government's ability to appropriate state authority "has endured and has influenced Congress always to confine its exercise of the bankruptcy power to measures that do not usurp state sovereignty.")

Following *Ashton*, Congress amended the statute by deleting the phrase "in the opinion of the judge" in order to render the definition of "property or revenues necessary for essential services" less subjective. Bankruptcy Act § 83(c), Act of Aug. 16, 1937, 50 Stat. 657; *ARECOS*, 478 B.R. at 18. The Supreme Court upheld this new formulation in *Bekins*, "reasoning that it was a cooperative enterprise by state and federal sovereigns that was *carefully drawn so as not to infringe state sovereignty*." *Id.* In *Bekins*, the Supreme Court underscored the fact that a state "retain[ed] control of its fiscal affairs," and that "no control or jurisdiction over [a city's property

and revenues] necessary for essential governmental purposes is conferred" on the federal courts. *Bekins*, 304 U.S. at 51.

In 1976, Congress made several additional amendments, including allowing for the municipality to consent to the exercise of otherwise prohibited federal authority, clarifying that the limitation on the courts' powers included a limitation on stays, and removing the phrase "necessary for essential governmental purposes." Bankruptcy Act § 82(c), Act of Apr. 8, 1976, 90 Stat. 316; *ARECOS*, 478 B.R. at 18-19. All of these amendments provided greater rights to the debtor municipality and placed tighter restrictions on the bankruptcy courts. The debtor was afforded the ability to consent to federal authority where it deemed it beneficial, while at the same time the federal courts were further limited from imposing stays on a municipality's use of *any* of its property and revenues. In 1978, the 1976 version of this section was reenacted as 11 U.S.C. § 904, and was amended to add the phrase "[n]otwithstanding any power of the court." *ARECOS*, 478 B.R. at 19.

Thus, successive amendments to what is now section 904 have strengthened the limitations on the ability of the federal courts to interfere with a municipality's property and revenues or its governing authority. In the words of the section's drafters, § 904 "makes clear that the court may not interfere with the choices a municipality makes as to what services and benefits it will provide to its inhabitants." H.R. Rep. No. 95-595, at 398; *ARECOS*, 478 B.R. at 19-20. This trend makes sense in light of the constitutional concerns underlying section 904, namely, the need to reconcile the power of the federal bankruptcy courts with state sovereignty under the Tenth Amendment.

C. The Limitation On The Court's Power To Approve Or Reject Settlements Is The Natural Result Of The Sovereignty Principles Inherent In Section 904 And The Tenth Amendment.

Bankruptcy courts must be able to oversee and direct a municipality's bankruptcy case, but cannot be given such authority that they effectively displace the rights reserved to the states by the Tenth Amendment. Section 904 lies at the heart of this balance and "imposes limits on the federal court to assure that powers reserved to the states are honored." *ARECOS*, 478 B.R. at 17.

The statutory limitation on the power of the bankruptcy courts to pass on a municipality's settlements or compromises follows naturally from the Tenth Amendment sovereignty concerns that underlie section 904. A court having the authority to approve or reject a municipality's use of its property and revenues to settle a claim would equate to it having the power to dictate the terms of a settlement to the municipality, including, in many cases, the terms of its labor contracts. Such authority would cut directly to the core of a municipality's ability to govern itself, and would overturn the careful balance upon which chapter 9 is predicated.

Congress recognized this potential conflict, and purposefully structured chapter 9 so as to make clear that bankruptcy courts were barred from exercising control over a debtor municipality's property and government functions, including in the context of settlements. In addition to the express prohibitions in section 904 against interference with a municipality's political or governmental powers or its property or revenues, Congress also omitted section 363 from application in chapter 9. *See* 11 U.S.C. § 901(a); *ARECOS*, 478 B.R. at 20. It is no accident that the only section recognized as the basis for a bankruptcy court's power to approve or deny settlements in non-chapter 9 cases was excluded from chapter 9. Section 904's limitation on interference with a municipality's property, revenues, and government powers would be severely undercut if a court could collaterally interfere with these protected functions by mandating the terms of the municipality's settlements. To take one example, it would be of little help for section 904 to prohibit a bankruptcy court from directly ordering a municipality debtor to compensate its police union creditors at court-specified levels if the court could instead simply reject any settlement for different amounts.

