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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-15 Chapter 9 **CITY'S SUPPLEMENTAL REPLY BRIEF IN SUPPORT OF CONFIRMATION OF THE FIRST AMENDED PLAN OF ADJUSTMENT, AS MODIFIED (AUGUST 8, 2014)** Date: October 1, 2014 Time: 10:00 a.m. Dept: Courtroom 35 Judge: Hon. Christopher M. Klein

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I. INTRODUCTION

In formulating its plan of adjustment, Stockton was driven by a desire to achieve negotiated settlements with its various creditor constituencies—institutional debt, current employees and retirees, among others—each of which was owed millions if not hundreds of millions of dollars, and each of which was competing for a pot of money that is woefully inadequate to pay creditors in full. But the City's overarching goal, in fact, its mandate, was to return to financial and service solvency such that its residents would remain and pay taxes, local businesses would thrive and new businesses would be established, City employees would continue to work for the City, and job-seekers would view Stockton businesses and the City itself as desirable employers.

The City is close to achieving those goals, but the fight in this Court goes on because the City has been unable to reach agreement with one creditor, Franklin. Contrary to Franklin's assertions, Stockton did not single Franklin out and set out to punish it for failing to make a deal. Rather, given no choice because a settlement could not be reached, the City proposed a plan that satisfies the requirements of the Bankruptcy Code and that is confirmable over Franklin's objection.

The City is submitting this brief—hopefully the last it will file in this case – in response to the Court's questions and Franklin's arguments about pension obligations. Franklin has made a full frontal assault on pensions, taking on CalPERS, among others, on the issue of whether the City and this Court have the power to impair pensions. As it did in its opening brief filed on August 11th, the City does not join this battle because whether or not it has the legal ability to impair pensions, it will not risk its future by gambling on whether City employees will flee if their pensions are cut by 60% and on whether prospective employees will seek jobs in Stockton.

It is easy for Franklin to argue that the City must disavow its pension obligations because it bears no risk if the City's fears of employee flight bear out. In that event, it will not be Franklin that suffers the harm. And it is easy for Franklin to summarily dismiss all of the City's evidence in support of its business decision as "hypothetical" or "self-interested." And it is easy for Franklin to submit no substantive evidence to rebut the City's decision and to rely instead on the

argument of counsel and the unsupported, anecdotal testimony of a financial (not pension, not labor) expert from Michigan who did not speak with a single City officer, and who admitted ignorance of nearly all of the critical California statutes and propositions at issue. What is hard is making the right decisions for the City and its constituents, negotiating meaningful settlements, and creating in good faith a plan of adjustment that provides a fair recovery for the City's creditors while also allowing the City to return to service and budget solvency. City officials and staff have of necessity made all of those hard decisions and, unlike Franklin, will have to live with their consequences.

This brief, like the City's August 11 brief, discusses the evidence that proves beyond question that the City's pension decision was rational, and, in fact, unavoidable. The brief also explains why the Plan satisfies the Bankruptcy Code's confirmation requirements. The confirmation discussion, among other things, points out the fallacy in Franklin's constant but baseless assertions that cram down is at issue and that the Plan discriminates unfairly against it.

On October 1, the City will have been in bankruptcy for almost exactly 27 months. The City has acted in good faith throughout this case, and its residents have borne substantial service cuts and have voted to impose a hefty sales tax increase in order to allow the City to propose a feasible plan. The City needs to move on. For the reasons stated in this brief as well as in all of the City's prior filings, the Court should confirm the Plan.

II. ARGUMENT

A. The Court Need Not Reach The Question Of Whether The City's Pension Obligations Can Be Impaired Through Bankruptcy.

The Court can confirm the Plan[1] without reaching the question of whether the City can impair pensions, despite Franklin's protestations to the contrary. *See* Franklin Post-Trial Br.,[2] at 5-9. As demonstrated below, in the City's prior briefs, and at the Evidentiary Hearing, the Plan satisfies all of the Bankruptcy Code confirmation requirements. This would be the case even if

[1] First Amended Plan for the Adjustment of Debts of City of Stockton, California, as Modified (August 8, 2014) [Dkt. No. 1645] ("**Plan**"). Any capitalized term used but not defined herein shall have the meaning ascribed to it in the Plan.

