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UNITED STATES BANKRUPTCY COURT

EASTERN DISTRICT OF CALIFORNIA

SACRAMENTO DIVISION

In re CITY OF STOCKTON, CALIFORNIA., Debtor.	Case No. 2012-32118 D.C. No. OHS-5 Chapter 9 **CALPERS' BRIEF REGARDING APPLICABILITY OF RULE 9019 IN CHAPTER 9 CASES** Date: January 30, 2013 Time: 10:00 a.m. Place: Robert T. Matsui U.S. Courthouse, 501 I Street Department C, Fl. 6, Courtroom 35 Sacramento, CA 95814 Hon. Christopher M. Klein

The California Public Employees' Retirement System ("CalPERS") files this brief in support of the motion of the City of Stockton ("Stockton" or the "City") for an order ruling that approval of a settlement agreement is not required under Rule 9019 of the Federal Rules of Bankruptcy Procedure or, alternatively, approving a settlement agreement pursuant to Rule 9019. This Court should (1) determine that Rule 9019 does not create a substantive requirement that the City must follow or, in the alternative, (2) pursuant to the request of the City, determine that the proposed settlement is reasonable based upon the principles of Rule 9019 without specifically deciding whether Rule 9019 acts as a restriction upon a chapter 9 debtor.

I. OVERVIEW AND INTRODUCTION

Rule 9019 is not a substantive right. It is a procedural rule. The Rule is expressed in the permissive: "the Court may approve a compromise or settlement." Therefore, the Rule does not require a debtor to seek court approval of a compromise while it remains under the jurisdiction of the Bankruptcy Court.

Parties to settlements in bankruptcy cases other than municipal cases are compelled to seek approval of their settlements as a consequence of the limiting effect on the debtor's ability to enter into agreements outside the ordinary course under section 363(b) of the Bankruptcy Code. Section 363, however, is not applicable in chapter 9 and therefore a chapter 9 debtor need not seek court approval to enter into an agreement out of ordinary course. Section 363 is not applicable in chapter 9 for good reasons. Principles of federalism and section 904 of the Code vest control over the City's property, revenues and governmental affairs in the municipal debtor regardless of the filing of the bankruptcy case. The Bankruptcy Court is expressly precluded from interfering with the governmental authority, property or revenues of a municipal debtor by section 904 and that section's constitutional underpinnings. A chapter 9 debtor is free to pay creditors, even prepetition creditors, and is free to modify its contracts without court approval. There are limitations on a municipal debtor's ability to compromise and pay claims, but those limitations lie principally in state law and the continued control the State maintains over its municipal creature in bankruptcy, as reflected in section 903 of the Code. Moreover, in addition to the valuable check section 903 provides, the

Bankruptcy Court's control over the confirmation of a plan of adjustment and the ability to dismiss the bankruptcy case, as well as certain avoidance powers, provide the balances necessary to prevent abuse of the bankruptcy process by a municipal debtor. The Court should not create a substantive right from Rule 9019 because to do so would impair the delicate balance of constitutional authority that is the foundation of all municipal bankruptcy cases.

Stockton's motion and the opposing briefs of the Capital Markets Creditors raise issues regarding the scope of section 904 of the Bankruptcy Code and its constitutional underpinnings. Although CalPERS addresses those issues in this brief, deciding them is unnecessary to the resolution of this motion. Because section 904 is based on constitutional concerns, the Court should follow the doctrine of constitutional avoidance and issue a narrow ruling.

II. LEGAL ARGUMENT

A. Rule 9019 Does Not Create a Substantive Requirement.

Rule 9019 provides, in pertinent part, that, "[o]n motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement." In a chapter 9 case, the term "trustee" means the debtor. 11 U.S.C. § 902(5). As the City has correctly explained, Rule 9019 is merely a rule of procedure and does not create any substantive rights absent a specific provision in the Code. *See* 28 U.S.C. § 2075. As the Third Circuit explained: "Section 363 of the Code is the substantive provision requiring a hearing and court approval; Bankruptcy Rule 9019 sets forth the procedure for approving an agreement to settle or compromise a controversy." *In re Martin*, 91 F.3d 389, 394 n.2 (3d Cir. 1996). Section 363 of the Code, however, has not been incorporated into chapter 9. *See* 11 U.S.C. § 901. Indeed, as explained more fully below, Congress's decision not to incorporate section 363 makes sense given the constitutional concerns reflected in sections 903 and 904 of the Code, which would arise if a bankruptcy court attempted to control how a city allocates its resources during a bankruptcy.

Despite the lack of substantive basis of the Rule, the Capital Markets Creditors argue that Rule 9019 requires a municipal debtor to seek court approval of a settlement given the central role such settlements play in the claims resolution process. *See generally* Limited Objection of the

Capital Markets Creditors [Dkt. No. 605] & Supplemental Brief of the Capital Markets Creditors [Dkt. No. 656]. These arguments are based on policy considerations, rather than on the language of the Rule. The plain language of Rule 9019 reads as an authorization for the court, rather than as a requirement imposed on the debtor. When possible, a court must follow the plain language of rules and statutes. *See, e.g.*, *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (noting that where a "statute's language is plain 'the sole function of the courts is to enforce it according to its terms.'") (quoting *Caminetti v. United States,* 242 U.S. 470, 485 (1917)). Policy arguments cannot substitute for a substantive requirement. Congress has expressly chosen not to impose a substantive limitation on a municipal debtor's operations and, as explained below, this is all the more important given sections 903 and 904 and their constitutional underpinnings.