The Capital Markets Creditors complain that any limitation on the Court's ability to review settlements will somehow despoil the "sanctity of the claims allowance process." CMC Supp. Br., p. 5. To the contrary, the limitations in section 904 and the omission of section 363 (and by proxy Rule 9019) from chapter 9 *preserve* the delicate state-federal balance required by the Tenth Amendment and carefully guarded by Congress. As this Court has recognized, Congress and the Supreme Court have "made it very clear that the jurisdiction of the court is strictly limited to disapproving or to approving and carrying out a proposed composition."

ARECOS, 478 B.R. at 18-19 (quoting H.R.Rep. No. 94-260, 94th Cong., 1st Sess., at 9-10, *reprinted in* 1976 USCCAN at 547-48) (internal quotations omitted). Thus, the limitation on the court's power to approve or reject settlements is entirely consistent with the overall structure of chapter 9 in general, and section 904 in particular.

D. The Application Of Unrelated Bankruptcy Code Sections In Chapter 9 Does Not Change The Fact That Neither Section 363 Nor Rule 9019 Are Applicable.

The CMC Supplemental Brief lists a number of Bankruptcy Code sections applicable in chapter 9 through § 901(a) (including 11 U.S.C. §§ 365, 501, 502, 503, 510, 549(a), and 1109) as evidence that the Court may limit the City's use of its property and revenues, irrespective of the application of § 904. None of the cited provisions addresses the City's ability to enter into settlements and compromises without Court approval. Further, per *ARECOS*, the City has consented under § 904 to the application of those Bankruptcy Code provisions that are incorporated into chapter 9. As each of these sections is made applicable to chapter 9 by § 901(a), the consent provision of § 904 is satisfied.[5] The same cannot be said for a requirement that the City submit its settlements to the Court's review, as such requirement has no basis in any section of the Bankruptcy Code applicable to chapter 9 debtors.

E. Bankruptcy Code § 926 Does Not Remove The Limitations Imposed On The Court's Authority by § 904.

The Capital Markets Creditors point to section 926 of the Bankruptcy Code as purported proof that "section 904 does not empower a municipality to make postpetition transfers or compromises that *otherwise violate* applicable provisions of the code." CMC Supp. Br., p. 9

[5] It is also worth noting that the question of the constitutionality of applying any of these sections to municipality functions protected by § 904 may still be open. It may be that later judicial decisions will conclude that these sections should be viewed as limited in scope by § 904, rather than as automatically satisfying § 904's consent provision. For at least some of these sections, this question already has been raised. *See* COLLIER ON BANKRUPTCY ¶ 901.04[12][a] ("Although section 502 is incorporated in chapter 9, there is nothing in chapter 9 that prevents a municipality from paying prepetition debt."); ¶ 901.04[13][b] ("Section 503(b)(1) should not be read to include the general operating expenses of a municipality during the period that the chapter 9 case is pending . . . Moreover, section 904 precludes the bankruptcy court from exercising control over the property or revenues of a municipality and section 903 counsels against any such interference."); ¶ 901.04[25] (Section 549 is "unlikely to have any significant use in chapter 9 cases," in part because "every transfer of property by a municipality is authorized by the Bankruptcy Code, including payments of prepetition debt," under section 904). However, it is sufficient in this case to note that under *ARECOS*, the applicability of these sections in chapter 9 has no bearing on a court's authority to review settlements and compromises.

(emphasis added). On its face, this contention appears not even to apply, because the Settlement Agreement at issue does not violate any applicable Bankruptcy Code sections.[6] The larger implication of this argument, however, is that § 926 *would* allow the Court to appoint a trustee to avoid an "improper" prepetition transfer made by the City, and involving the City's property or revenues, regardless of section 904. This is not the case.