[2] Franklin's Post-Trial Brief [Dkt. No. 1689] ("**Franklin Post-Trial Brief**").

the Court were to find that the City has the ability to impair pensions through bankruptcy if it chose to do so. The Court can therefore confirm the Plan while assuming, without deciding, that the City has the ability to impair pensions.

B. The Plan Properly Classifies Franklin's Claim.

Classification has been briefed at length[3], so the City will merely note that debtors are afforded considerable discretion in classifying claims under 11 U.S.C. § 1122 and can separately classify similarly-situated claims when their legal character is different or when there are business or economic justifications for doing so. *Steelcase Inc. v. Johnston (In re Johnston)*, 21 F.3d 323 (9th Cir. 1994); *In re Loop 76, LLC*, 465 B.R. 525, 536 (B.A.P. 9th Cir. 2012).

Notwithstanding the proper classification scheme of the Plan, Franklin continues to accuse the City of gerrymandering because it understands that the unfair discrimination test applies only "with respect to *each class of claims* or interests that is impaired under, *and has not accepted*, the plan." 11 U.S.C. § 1129(b)(1) (emphasis added). Thus, as is discussed below, since Class 12 has accepted the Plan by an overwhelming margin, Franklin, as a dissenting creditor within an accepting class, lacks standing to object to the Plan on the ground of unfair discrimination. And while Franklin bemoans its treatment, it ignores the fact that almost all of the approximately 1,100 Retiree Health Benefit Claimants in Class 12 voted to give up lifetime health benefits for themselves and their dependents. This is a real and meaningful sacrifice made by the Retiree Health Benefit Claimants in order to allow the City to confirm a feasible Plan, and not a ploy manufactured to punish Franklin, as it repeatedly suggests.

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[3] *See, e.g.*, City's Supplemental Memorandum of Law in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1309] ("**City Suppl. Mem.**"), § III.A; City's Memorandum of Law in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1243] ("**Conf. Mem.**"), § IV.A.1; City's Supplemental Brief in Support of Confirmation of the First Amended Plan of Adjustment, As Modified (August 8, 2014) [Dkt. No. 1657] ("**City Post-Trial Br.**"), § II.B.

Franklin objects to its deficiency claim[4] being placed in the same class as the Retiree Health Benefit Claims while the pension claims are classified separately, arguing, in effect, that the Plan should create classes of creditors and not classes of claims. Ignoring the fact that it holds both a secured and unsecured claim in different classes, Franklin continues to urge that both the Retiree Health Benefit Claims and the pension-related claims (which are held by both employees and retirees) should be placed into a single class, Class 12. Franklin's argument is clearly inconsistent with basic bankruptcy law.[5]

As the City has explained in its prior submissions to the Court, classifying the unsecured Retiree Health Benefit Claims (even though the approximately 1,100 Retiree Health Benefit Claimants also hold pension claims) together with the unsecured Franklin deficiency claim (even though Franklin holds a secured claim) is entirely proper because both sets of general unsecured claims have the same legal character. As the City has also explained, separately classifying the claims of other creditors that have entered into compromise agreements with the City (e.g., Ambac, NPFG, Assured, etc.) and/or whose claims have a contractual component that will be assumed or honored by the City under the Plan (e.g., Stockton Police Officers' Association, employee and retiree pension obligations, the SEB claims of NPFG, etc.) is entirely proper even if some component of those claims could be characterized as being unsecured, because those claims now have a different legal character than the purely unsecured claims of Franklin, of the