In order to get around the plain language of Rule 9019, the Capital Markets Creditors alternatively argue that Rule 9019 "has a myriad of statutory bases." Supplemental Brief of Capital Markets Creditors [Dkt. No. 656] at 5, n.3; *but see In re Martin*, 91 F.3d at 394 n.2. The Capital Markets Creditors, however, cite only three such statutory bases: Sections 502, 943 and 1129 of the Code. *Id*. These Code sections, however, do not support the arguments of the Capital Markets Creditors. Section 502 speaks to proofs of claim and their allowance; it says nothing about requiring a chapter 9 debtor to obtain court approval of settlements, as would be the case if the various notice and hearing requirements of section 363 applied. The City has already explained why section 502 does not apply given the facts underlying this motion. *See* City of Stockton's Reply [Dkt. No. 613] at 4-6. Section 943 governs confirmation of a plan and says nothing about the management of the debtor's property during the pendency of the case or the settlement of claims. Similarly, section 1129 applies in part to chapter 9 cases, but only supplements the requirements for confirmation of a plan contained in section 943. At bottom, all of the Capital Markets Creditors' arguments rest on policy considerations that may have particular force in cases under other chapters of the Code, but are simply not applicable in a chapter 9 case given the delicate Federal/State balance Congress struck in passing the municipal bankruptcy laws.

Although not expressly stated, the Capital Markets Creditors intimate that Rule 9019, coupled with the various penumbras of the Code, effectively trump section 904, which prohibits a court (absent consent) from interfering with "any of the property or revenues of the debtor." 11 U.S.C. § 904. This cannot be so. In rejecting a similar argument regarding Bankruptcy Rule 9024, the Third Circuit stated:

> [The creditor] wisely does not attempt to argue that Rule 9024 simply trumps Section 1330(a), for when Congress accorded the Supreme Court authority to promulgate the Bankruptcy Rules, it stated "such rules shall not abridge, enlarge, or modify any substantive right" (28 U.S.C. § 2075). Thus, as a general matter, the Code defines the creation, alteration or elimination of substantive rights but the Bankruptcy Rules define the process by which these privileges may be effected. So Rule 9024 cannot validly provide [the creditor] with a substantive remedy that would be foreclosed by Section 1330(a).

In re Fesq, 153 F.3d 113, 116 (3d Cir. 1998) (quotation and citation omitted); *accord In re Young*, 237 B.R. 791, 802 (10th Cir. BAP 1999) ("The Bankruptcy Code defines substantive rights, while the Bankruptcy Rules delineate the process for protecting those rights."). Indeed, as the Ninth Circuit has expressly stated: "[A]ny conflict between the Bankruptcy Code and the Bankruptcy Rules must be settled in favor of the Code." *In re Pac. Atl. Trading Co.*, 33 F.3d 1064, 1066 (9th Cir. 1994); *see also In re Logan Props., Ltd.*, 327 B.R. 811, 815 (Bankr. S.D. Tex. 2005) ("Thus, the Rules cannot allow what the Code prohibits.") (citing cases). Thus, to the extent that this Court concludes that section 904 has any role to play in this motion—a decision, as explained in more detail below, this Court should avoid—section 904 must control.

Based on comments made during the first hearing on this matter, the Court appeared concerned that, if Rule 9019 did not apply, that there would be no check on Stockton's decisions to settle or pay prepetition claims. *See* Transcript of Hearing at 44. These concerns may be alleviated in several ways. First, as discussed during the hearing, the Court could address the propriety of Stockton's settlements on a motion to dismiss made by a party. *See* Hearing Transcript at 54. Second, the court could deny confirmation of the debtor's proposed plan of adjustment. *See, e.g.*, 11 U.S.C. § 1129(a)(3). In other words, if the City settles or pays claims without first obtaining Court approval, it will be required to answer for such settlements at the time of plan confirmation, and the

Capital Markets Creditors will be free to raise the propriety of those settlements at that time. Accordingly, a municipal debtor that settles matters without court approval does so at its own peril.

Third, it is a well-established tenet of municipal law that there are legal limitations on Stockton's ability to enter into improper settlements. "An act of a city in excess of its power is, as a general rule, void." 45 Cal. Jur. 3d Municipalities § 211. "To be valid and enforceable, . . . the contract must be within the scope of the municipal powers, *i.e.*, it must not be ultra vires, it must be made by officers or bodies duly empowered and authorized to act, and it must be made, in substance at least, as prescribed by the laws applicable." 10A McQuillin Mun. Corp. § 29:91 (3d ed.). California courts have not hesitated to invalidate settlement agreements and other contracts executed by city officials as in excess of the limitations of their statutory powers. *See, e.g.*, *Summit Media LLC v. City of Los Angeles*, 211 Cal. App. 4th 921 (2012) (ruling that a City's settlement agreement with billboard companies exempting the companies from ordinances and regulations that apply to everyone else was *ultra vires* and void); *Midway Orchards v. Cnty. of Butte*, 220 Cal. App. 3d 765, 783 (1990) ("A contract entered into by a local government without legal authority is 'wholly void,' ultra vires, and unenforceable."); *G.L. Mezzetta, Inc. v. City of Am. Canyon*, 78 Cal. App. 4th 1087, 1093-94 (2000) (finding a City's alleged contract void and unenforceable when the "statutes in question specifically set forth the ways in which the City may enter into contracts," which were not followed); *San Diego City Firefighters, Local 145 AFL-CIO v. Bd. of Admin. of San Diego City Employees' Ret. Sys.*, 206 Cal. App. 4th 594, 608-09 (2012) (finding that a pension benefit adopted by city resolution was void because it conflicted with the city charter, which required adoption by ordinance).

