



THE PUBLIC SECTOR

What's happening in Stockton?

by Jonathan Holtzman

By now, you likely know that Stockton has entered a prebankruptcy mediation process under Assembly Bill (AB) 506 and that if the mediation doesn't succeed, it may become the largest California city to seek bankruptcy protection. The causes of Stockton's fiscal distress are well-known and include the housing market crash, pensions, retiree health, excessive labor contracts, and overly optimistic development plans.

What is perhaps less well-known is how this new mediation/neutral evaluation process will work. AB 506 was a labor-sponsored bill that became effective January 1, 2012. It requires a local government to engage in a mediation/neutral evaluation process before it is eligible to file a case under Chapter 9 of the Bankruptcy Code.

Under AB 506, a local public entity must notify "interested parties" of the commencement of the mediation/neutral evaluation process, which Stockton has now done. Interested parties include creditors holding in excess of \$5 million of noncontingent debt, parties to contracts (such as labor contracts) that might be rejected in a bankruptcy case, and an association of retirees. In short, the law calls for a city, banks and credit insurers, unions, and retirees to negotiate with each other over concessions! Can I watch?

Stockton and the interested parties first must attempt to jointly select a mediator. The new law mandates that if the parties can't agree on a mediator, Stockton must provide the names of five candidates, and a majority of the interested parties may eliminate up to four. The bill lists a variety of qualifications for possible mediators, with an emphasis on folks with financial and/or bankruptcy experience, particularly retired bankruptcy judges.

The mediation proceeds over the next 60 days after the selection of the mediator unless an agreement is reached sooner. It may be extended an additional 30 days if requested by the city or a majority of interested parties. Both the mediation and documents and financial data shared are subject to strict confidentiality rules. AB 506 does, however, provide an "emergency off ramp." If the city council finds

that the city is unable to pay its obligations within the next 60 days and that the health, safety, or well-being of its residents is threatened absent bankruptcy, the city may declare bankruptcy after a noticed public hearing on its fiscal condition.

In Stockton's case, having previously declared fiscal emergencies under its state constitutional powers, there seems little doubt it could meet the "emergency off ramp" test now. However, the city is struggling to stay afloat in the hope that the AB 506 process will allow it to avoid bankruptcy.

No one likes the prospect of a municipal bankruptcy, but it does have one advantage over the AB 506 process: It automatically halts all litigation. AB 506, unfortunately, does not. So far, the city already has been sued by Wells Fargo Bank, which holds debt secured by leases on garages Stockton owns. On March 1, the city defaulted on about \$2 million in debt payments.

Stockton also is in active litigation with (you guessed it) the Stockton Police Officers Association (SPOA), which plans to seek a temporary restraining order to force the city to pay vacation and leave balances to departing employees during the AB 506 process. The city was forced to suspend those payments during the AB 506 process to avoid cash insolvency leading to the emergency off ramp.

Finally, there is a significant issue regarding retirees. While AB 506 requires the city to include an association representing retirees in the mediation and has invited one, retiree associations have no ability to bind their members. And retiree health benefits are a central problem for Stockton.

The upshot: There are many potential obstacles to reaching an agreement in the AB 506 process. But if nothing else, the process is proving to be a good divining rod for determining who sincerely wants the city to avoid bankruptcy and who wants to elbow their way to the front of the line. We should hope that all parties give this flawed but potentially workable process a chance.



The author can be reached at Renne Sloan Holtzman Sakai LLP in San Francisco, jholtzman@publiclawgroup.com. ❖