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[4] Franklin's unsecured claim was created when the City, for tactical reasons, chose to forego litigating whether Franklin's collateral should be treated as a lease. The City decided to proceed in such a fashion to streamline the bankruptcy case and simplify the issues at the Evidentiary Hearing. Franklin's contention that the City "concede[d] defeat before trial" on this issue misstates the record. Franklin Post-Trial Br., at 3. As the City made abundantly clear in its Motion for Judgment, [Adv. Dkt. No. 28] ("**Mtn. For Judgment**"), it made the strategic decision to treat Franklin's claim as a financing transaction in order to avoid "spend[ing] valuable time and resources on a battle over form," and did so "solely to move the case more quickly and efficiently towards confirmation of a plan of adjustment." Mtn. for Judgment, at 2. Counsel for the City reiterated this purpose at the April 7, 2014 hearing on the Motion for Judgment, explaining that the City "filed this motion in an attempt to streamline the trial," and the Court itself stated that "anything that actually simplifies the process will probably help everybody." Transcript, April 7, 2014, at 25:25-26:15, 42:21-24. Franklin's description of the City's tactical decision as a concession of a "baseless and discredited argument" is flat out wrong, if not intentionally misleading. Franklin Post-Trial Br., at 3.

[5] Franklin complains bitterly that retirees and employees will receive payment of their pension benefits in full, and continues to erroneously assert that it will receive a sub-1% payment on its claim—ignoring the $4,052,000 in cash it will be paid on account of its secured claim. Franklin Post-Trial Br., at 40 ("Franklin, on the other hand, gets no corresponding benefit to accompany the sub-1% recovery on its unsecured claim."). In fact, Franklin makes more than two dozen references in its brief to its purported "sub-1%" recovery, but completely ignores that it is being paid 100% of its secured claim. Franklin Post-Trial Br., at 1, 2, 4, 5, 6, 9, 34, 35, 36, 39, 40, 41, 45, 46, 52, 63, and 64.

Retiree Health Benefit Claimants and of the other Class 12 creditors, such as holders of Leave Buyout Claims.

Moreover, the City has valid business justifications for separately classifying the Claims of NPFG, Assured, Ambac and others, among them being that separate classification is necessary to implement the compromises and settlements reached with the holders of those claims. The City's business reasons for reaching agreement with NPFG in order to retain the Arena and the parking garages, for reaching agreement with Ambac in order to retain the Essential Services Building and for reaching agreement with Assured Guaranty in order to shed itself of the cost of retaining 400 East Main in the long run while obtaining a new City Hall for the next 8 to 12 years at a below market rate were the subject of testimony at the Evidentiary Hearing and briefs filed previously. The City's business reasons for concluding that its pension obligations are significantly different than its pure general unsecured obligations also were the subject of testimony at the Evidentiary Hearing, and are discussed below.

C. The Plan Is In The Best Interests Of Creditors.

1. The Plan Satisfies The Best Interests Of Creditors Test.

As the City has described in its prior briefs, the Plan satisfies the "best interests" test of 11 U.S.C. § 943(b)(7).[6] In chapter 9, a plan satisfies the best interests test when it represents "a reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case." *See* Collier on Bankruptcy ¶ 943.03[7][a] (16th ed. 2014) ("**Collier**"); *see also In re Pierce County Hous. Auth.*, 414 B.R. 702 (Bankr. W.D. Wash. 2009); *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 37-38 (Bankr. D. Colo. 1999). This is a relatively low standard. *Mount Carbon*, 242 B.R. at 37; *see also* Collier ¶ 943.03[7][a] ("The municipal debtor is not required to meet too strict a standard, and the plan can go forward with the consent of all classes of creditors.

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[6] Franklin incorrectly claims that the Plan's supporters "say next to nothing" about the best interests test. Franklin Post-Trial Br. at 34. While the City's Post-Trial Brief focused on the finite additional issues raised by the Court at the July 8 hearing, the City has repeatedly and fully laid out its position that the Plan satisfies the best interests of creditors test. *See* Conf. Mem., § IV.G.1; City Suppl. Mem., § III.B; City's Response to Supplemental Objection of Franklin High Yield Tax-Free Income Fund and Franklin California High Yield Municipal Fund to Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1435] ("**Response**"), § II; City Post-Tr. Br., § II.C.

The court must also temper its examination into the debtor's ability to pay with due regard for the debtor's exercise of its political and governmental powers.").