For one, section 926 only allows for a trustee to pursue causes of action to *avoid* certain transactions which the municipality, for whatever reason, decides not to pursue. This is a far cry from a court directly controlling a municipality's governing decisions, and may or may not involve the municipality's own property and revenues. Moreover, where these concerns do overlap – that is, where a creditor makes a request under section 926 for the appointment of a trustee to avoid a prepetition transfer made in the exercise of a city's political or government functions – § 904 necessarily trumps § 926 (as well as other, similar sections). This is the obvious result of § 904's application "[n]otwithstanding any power of the court."[7] The court generally has the authority to appoint a trustee under section 926, but that authority is circumscribed by section 904 where it encroaches on a municipality's control of its property, revenues, or government functions. This limitation is specifically discussed in 6 COLLIER ON BANKRUPTCY ¶ 926.02:

> [B]ecause of the strict limitations on the court's ability and power to interfere with the governmental or political functions of the debtor in a chapter 9 case, courts should be very hesitant to appoint a trustee [under § 926] . . . [W]hen the debtor has made a prepetition transfer in the exercise of its political or governmental functions, or in control of its income or property, the appointment by the court of a trustee to undo that transfer *may constitute an interference with those powers or with that property, contrary to the mandatory dictates of section 904*.

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[6] Nor does the City's entering into a settlement agreement with the SPOA.

[7] The CMC Supp. Brief makes the strange argument that the phrase "notwithstanding any power of the court," in § 904 limits only the "authority of the court" but *not* the "provisions of the Bankruptcy Code made applicable in Chapter 9 cases," and argues that if the latter had been Congress' intention, it would have chosen the phrase "notwithstanding any other provision of this title." CMC Supp. Br., p. 7. This is a false distinction. The authority of the Court in a chapter 9 case necessarily arises from the Bankruptcy Code sections that are applicable in chapter 9, and section 904 serves as a limit on that authority when it intrudes upon rights reserved to the City. Considering that § 904's purpose is to police the court's authority in chapter 9 cases, it strains credulity to argue that § 904 does not apply to any part of the Bankruptcy Code incorporated into chapter 9.

(emphasis added). *See also In re New York City Off-Track Betting Corp.*, 09-17121 MG, 2011 WL 309594 (Bankr. S.D.N.Y. Jan. 25, 2011) (citing Collier and denying a § 926 motion for appointment of a trustee to avoid transfers made by the debtor where the transfers at issue were made pursuant to state law such that appointing a trustee to avoid the transfers would violate the Tenth Amendment and § 904)

Thus, § 926 does not, as the Capital Markets Creditors suggest, grant the Court the power to approve or reject the City's settlements or otherwise reduce § 904's effect.

F. The City's Filing Of Its Chapter 9 Petition Did Not Constitute Consent To Court Review Of Its Settlements And Compromises.

The Capital Markets Creditors assert that the City has consented, within the meaning of § 904, to the Court's review of its settlements and compromises in two separate ways. First, they claim that the City has consented to such review simply by filing its chapter 9 petititon. CMC Supp. Br., p. 7 ("[b]y filing its Chapter 9 petition, the City consented to the Court's enforcement of [those sections of the Bankruptcy Code incorporated into chapter 9] and voluntarily relinquished," its ability to compromise claims without the Court's approval). Second, they assert that the City's consent is also "evidenced by its voluntary act of seeking to compromise a disputed prepetition claim." *Id.*; *see also* CMC Supp. Br., p. 8 n. 6 ("By electing to settle a prepetition disputed claim prior to the bar date and outside of a plan process, the City has consented to review of the compromise by the Court upon proper notice of all interested parties."). Both of these arguments are without merit.

In support of its first argument, the Capital Markets Creditors cite the statement in *ARECOS* that "[a] municipality's voluntary act of filing a chapter 9 case [means that] the municipality consents, within the meaning of § 904, to interference by a federal court *as to the Bankruptcy Code provisions that apply in chapter 9 cases*." CMC Supp. Br., p. 7 (emphasis added); *ARECOS*, 478 B.R. at 22. As discussed in detail in Section I, however, no requirement of court approval of settlements arises from any Bankruptcy Code section incorporated into chapter 9. Instead, § 363, which provides the substantive basis for that requirement, is purposefully omitted from chapter 9. The City thus has not consented to review of its settlements

and compromises as part of its consent to those Bankruptcy Code sections "that apply in chapter 9."