Here, the Stockton City Charter contains multiple limitations on expenditures of municipal funds. *See, e.g.*, Art. XII, §1201 City Manager (limiting expenditure authority to sums of $20,000 or less); Art. XIX, § 1908 (mandating annual adoption of budget through public process and limiting expenditures to those for which funds are appropriated in budget; restricting transfer of funds without City Council approval; and requiring amendment of budget prior to expenditure of additional funds). Further, Article XV of the Charter creates the position of City Auditor and requires an annual

audit of all fiscal transactions and accounts of the City, as well as annual performance audits, culminating in a public report of all findings. An especially relevant example of City Code limitations on the City's settlement authority is the specific requirement for the City Council's approval of the terms of negotiated employment wage and conditions agreements (*e.g.* collective bargaining agreements) when the dollar value of the contract exceeds the authority of the City Manager set forth in the Charter ($20,000, *supra*). *See* Stockton City Code § 2.74.040. Within the same Employer-Employee Relations chapter of the City Code, the City's Employee Relations Officer (the Human Resources Director) is further limited in his/her authority to settle contracts with employee units to 90% of the City Manager's expenditure authority under the City Charter. *See* Stockton City Code § 2.74.050. Thus, local law provides significant limitations on the City's authority to settle prepetition claims. In fact, prior public notice of meetings and transparency around the City's Council's actions in settling such claims is ensured by the State's open public meeting requirements imposed upon all cities by the Brown Act, codified in §§ 54950-54963 of the California Government Code. Under the Brown Act: "All meetings of the legislative body of a local agency shall be open and public, and all persons shall be permitted to attend any meeting of the legislative body of a local agency…" Cal. Gov. Code § 54953 (a); *Boyle v. City of Redondo Beach,* 70 Cal. App. 4th 1109, 1116 (1999).

State law provides further protections against the misuse of public funds through improper settlements by authorizing any taxpayer to seek injunctive relief under the California Code of Civil Procedure § 526(a) when public funds have been improperly spent. (Authorizing "[a]n action to obtain a judgment, restraining and preventing any illegal expenditure of, waste of, or injury to, the estate, funds, or other property of a county, town, city or city and county of the state, may be maintained against any officer thereof, or any agent, or other person, acting in its behalf, either by a citizen resident therein, or by a corporation, who is assessed for and is liable to pay, or, within one year before the commencement of the action, has paid, a tax therein. …"). The right of the State to seek appointment of a receiver is also available, either by a plaintiff in a pending court action or through independent action of the State Attorney General. *See* Cal. Civ. Pro. § 564(b)(1); Cal. Gov.

Code § 12527. In addition, as explained below, state law continues to be a constraint on a municipal debtor's ability during the pendency of a chapter 9 case by virtue of section 903 of the Code, which expressly states that States retain "control" over their municipal creatures during a chapter 9 proceeding. *See* 11 U.S.C. § 903. State law, therefore, provides a measure of direction in a chapter 9 case that compensates for the check on the court's power imposed by section 904.

Stockton's motion should be granted because Rule 9109 does not create a substantive requirement. Alternatively, the Court could determine—without deciding whether the City is required to seek approval—that the proposed settlement is reasonable and meets the approval of the Court under the standards articulated in *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414 (1968), and *In re A&C Properties*, 784 F.2d 1377 (9th Cir. 1986), a point which the Capital Markets Creditors do not dispute.

By ruling either of these ways, the Court would (and should) avoid deciding the thornier question of whether requiring compliance with Rule 9019, construed as a substantive requirement, violates either section 904 or implicates the Tenth Amendment. Such a ruling would be consistent with the longstanding principle that courts should avoid reaching or raising issues with constitutional dimensions when the motion at hand can be decided on narrower grounds. *See, e.g.*, *Escambia Cnty., Fla. v. McMillan*, 466 U.S. 48, 51 (1984) (per curiam) ("It is a well established principle governing the prudent exercise of this Court's jurisdiction that normally the Court will not decide a constitutional question if there is some other ground upon which to dispose of the case.") (citing *Ashwander v. Tenn. Valley Auth.*, 297 U.S. 288, 347 (1936) (Brandeis, J., concurring)); *see also Clark v. Martinez*, 543 U.S. 371, 380-81 (2005) (explaining doctrine of constitutional avoidance in interpreting statutes and noting that construction that avoids constitutional issues should prevail over one that raise constitutional issues). Put simply, ease of administration of future settlements of prepetition claims by the City is not a strong enough reason in and of itself for this Court to reach out and decide certain issues—namely the full scope and impact of section 904—that have at their core constitutional underpinnings. Consequently, this Court should follow the doctrine of constitutional avoidance and rule in the City's favor on one of the alternative grounds discussed above.