Section 943(b)(7) requires only that the Plan be in the "best interests of creditors" generally, and not in the best interests of Franklin as an individual dissenting creditor. This is clear from the plain language of section 943(b)(7), as well as the legislative history of that section. *See* City Suppl. Mem., at 19-21 (discussing 124 Cong. Rec. 32,403 (Sept. 28, 1978) (statement of Rep. Edwards)). Thus, contrary to Franklin's repeated assertions, the Plan need not provide the best possible recovery to each individual creditor in order to satisfy the best interests standard. *Id.* It need only make a reasonable effort to provide a better recovery to its creditors as a whole than could be achieved through dismissal.[7]

The Plan undoubtedly satisfies this standard. It makes a reasonable effort to provide a fair recovery to its creditors as a whole, while allowing the City to continue its recovery and to address lingering service and deferred maintenance needs. The City's effort in this regard is amply demonstrated by the City's earnest work to reduce expenses and raise revenues, including the passage of Measure A, in order to provide for payment of creditors. The City's reasonable effort also is evidenced by the City's having reached mediated agreements with all but one of its major creditors and creditor groups. There can be no doubt that absent these efforts, creditor recoveries would be substantially diminished.

The Plan also is clearly superior to any recovery that the City's creditors, including Franklin, could hope to achieve outside of bankruptcy. Dismissal of this bankruptcy case would result in a chaotic race to the courthouse by thousands of individual claimants, the depletion of the City's remaining resources, and the potential imposition of a staggering termination liability and lien by CalPERS (the "**CalPERS Lien**"). As the Court itself has stated, if the City's bankruptcy case were dismissed, the result would be even greater financial difficulties than the

[7] This plain reading of section 943(b)(7) was also adopted by the City of Detroit in its recent confirmation hearing. Represented by Jones Day, Detroit argued that "the alternative of course in a Chapter 9 case is dismissal," that "the relevant standard is not whether someone can conjure up . . . a particularly rosy scenario for that creditor," and that "[t]he test in Chapter 9 for best interests looks at the creditor body as a whole." *See* Request for Judicial Notice In Support of City's Supplemental Reply Brief ("RJN"), Ex. A, at 4:10-5:3; *see also* RJN, Ex. A, at 12:22-13:2 ("Chapter 9 very clearly states that the test relates to creditors generally").

City already faces. *In re City of Stockton*, 493 B.R. 772, 791-92 (Bankr. E.D. Cal. 2013) ("**Eligibility Opinion**") ("If the City's case were to be dismissed . . . then even more financial trouble would be in store."). The City's negotiated settlements with its retirees and labor organizations, and possibly with one or more of the other capital markets creditors, would unravel, sending the City and these creditors back to square one. Restarting these negotiations and litigations would deplete resources that would otherwise have gone towards creditor recoveries and remedying the City's service insolvency.

Moreover, the CalPERS Lien and the termination liability would prevent any meaningful recovery for the City's other creditors. Regardless of whether the CalPERS Lien is enforceable in bankruptcy, it would apply with full force absent bankruptcy. In that scenario, the City would have no alternative but to continue making its pension payments. If it did not, CalPERS would terminate the City's pension plan, and the CalPERS Lien would attach to all of the City's assets in order to secure payment of its immediate $1.6 billion termination liability. In the face of this massive liability secured by a priming lien, none of the City's other creditors could expect to receive any recovery until CalPERS was paid on a current basis, including the current portion of the City's unfunded pension obligation. All of the City's obligations, including Franklin's now-secured claim, would be subordinate to the CalPERS Lien. Under such circumstances, none of the City's creditors would be better off.

Nor would Franklin benefit if the City was forced to terminate its CalPERS contract in this bankruptcy case and take on an immediate $1.6 billion claim that would completely swamp Class 12, including Franklin's deficiency claim.[8] Franklin asserts, without any facts or analysis, that the termination liability would not diminish Franklin's recovery because "[t]ermination of the City's relationship with CalPERS would not result in a new liability." Franklin Post-Trial Br., at

[8] Franklin contends that the City's "current alleged termination liability is substantially smaller than the hypothetical liability calculated by CalPERS" as of June 30, 2012. Franklin Post-Trial Br., at 61. However, Franklin bases this assertion on new "evidence" (i.e. news articles) relating to a tiny fraction of the factors that go into calculating the City's termination liability and provides no calculation as to what the "new" termination liability should be. This is mere legal argument, and the media reports cited by Franklin are not proper evidence. The evidence presented at the Evidentiary Hearing, in the form of the testimony of David Lamoureux, was that the best estimate of the City's termination liability was $1.6 billion. Moreover, it is fair to say that even if that liability were reduced by as much as half a billion dollars to $1.1 billion (which is extremely unlikely), it would still dwarf Franklin's $32 million unsecured claim.