The City also has not consented to review of its settlement agreements simply by seeking to enter a settlement in the first place. This is a conclusory argument that simply assumes the result the Capital Markets Creditors seek. If a municipality's attempt to undertake any action was sufficient in itself to render that action subject to court approval, the critical separation of state and federal powers under chapter 9 would evaporate. If that were the case, bankruptcy courts would be able to review, and potentially reject, *any* action by the debtor municipality. This clearly cannot be the case, as chapter 9 is structured specifically to maintain sovereign powers of the state. Moreover, the City has not consented in any fashion to review of its settlement agreements – a point that could not be made more clear than by simple reference to the fact that the 9019 Motion asks the Court to recognize its lack of authority to undertake such review.

IV. THE ALTERNATIVE BANKRUPTCY CODE SECTIONS RAISED BY THE COURT AT THE NOVEMBER 20, 2012 HEARING DO NOT GIVE RISE TO COURT AUTHORITY TO REVIEW THE CITY'S SETTLEMENTS AND COMPROMISES.

At the November 20 hearing, the Court raised questions regarding a number of alternative Bankruptcy Code sections that the Court suggested might potentially impact its analysis of section 904 and the Court's power to review settlements. The City addresses each of these sections in turn.[8]

A. Section 502

The role of § 502 (if any) in establishing a requirement that the Court approve the City's settlements was a main point of contention at the November 20 hearing. The CMC Supplemental Brief, like the Limited Objection before it, attempts to identify a separate substantive requirement for court approval of settlements by claiming that section 502 of the Bankruptcy Code provides such a requirement. This argument clearly fails on the language of section 502 alone.

[8] The Capital Markets Creditors discuss only some of these sections in the CMC Supplemental Brief, and often only in passing. Because the Court specifically raised these issues, this brief contains a discussion of all sections mentioned by the Court, regardless of whether the CMC Supplemental Brief addresses the same.

Section 502(b) provides that where a proof of claim is filed, and an objection is made to such proof of claim, "the court, after notice and a hearing, shall determine the amount of such claim . . . as of the date of the filing of the petition, and shall allow such claim in such amount [with exceptions]." Thus, by its plain language, section 502 is limited to the determination of the allowability and amount, if any, of proofs of claim to which the debtor has objected. It makes no mention of a requirement that a bankruptcy court approve the settlement of claims against a debtor. Nor does it reference the disposition of the debtor's property (necessary to consummate the settlement), as does section 363. The CMC Supplemental Brief does not cite any authority interpreting section 502 to create a court approval requirement for settlements, and the only case noted, *In re Columbia Gas Sys.*, is inapposite. Further, none of the cases that *expressly* state that the substantive requirement for court approval of settlements is found in section 363 (*e.g. Mickey Thompson Entm't Group*, etc.) make any mention of section 502 on this issue. By contrast, section 904, in addition to the omission of § 363 from chapter 9, has been recognized as removing any limitation on the City's ability to spend money on settlements. *See* 6 COLLIER ON BANKRUPTCY ¶ 901.04[12][a] ("Although section 502 is incorporated in chapter 9, there is nothing in chapter 9 that prevents a municipality from paying prepetition debt. Section 363 is not incorporated in chapter 9. Furthermore, under section 904 of the Code, the bankruptcy court has no authority over 'any of the property or revenues of the debtor.'"). As stated by the Bankruptcy Court for the Northern District of California in *In re Richmond Unified Sch. Dist.*, "pursuant to section 904, [the debtor municipality] may borrow and spend without court authority." 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991).

Moreover, even if section 502 did create a substantive requirement for court approval of all claim settlements in chapter 9 cases, such a requirement would not be applicable here. The notice and hearing requirement of section 502, by its express terms, applies only where an "objection to a claim is made," upon a claim "proof of which is filed under section 501." 11 U.S.C. § 502(a), (b). Hallon has not filed a proof of claim, and, necessarily, neither the City nor any other party has objected to such non-existent proof of claim. As neither of these pre-

requisites has occurred, section 502 is not applicable to the Hallon Settlement Agreement in any case.