B. Other Issues Raised By the Parties and the Court.

The briefs and argument on the City's Motion raise collateral issues that need not be decided by the Court on the instant motion, but that may be important at some point during the pendency of this case. While CalPERS does not request a ruling on any of these issues, it offers the analyses below to apprise the Court of its position pursuant to the invitation of the Court.

First, there appears to be confusion in prior argument before the Court between the concept of "sovereignty," which reflects the dual nature of our Nation's constitutional structure, and the concept of "sovereign immunity," which relates to whether a State or its arms/agents can be sued in Federal Court. As explained below, although related, the two concepts are distinct and arise from different constitutional provisions.

Second, the primary collateral argument advanced by the City is that section 904 precludes the Court from requiring the approval of settlements because to do so would interfere with the City's ability to control its fiscal affairs. CalPERS agrees with the City that section 904 prevents the Court from telling the City how to spend its money during this bankruptcy case. As explained below, however, section 904 cannot be viewed in isolation and must be read in conjunction with section 903. These sections reflect Congress's concern with protecting State sovereignty and the control of the State over its municipal creatures. The two provisions work in tandem to protect State sovereignty.

1. Stockton is a Municipality and Therefore Does Not Enjoy Sovereign Immunity.

During the initial hearing on this matter, the Court questioned the parties as to whether section 106(a)(1) of the Code and its purported abrogation of sovereign immunity should play any role in the Court's analysis on the meaning and scope of section 904. *See* Transcript Hearing at 70. Seizing on this question, the Capital Markets Creditors claim section 106's purported abrogation of sovereign immunity somehow supports their limited interpretation of section 904. *See* Supplemental Brief of Capital Markets Creditors [Dkt. No. 656] at ¶ 19 (quoting *In re City of Stockton, Cal.*, 478 B.R. 8, 22 (Bankr. E.D. Cal. 2012)). The Capital Markets Creditors' reliance on section 106 is misplaced and stems from an apparent confusion between the consequences that flow (in part) from the Tenth and the Eleventh Amendments to the United States Constitution. The two Amendments are different, and

the interests they protect distinct. As explained below, section 106 has no role to play in the Court's analysis because municipalities such as Stockton do not enjoy sovereign immunity.[1] Simply put, "sovereignty" and "sovereign immunity" are different concepts. The former recognizes the dual nature of sovereigns inherent in our Nation's design and the need to keep the Federal Government separate from the States, while the latter addresses when States (or their arms/agents) can be sued or required to respond to compelled process.

The Tenth Amendment embodies our Nation's commitment to dual sovereignty and federalism and protects both the States (and their creatures such as Stockton) and their citizens from undo interference by the Federal Government. *See, e.g.*, *Bond v. United States*, 131 S. Ct. 2355, 2364-65 (2011). Municipalities, like the City of Stockton, enjoy Tenth Amendment protection as a result of their relationship to the States in which they are located. Municipalities are not independent sovereigns. *Ysursa v. Pocatello Educ. Ass'n*, 555 U.S. 353, 362 (2009) ("Political subdivisions of States—counties, cities, or whatever—never were and never have been considered as sovereign entities.")(citation and quotation omitted). This reality, as explained in further detail below, is reflected in sections 903 and 904 of the Code. The latter prevents the court from interfering with a municipal debtor's functions during a chapter 9 case, because doing so protects both the States and

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[1] Likewise, in its decision on the Retirees' Motion, this Court referred to Stockton as an "arm of the state cloaked in the state's sovereignty." *In re City of Stockton,* 478 B.R. at 17. Respectfully, this statement was not accurate. Stockton is not "an arm of the state;" but rather a mere creature of the state and therefore subordinate to the State. *See, e.g.*, *Louisiana ex rel. Folsom v. Mayor and Administrators of New Orleans*, 109 U.S. 285, 287 (1883) ("Municipal corporations are instrumentalities of the State for the convenient administration of government within their limits."); *see also Ysursa v. Pocatello Educ. Ass'n*, 555 U.S. 353, 362 (2009) (same). Indeed, the term "arm of the state" is a term of art used in determining whether a governmental unit is entitled to sovereign immunity. *See, e.g.*, *Mt. Healthy City Sch. Dist. Bd. of Educ. v. Doyle*, 429 U.S. 274, 280 (1977). In order to make such a determination, courts in the Ninth Circuit employ a five-factor test to determine whether an entity is an "arm of the state." *See, e.g.*, *Beentjes v. Placer County Air Pollution Control Dist.*, 397 F.3d 775, 778 (9th Cir. 2005); *see also Barroga v. Bd. of Admin. of CalPERS*, No. 2:12-cv-01179, 2012 WL 5337326 at *5 (E.D. Cal. Oct. 26, 2012) (finding that CalPERS is an "arm of the state" for sovereign immunity purposes) (citing cases holding the same); *cf. CalPERS v. Moody's Corp.*, No. C09-03628, 2009 WL 3809816 at *6 (N.D. Cal. Nov. 10, 2009) (employing five-factor test to conclude CalPERS was "an arm of the state" for diversity jurisdiction purposes). As far a CalPERS is aware, Stockton has never claimed to be an "arm of the state" and instead has consistently maintained that it is a "municipality." *See, e.g.*, Statement of Qualifications Under Section 109(c) [Dkt. No. 5] at ¶ 1.

their citizens from undue control by an instrumentality of the Federal Government, while the former maintains the State's control over a municipal debtor when that debtor is in bankruptcy.