53 (emphasis in original). This argument ignores the fact that the termination liability would come due *immediately*, and would thus prevent any increase in payments to Class 12 in any case. For instance, if the termination liability were added to Class 12,[9] then before the City could pay any *other* class 12 claimant *more*, it first would have to pay CalPERS the approximately 1% payout currently allotted to everyone else. So, before Franklin could recover even one more dollar, the City would need to come up with an additional $16 million to pay to the CalPERS claim as of the Effective Date. Then, for every additional dollar Franklin would hypothetically recover above its current allotment, the City would also have to pay approximately $50 to CalPERS and an additional $17 dollars to the Retiree Health Benefit Claimants (based on the relative sizes of their claims). So, in order for Franklin to receive even double its current recovery (an additional ~$320,000), the City would have to find an additional $37.76 million ($21.76 million in payments to Franklin, CalPERS, and the Retiree Health Benefit Claimants, plus $16 million for the initial CalPERS payment) above and beyond what the Plan already provides to Class 12. The City clearly lacks the ability to pay this amount as of the Effective Date. In fact, the City would have less money available than it does today due to the need to transition to a separate, less efficient pension system (discussed below).

Thus, there is no scenario in which Franklin or the City's creditors as a whole would benefit either from the impairment of the City's pension obligations or the dismissal of the bankruptcy case. The Plan constitutes a reasonable effort to provide creditors with a better recovery than they would achieve outside of bankruptcy, and as such, satisfies the best interests test.

2. The City Is Not Hoarding Money In Its Long-Range Financial Plan Or In Its Public Facilities Fees.

As part of its best interests argument, Franklin repeats its contention that the City has "manipulated" its Long-Range Financial Plan ("**LRFP**") in order "to keep money from Franklin." Franklin Post-Trial Br. at 35, n.94. Franklin can maintain this argument only by turning a blind

[9] For the sake of mathematical simplicity, this section assumes the Franklin unsecured claim to be an even $32 million, the Retiree Health Benefit Claimants' claim for medical benefits to be $545 million, and the hypothetical termination liability to be $1.6 billion, and ignores the other claims (such as the leave buyout claims) in Class 12.

eye to the evidence presented in the declarations and live testimony of the City's witnesses. The City's methodology in constructing the LRFP was clearly and carefully explained by Robert Leland and Stephen Chase. In his direct testimony declaration, Leland, the principal author of the LRFP, explained in detail the bases for the LRFP's revenue and expense projections. Leland DTD[10], ¶¶ 3-10, 18-19. He also discussed the level and need for the LRFP's reserve and annual contingency. *Id.* ¶¶ 11-17; *see also* Conf. Tr.[11], May 12, 2014, at 160:11-163:6 (testimony of Robert Leland). During his live testimony, Leland explained that as the City receives new information, it updates its projected revenues and expenses, as it did between its original and current LRFP; in doing so, he provided concrete examples. Conf. Tr., May 12, 2014, at 107:19-108:12, 116:5-117:24, 130:10-134:22, 135:21-136:11, 138:23-139:18 (testimony of Robert Leland). Chase supplemented Leland's testimony with respect to updates to the City's public facility fee (PFF) projections. Chase DTD[12] ¶¶ 14-20; Conf. Tr., May 13, 2014, at 88:22-89:6, 89:23-91:7 (testimony of Stephen Chase).

Nevertheless, Franklin argues that the LRFP "is designed to suck up every single extra dollar generated by the City for hypothetical 'mission critical' expenses the City has not even identified." Franklin Post-Trial Br. at 2. In order to do so, it mischaracterizes Leland's testimony, claiming that he "conceded" that "'mission critical' is just a fancy name for a plug number". *Id.* at 35. To the contrary, the City *has* identified what expenses mission critical funding will cover. Leland testified at trial that there is a "daunting array of needs that the City has not funded, including improving police further than the Marshall Plan, including improving other services that the City has, dramatically increasing deferred maintenance expenditures, replacing the computer system – the City hopes to not have to wait 20 years to do that." Conf. Tr., May 12, 2014 at 162:19-163:6 (testimony of Robert Leland). The City uses 23-year-old accounting and financial payroll systems that "need desperately to be replaced"; the City's

[10] Direct Testimony Declaration of Robert Leland in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1388, Trial Ex. 3057] ("**Leland DTD**").