B. Section 943

At the November 20 hearing, the Court questioned whether section 943(b)(3) might impact the need for the City to seek the Court's approval of the Settlement Agreement. *See* Transcript of November 20, 2012 Hearing ("9019 Hearing Transc."), p. 45-47. The CMC Supplemental Brief cites § 943 in several places, but without a detailed explanation of how it might give rise to such a requirement. *See* CMC Supp. Br., pp. 2, 4, 5 n. 3, 10-12.

Section 943(b) lists several requirements that must be satisfied to confirm a plan of adjustment, including 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," § 943(b)(3), and that "the plan is in the best interests of creditors and is feasible," § 943(b)(7). While these requirements impact the ultimate confirmation of any plan the City may file, neither imposes an obligation upon the City to seek the Court's approval of a settlement or compromise. First, § 943(b)(3) creates a disclosure and reasonableness requirement for amounts "to be paid" by the City. This phrasing is prospective, rather than retrospective, and thus refers to payments to be made under the plan, and not to payments previously made by way of settlement. Second, § 943(b)(7)'s requirements that the plan be in the best interest of creditors and be feasible draw no direct connection to prior settlements. While the Court may ultimately determine that a plan as a whole is not feasible or in the best interest of creditors, it may not extend that determination to the approval and rejection of specific settlements. Additionally, these questions are not currently before the Court, as they apply to the confirmation of a plan of adjustment.

C. Section 1129(a)(3)

The CMC Supplemental Brief also cites to § 1129 in several places, including as a potential source of a substantive requirement for Court approval of settlements. *See, e.g.*, CMC Supp. Br., p. 5 n. 3. Section 1129(a)(3), which was raised by the Court at the November 20 hearing as another potential policing mechanism for the City's settlements (*see* 9019 Hearing Transc., pp. 53-55), provides that a plan must be "proposed in good faith and not by any means

forbidden by law" in order to be confirmed. Like section 943(b), section 1129(a)(3) does not invoke any requirement that the Court approve specific settlements, and instead only requires that the plan be proposed "in good faith" considering the totality of the circumstances. *See, e.g., In re Plant Insulation Co.*, 469 B.R. 843, 859 (Bankr. N.D. Cal. 2012) *aff'd*, C 12-01887 RS, 2012 WL 4833148 (N.D. Cal. Oct. 9, 2012). Thus, while it is arguably possible that the Court might consider settlements previously entered into by the City as part of its determination of the City's good faith in proposing its plan, such an analysis does not allow the Court to reject specific settlement agreements.

D. Section 549

Section 549(a) of the Bankruptcy Code provides that a trustee may avoid a postpetition transfer of estate property "that is not authorized under this title or by the court." 11 U.S.C. § 549(a)(2)(B). At the November 20, 2012 hearing, the Court questioned whether section 549(a)(2)(B) might require court approval of settlements, lest they be avoided as "unauthorized" under title 11 or by the Court. *See* 9019 Hearing Transc., p. 68-69. However, section 549 has no such effect. The transfer of a debtor municipality's property as part of a settlement *is* authorized under the Bankruptcy Code, both by the plain language of section 904, which prevents any court interference with such transfers, and implicitly through the omission of section 363. As explained in Collier on Bankruptcy:

> While section 549(a) applies in a chapter 9 case, the absence of section 363 in a chapter 9 case and the presence of section 904 together provide the 'authorization' required to exempt a postpetition payment of prepetition debt from avoidance pursuant to section 549(a).

6 COLLIER ON BANKRUPTCY ¶ 901.04[12][a]; *see also*¶ 901.04[25] ("[T]he Bankruptcy Code prohibits the court from in any way interfering with the use or disposition by the municipality of its property. Thus, *every* transfer of property by a municipality is authorized by the Bankruptcy Code, including payments of prepetition debt.") (emphasis added).