Importantly, to the extent that the Capital Markets Creditors imply that by filing a chapter 9 petition Stockton (or, for that matter, the State) consented to the court's interference with the State's control over its municipal creature by effectively waiving its Tenth Amendment rights, *see* Supplemental Brief at ¶ 19, this argument must be rejected.[2] The Supreme Court has made it abundantly clear that because federalism and our system of dual sovereignty are ultimately designed to protect individuals, States cannot "waive" any aspects of sovereignty. *See, e.g.*, *New York v. United States*, 505 U.S. 144, 182 ("Where Congress exceeds its authority relative to the States, the departure from the constitutional plan cannot be ratified by the 'consent' of state officials."); *cf. Bond*, 131 S. Ct. at 2364 ("The allocation of power in our federal system preserves the integrity, dignity, and residual sovereignty of the States. [. . .] Federalism also protects the liberty of all persons within a State by ensuring that laws enacted in excess of delegated governmental power cannot direct or control their actions."). Indeed consent, in and of it itself, is not the constitutional *sine qua non* of chapter 9 because if it were, then the Supreme Court never would have struck down the first municipal bankruptcy act in *Ashton* where the State of Texas authorized its political subdivision to seek bankruptcy protection. *Ashton v. Cameron Cnty. Water Improvement Dist.*, 298 U.S. 513, 527 (1936).

In contrast, the concept of "sovereign immunity," which arises in part from the Eleventh Amendment, is separate and apart from the Tenth Amendment, as it deals with a State's (or one of its arms or agencies) immunity from suit and process. As the Supreme Court has explained:

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[2] This argument is contrary to the arguments made by one of the Capital Markets Creditors—Assured Guaranty Municipal Corp.—in an appeal brief filed with the United States Court of Appeals for the Eleventh Circuit in the *Jefferson County* bankruptcy case. *See* Exhibit 3 at 11 ("this Court must reject the County's argument that Alabama's consent to bankruptcy court authority over its municipalities ratifies all actions that may infringe upon state sovereignty."). In addition, it is interesting to note that in the *Jefferson County* case, Assured was represented by Mr. Lawrence Larose, who (among others) currently represents National Public Finance Guarantee Corporation—another one of the Capital Markets Creditors—in this case.

> The Eleventh Amendment makes explicit reference to the States' immunity from suits "commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." We have, as a result, sometimes referred to the States' immunity from suit as "Eleventh Amendment immunity." The phrase is convenient shorthand but something of a misnomer, for the ***sovereign immunity of the States*** neither derives from, nor is limited by, the terms of the Eleventh Amendment. Rather, as the Constitution's structure, its history, and the authoritative interpretation by this Court make clear, the ***States' immunity from suit is a fundamental aspect of the sovereignty which the States enjoyed before the ratification of the Constitution***, and which they retain today (either literally or by virtue of their admission into the Union upon equal footing with the States) except as altered by the plan of the Convention or certain constitutional Amendments.

Alden v. Maine, 527 U.S. 706, 712-13 (1999) (citation omitted) (emphasis added). Thus, in contrast to the Tenth Amendment, municipalities like Stockton do not enjoy "sovereign immunity." *Id.* at 756 ("The second important limit on the principle of sovereign immunity is that it bars suit against States but not lesser entities. ***The immunity does not extend to suits prosecuted against a municipal corporation or other governmental entity which is not an arm of the State.***") (emphasis added); *see also Jinks v. Richland County*, 538 U.S. 456, 466 (2003) ("[M]unicipalities, unlike States, do not enjoy a constitutionally protected immunity from suit.") (citations omitted).

Perhaps the most important distinction between "sovereignty" and "sovereign immunity" is that "sovereign immunity" can be waived or "abrogated," while "sovereignty" cannot be waived or given away by consent. *Compare Alden,* 527 U.S. at 755 (noting that State may waive sovereign immunity) *with New York*, 505 U.S. at 182 (noting Tenth Amendment sovereignty cannot be waived or consented away). Because Stockton—as a municipality—does not enjoy "sovereign immunity," any discussion of whether section 106's purported abrogation of sovereign immunity applies is wholly irrelevant to the meaning and import of sections 903 and 904.[3]

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[3] Although not relevant given the fact that the City of Stockton enjoys no sovereign immunity, the Ninth Circuit has held "that § 106(a) was not a valid abrogation of the State's Eleventh Amendment immunity." *In re Death Row Records, Inc.*, No. 10-02574, 2012 WL 952292, at *5 (9th Cir. BAP Mar. 21, 2012 (Cal.)) (citing *In re Mitchell*, 209 F.3d 1111 (9th Cir. 2000)). In *Central Virginia Community College v. Katz*, the Court granted *certiorari* to determine whether Section 106(a) was a valid abrogation of State sovereign immunity. 546 U.S. 356, 361 (2006). Ultimately, the Court did not address the issue directly and instead ruled, 5-4, that the determination of whether Section 106(a) properly abrogated sovereign immunity was not relevant because the States, at the time the Constitution was ratified, subordinated "whatever sovereign immunity they might otherwise have asserted in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts." *Id.* at 378. As a result: "After *Katz*, then, courts faced with state-sovereign-immunity questions in bankruptcy proceedings should limit their focus to the 'litigation waiver' theory and 'consent by ratification' theory." *In re Diaz*, 647 F.3d 1073, 1085 (11th Cir. 2011); *see also id.* at 1082-84

2. Overview of Chapter 9's Provisions Relating to State Sovereignty.

Congress's first attempt at crafting municipal bankruptcy legislation was declared unconstitutional by the Supreme Court in *Ashton v. Cameron County Water Improvement District*, 298 U.S. 513 (1936). In so declaring, the Court recognized the dual nature of sovereignty that exists between the federal government and the several States:

> If obligations of ***states or their political subdivisions*** may be subjected to the interference here attempted, they are no longer ***free to manage their own affairs***; the will of Congress prevails over them[.] ***And really the sovereignty of the state, so often declared necessary to the federal system, does not exist.***

Id. at 531 (citations omitted) (emphasis added). The Court added:

> Neither ***consent nor submission by the states*** can enlarge the powers of Congress; none can exist except those granted to the United States. The sovereignty of the state essential to its proper functioning under the Federal Constitution cannot be surrendered; ***it cannot be taken away by any form of legislation***.

Id. (citations omitted) (emphasis added). Accordingly, the Court held "that the federal government, acting under the bankruptcy clause" could not "impose its will and impair state powers" or "pass laws inconsistent with the idea of sovereignty." *Id.*

Congress responded to *Ashton* by amending bankruptcy law to require that a municipal petitioner must show that it is "authorized by law to take all actions necessary to be taken by it to carry out the plan" and that, if the court is not satisfied on that point as well as on others mentioned, it must dismiss the proceeding. *United States v. Bekins*, 304 U.S. 27, 49 (1938) (citing chapter 10, section 83(e)). This provision, among others, was the precursor to the current chapter 9. In *Bekins*, the Court upheld the amended bankruptcy law for municipal petitioners, noting that "'[t]he phrase authorized by law' manifestly refers to the law of the state." *Id.* at 49. Thus, because "[t]he ***State retains control*** of its fiscal affairs," even following the filing of a bankruptcy case, the Court

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(explaining three ways that bankruptcy courts may exercise *in personam* jurisdiction over a State and get around issue of sovereign immunity.). Notably, *Katz* was not a chapter 9 case and, given that there is no "estate" (*i.e.*, *in rem* jurisdiction) in a chapter 9 proceeding, it is questionable whether *Katz's* conclusion regarding the waiver of sovereign immunity would even apply in this case, a point implicitly acknowledged by the majority in *Katz*. *Katz*, 564 U.S. at 378 n.15 ("We do not mean to suggest that every law labeled a 'bankruptcy' law could, consistent with the Bankruptcy Clause, properly impinge upon state sovereign immunity."); *see also id.* at 388 n.4 (Thomas, J., dissenting).

determined that the constitutional objection to municipal bankruptcy cases had been removed. *Id.* at 51 (emphasis added); *see also id.* at 50 (noting that changes to law were "especially solicitous to afford no ground for [the] objection" that States "would no longer be 'free to manage their own affairs.'")(quoting *Ashton*). Thus, under *Bekins*, so long as a State retains control over its essential governmental powers—including powers over the fiscal affairs of its creatures—State sovereignty is not violated.

Given the basic structure of our Nation's constitutional design, and the control States have over their municipalities, "any federal debt relief legislation affecting municipalities must be sufficiently narrow in scope to avoid intrusion by the federal courts on the sovereign power of the states." *In re Richmond Unified Sch. Dist.*, 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991); *see also In re City of Harrisburg, PA*, 465 B.R. 744, 753 (Bankr. M.D. Pa. 2011) ("where federal bankruptcy law intersects with the ***rights of states to regulate activities of political subdivisions created by the state, principles of dual sovereignty as defined by the Tenth Amendment must be considered.***") (emphasis added). Chapter 9 of the Code seeks to protect *State* sovereignty in several ways.

First, section 109 of the Bankruptcy Code, which is entitled "Who may be a debtor," states that a municipality may file a chapter 9 petition if it "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter." 11 U.S.C. § 109(c)(2). Under this section, the State acts as a gatekeeper to one of its creature's entry into chapter 9. *See Harrisburg*, 465 B.R. at 754 ("Congress amended § 109(c)(2) to clarify that a state must provide 'specific' authorization to comply with Tenth Amendment constraints."). Once a state consents to a municipality filing a chapter 9 petition, however, the State's control over its political subdivision is not at an end. As the court in *Harrisburg* aptly stated: "***Even after an order of relief is granted, states maintain significant control over their political subdivisions. This position is set forth bluntly in § 903 of the Bankruptcy Code[.]***" *Id.* at 755 (emphasis added).

Second, section 903 of the Bankruptcy Code protects the rights of States *qua* States by allowing States to control the affairs of their political subdivisions even while such subdivisions are

in chapter 9. Section 903, which is entitled "Reservation of state power to ***control*** municipalities" states in full:

> This chapter does not limit or impair the power of ***a State to control***, by legislation *or* ***otherwise***, a municipality of or in such State in the exercise of its political or governmental powers of such municipality, including expenditures for such exercise, but—
>
> (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
>
> (2) a judgment entered under any such law may not bind a creditor that does not consent to such composition.