E. Section 106(a)

Finally, the Court asked at the November 20, 2012 hearing whether, pursuant to 11 U.S.C. § 106(a), the City waives its sovereign immunity – and therefore its right to enter settlements

without the Court's approval – by filing its chapter 9 petition. *See* 9019 Hearing Transc., pp. 70-72. The Capital Market Creditors reference section 106(a) only once, in a citation to *ARECOS*. CMC Supp. Br., p. 7. Section 106(a) states that a municipality's sovereign immunity is abrogated with respect to a number of sections of the Bankruptcy Code (including, for the purposes of this Supplemental Response, sections 901 and 363, but not section 904). *ARECOS* considered the intersection of section 904 and section 106(a), and held that:

> [a] municipality's voluntary act of filing a chapter 9 case triggers two relevant consequences: First, the municipality consents, within the meaning of § 904, to interference by a federal court as to the Bankruptcy Code provisions that apply in chapter 9 cases. [citation omitted] Second, sovereign immunity is voluntarily abrogated *to the extent provided in § 106*.

478 B.R. at 22 (emphasis added).

With regard to the first consequence – which does not directly implicate § 106(a) – a municipality's filing of a chapter 9 petition does not constitute consent to the court's oversight and approval of its settlements, because such oversight is not provided for in those "provisions that apply in chapter 9 cases." As discussed multiple times *supra*, § 363 provides the substantive basis for a requirement of court approval of settlements, and is not among the provisions incorporated into chapter 9 by § 901(a).

As to the second consequence, the City's voluntary abrogation of sovereign immunity under § 106 does not include an abrogation of its right not to have control of its property and revenues (including entering into settlements) subject to court review. For one, "sovereign immunity" refers only to a sovereign state's immunity *from suit*, absent its consent. *See Hans v. Louisiana*, 134 U.S. 1, 12, 10 S. Ct. 504, 506, 33 L. Ed. 842 (1890); *Alden v. Maine*, 527 U.S. 706, 713, 119 S. Ct. 2240, 2246, 144 L. Ed. 2d 636 (1999) ("the States' immunity from suit is a fundamental aspect of the sovereignty," of the states). "Sovereign immunity" does not refer to the protections afforded to the City's control over its property, revenues, and government functions by § 904. In fact, if this were the case, § 904 would be rendered a nullity, as the City would be deemed to have consented to waiving the limitations of § 904 the moment it filed its chapter 9 petition.

Further, § 106(a) cannot be read to import a requirement for approval of settlements into chapter 9 where it does not already exist. Although § 363 is included among the sections listed in § 106(a) (for which sovereign immunity is abrogated, according to *ARECOS*), this means only that the City has consented be *sued*. It cannot mean that § 363 – or any other section excluded from § 901(a) – is applicable in chapter 9 cases through the backdoor of § 106(a). Such a reading would vitiate § 901(a) as the definitive catalog of which sections of the Bankruptcy Code apply in chapter 9. Moreover, even if section § 106(a) was given such an interpretation, it would still be trumped by section 904, which prohibits interference with the City's property and revenues "[n]otwithstanding any power of the court." This must certainly include the power of the Court to abrogate the City's sovereign immunity.

Therefore, § 106(a) does not create a requirement that the City submit settlements of claims against it to the Court's approval, nor does it in any way mitigate the limitations on the Court's power imposed by § 904.

The Capital Markets Creditors, meanwhile, cite this portion of *ARECOS* for the proposition that "the enforcement of those applicable statutory provisions (including section 502) does not offend the Tenth Amendment or state sovereignty." CMC Supp. Br., p. 7. This argument misses the mark. The issue of whether any particular portion of chapter 9 violates the Tenth Amendment or § 904 is not before the Court. The City contends that the requirement of court approval of settlements and compromises, grounded in § 363, *does not apply* in chapter 9 in the first place. Moreover, the Capital Market Creditors make no showing that those sections that do apply in chapter 9 (including section 502) give rise to a settlement approval requirement.

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V. CONCLUSION

For the foregoing reasons, the City respectfully requests that the Court rule that the City is not required to seek the Court's approval of the City's settlements and compromises.

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