11 U.S.C. § 903 (emphasis added). Thus, section 903 honors the long-standing rule that municipal corporations like the City are mere "instrumentalities of the State for the convenient administration of government within their limits [and that] State political subdivisions are merely departments of the State, and the State may withhold, grant or withdraw powers and privileges as it sees fit." *Ysursa v. Pocatello Educ. Ass'n*, 555 U.S. 353, 362 (2009) (quotations; citations and internal alterations omitted) (not a chapter 9 case). As a result, simply because a municipal corporation seeks chapter 9 protection, the State is not powerless to control the affairs of its own creatures during the bankruptcy case and section 903 expressly preserves such control. *See, e.g.*, *Harrisburg,* 465 B.R. at 755 (noting that under § 109(c)(2) "a state serves as a municipality's gatekeeper into chapter 9" and that "[e]ven after an order of relief is granted, states maintain significant control over their political subdivisions" under § 903); *In re New York City Off-Track Betting Corp.*, 434 B.R. 131, 141 (Bankr. S.D.N.Y. 2010) ("The ability of a chapter 9 debtor to consent under section 904 is limited by section 903 of the Bankruptcy Code and federalism concerns."). Section 903 means that, during the pendency of a chapter 9 case, state law controls the actions of the municipality. Thus, even though the court cannot interfere with the debtor's use of its property under section 904, the State *can*, "by legislation or otherwise." *Id.* at 142; *see also In re Jefferson Cnty., Ala.*, -- B.R. --, No. 11-05736, 2012 WL 6629645 at *27 (Bankr. N.D. Ala. Dec. 19, 2012) ("Added to § 904 is 11 U.S.C. § 903. ***Among other things, it restricts a Chapter 9 debtor's ability to consent.***") (emphasis added). Given the

limitations imposed on the court by section 904, without section 903 a municipal debtor would be a law unto itself during the pendency of its bankruptcy case. This is not what Congress intended.

CalPERS recognizes that there are more restrictive views of section 903 that have been articulated in some municipal bankruptcy case opinions, such that section 903 is merely another "gatekeeper" provision and that its has no independent meaning and force. *See, e.g.*, *In re City of Vallejo*, 403 B.R. 72, 75-76 (Bankr. E.D. Cal. 2009) (section 903 has no substantive meaning or independent force) (citing *Collier*); *In re Cnty. of Orange*, 191 B.R. 1005, 1018 & 1021 (Bankr. C.D. Cal. 1996) (same) (citing *Collier*); *cf. In re City of Stockton, Cal.*, 478 B.R. 8, 17-18 (Bankr. E.D. Cal. 2012) (suggesting the same).[4] These cases appear to hold that a State's control over its creatures ends once the State provides authorization for those creatures to file for chapter 9 protection. Respectfully, CalPERS submits that those courts' interpretation of section 903 render 903 meaningless surplusage in the Code because they relegate section 903 to performing merely the same function as section 109(c)(2). Section 903, however, is not a redundancy in the Code; indeed, it was placed into the Code to respect state sovereignty. To read it out of the Code would violate a cardinal rule of statutory interpretation—that every word and phrase of a statute must be given meaning. *TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001) (noting the "'cardinal principle of statutory construction' that 'a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.'") (quoting *Duncan v. Walker,* 533 U.S. 167, 174 (2001)). In order to respect the delicate Federal/State balance that municipal bankruptcies present, section 903 must have independent meaning and force.[5]

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[4] These decisions conflict with *Harrisburg*, *Off-Track Betting* and *Jefferson County* insofar as they do not give meaning to section 903; thus, there is dispute brewing in the lower courts on what effect or meaning, if any, section 903 has in a chapter 9 case. A careful reading of the *Vallejo*, *Orange County* and *Stockton* cases, however, demonstrates that none of them involved the State as the party in interest in the matter before the Court. Accordingly, any statements relating to the substantive force or meaning of section 903—which specifically addresses State control over its creatures—were unnecessary to the determination before the court and are, therefore, *obiter dicta*. *See, e.g.*, *Vallejo*, 403 B.R. at 74 (private unions); *Orange*, 191 B.R. at 1017 (Merrill Lynch raised 903 issue); *cf. Stockton*, 478 B.R. at 13 (Stockton retirees); *see also id*. at 16 (noting section 903 discussion merely provided "context to this dispute.").

[5] Again, on the interpretation of section 903, there should be general agreement between the Capital Markets Creditors and CalPERS. In recent briefs filed with the Eleventh Circuit in the *Jefferson*

Indeed, not only does CalPERS' interpretation of section 903 comport with that section's plain language and with cardinal principles of statutory construction, it is further bolstered by section 903's legislative history. CalPERS' construction is consistent with the legislative history surrounding the amendments made to bankruptcy laws in the mid-1970s, which culminated in the adoption of the Bankruptcy Code in 1978. For example, the legislative history of the precursor to section 903 states:

> The purpose of section 83, copied from present section 83(i) [now Section 903], is the same as that of Section 82(c) [now Section 904]. It is to prevent the statute or the court from interfering with the power constitutionally reserved to the State by the Tenth Amendment. This section makes clear that the chapter may not be construed to limit the power of the State to control, by legislation or otherwise, any municipality, political subdivision or public agency or instrumentality in the exercise of its governmental functions. ***Any State law that governs municipalities or regulates the way in which they may conduct their affairs controls in all cases. Likewise, any State agency that has been given control over any of the affairs of a municipality will continue to control the municipality in the same way, in spite of a Chapter IX petition***.

H.R. Rep. No. 94-686, at 19 (1975), *reprinted in* 1976 U.S.C.C.A.N. 539, 557 (emphasis added).[6] Thus, under the plain terms of section 903 and its legislative history, the States still retain control over their political subdivisions even when those subdivisions seek protection under chapter 9.

CalPERS' construction of section 903 is also harmonious with section 943(b)(4), which prohibits a plan from being confirmed "if it permits a debtor to do something that is prohibited by state law[.]" *In re Sanitary & Improvement Dist., No.7,* 98 B.R. 970, 974 (Bankr. D. Neb. 1989); *see also In re City of Colo. Springs Spring Creek Gen. Improvement Dist.,* 177 B.R. 684, 694 (Bankr. D. Colo. 1995) ("Where a plan proposes action not authorized by state law, or without satisfying state law requirements, the plan cannot be confirmed."). Thus, sections 109(c)(2), 903 and 943(b)(4) operate in harmony to protect State sovereignty by maintaining the State's control over its political subdivisions from the "cradle to the grave" of a chapter 9 proceeding. Under these provisions, the

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County bankruptcy case, Assured (through National's counsel in this case) signed onto several briefs that made arguments strikingly similar to those made by CalPERS. Relevant excerpts of these briefs are attached at Exhibit 2 and Exhibit 3.

[6] A true and correct copy of the relevant portions of the House Report is attached as Exhibit 1.

control of the State over its creatures during chapter 9 provides a measure of direction that, in cases under other chapters of the Code, would issue from the Court, but that the Court is unable to effect for a municipal debtor because of the restriction on its power in section 904.

Third, section 904 protects State sovereignty by protecting the rights of a State's creature (*i.e.*, a municipality like the City) to control its political and governmental affairs and property during a chapter 9 proceeding. It reads in full: "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property." 11 U.S.C. § 904. Preventing undue control by an instrumentality of the Federal Government (*i.e.*, the bankruptcy court) over a creature of the State protects State sovereignty because municipal corporations such as the City enjoy only such powers as are entrusted to it by the State. *Hunter v. City of Pittsburgh*, 207 U.S. 161, 178 (1907) ("The number, nature, and duration of the powers conferred upon these [municipal] corporations and the territory over which they shall be exercised rests in the ***absolute discretion of the state***.") (emphasis added). Under section 904, the court cannot exercise undue control and direct the debtor to do certain things because, given the relationship between a State and its creatures, that is the State's function. As explained above, this reality is reflected in section 903.

The Capital Markets Creditors assert that the broad "notwithstanding any power of the court" language of section 904 is "not a limitation on the provisions of the Bankruptcy Code." *See* Supplemental Brief at 7 (emphasis in original). This interpretation proves too much. The phrase "any power of the court" refers to all of the Court's powers, whether those powers derive from equity or the Code itself. Obviously, the Court can only act in ways authorized by the Code and it is from the Code that all of the "power[s] of the court" derive. Congress made the choice—based on constitutional concerns—that municipal debtors in a chapter 9 case are free to manage their own affairs unless they expressly "consent" to such interference or propose such interference via a "plan" of adjustment. Under section 904, this freedom from interference, however, is only limited to three

circumstances: When such interference touches upon any (1) "political or governmental powers," (2) "property or revenues" or (3) "use and enjoyment of income-producing property" of the municipal debtor. If the interference contemplated does not touch upon any of these protected categories, the applicable provisions of the Code would have effect and section 904 is not implicated. Here, because the payment of settlements funds would implicate the "property or revenues" of the City, section 904 is implicated.

To be clear, CalPERS is not asking the Court as this time to issue any ruling on the meaning and scope of sections 903 and 904. Indeed, it should avoid doing so because the interpretation of these sections raises serious constitutional questions that are best left for another day. *See supra* (citing cases on constitutional avoidance). That said, any interpretation of section 904 must be informed by section 903—as well as other sections of the Code discussed above—because these two Code sections work in tandem to protect state sovereignty. *See, e.g.*, *Jefferson Cnty.*, 2012 WL 6629645 at *27 ("All of these have been designed to retain as and to the extent called for in our Constitution the separateness of states and their subdivisions from that of the United States government."). In order to achieve the correct constitutional balance that Congress attempted to strike after *Ashton*, both sections 903 and 904 must have independent meaning and force and must mean what they say. Any interpretation that removes the State's ability to "control" its political subdivisions under section 903 yet provides force to section 904 turns a municipal debtor into a "super sovereign" and is inconsistent with the notion that municipalities, like the City of Stockton, are mere creatures of the state that do not, in and of themselves, possess sovereign status. *Ysursa*, 555 U.S. at 362 (2009) ("Political subdivisions of States—counties, cities, or whatever—never were and never have been considered as sovereign entities.") (citation and quotation omitted).

III. CONCLUSION

For the reasons stated above, the City's motion should be granted. Under the doctrine of constitutional avoidance, this Court should avoid issuing a broad ruling on the scope and meaning of section 904. It can do so by simply concluding the Rule 9019 does not impose a substantive requirement on a chapter 9 debtor given the absence of section 363's application in a chapter 9 case.

Alternatively, the Court could determine—without deciding whether the City is required to seek approval—that the proposed settlement is reasonable and meets the approval of the Court under the applicable Ninth Circuit standards.

Respectfully submitted,

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