[11] Transcript of Confirmation Proceedings ("**Conf. Tr.**").

[12] Direct Testimony Declaration of Stephen Chase in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1384, Trial Ex. 3045] ("**Chase DTD**").

workers' compensation funds are still running a deficit; and deferred maintenance is still millions of dollars a year. *Id.* at 118:20-120:2. The City remains in a service-insolvent state for libraries, administrative support, and recreation. *Id.* at 169:10-14. *See also* Leland DTD, Ex. L [Dkt. No. 1390, Trial Ex. 3059], at page 2 of 10 ("mission critical needs for spending" include "significant expenditures for deferred building and facility maintenance, deferred tree maintenance, mobile and portable radios for public safety, proposed technology projects identified in the City-wide Technology Strategic Plan," and more). Moreover, the City's mission critical expenditures will be $0 for the first 19 years of the LRFP. Conf. Tr., May 12, 2014 at 118:20-120:2 and 122:16-123:20 (testimony of Robert Leland). Thus, Franklin's allegation that the City has "rigged the game" by arbitrarily manipulating its LRFP is specious. Franklin Post-Trial Br., at 35. The City's mission critical expenses are not a plug number. They are the real and necessary needs of a city emerging from bankruptcy after years of recession.

Franklin also repeats its claim that the City "could pay Franklin from public facility fees (PFFs)" and that future PFFs "could be devoted to repayment of Franklin." Franklin Br. at 37-38. The City demonstrated at the Evidentiary Hearing and in its prior briefs[13] that such assertions are incorrect. Chase, the City's Community Development Director, testified to the requirement that there be a "nexus" between the "level of service and/or infrastructure costs and the [PFF] charged." Chase DTD, ¶ 3. Because of this requirement, PFFs can be used only for the purposes for which the PFF was imposed. *Id.*, ¶ 4. Moreover, fewer PFF receipts will be available in the future to pay Franklin because "the dollars are already spoken for." Conf. Tr. May 13, 2014 at 85:19-86:4 (testimony of Stephen Chase). Further, Chase testified that given the slow housing recovery in Stockton, it is unlikely that sufficient PFF receipts will be received in the near future to pay Franklin. *Id.* at 137:24-138:12 (noting that "[t]he generation of such revenues has not met the most recent forecasts that have come forward from the experts").

Franklin also trots out its oft-repeated argument that "[i]f the City averages just a half-percent better than forecast, the City will generate nearly an extra half billion dollars over the forecast period." Franklin Post-Trial Br., at 36. Of course, Franklin pays no heed to the

[13] *See* City Suppl. Br. at §§ III.A.2.c and III.B.4.d; Response at § II.C.

possibility that the City might perform a half-percent *worse* than projected. Responsible municipal forecasting requires that the City plan for the possibility of bad times, as well as good. *See* Leland DTD, ¶¶ 14, 16, 26. Such uncertainties are the reason the City and Assured Guaranty agreed to a settlement that allows that creditor to share in the City's hoped-for future prosperity without undercutting the City's economic safety net in the event of a future downturn. The settlement with Assured Guaranty left room for a similar settlement with Franklin. The Reimbursement Agreement Between Assured Guaranty Municipal Corp. and City of Stockton ("**Reimbursement Agreement**"), which memorializes the contingent payment settlement and was filed last February, provides that Franklin could have shared in up to 22% of the contingent payments under that agreement if this Court approved a settlement at or before confirmation of a plan of adjustment that provided for such contingent payments to Franklin.[14] Needless to say, the City and Franklin have been unable to reach a settlement.

Settlements in future chapter 9 (and chapter 11) cases will be impossible if creditors know that they can hold out and vacuum up the savings created when the debtor reaches deals with other creditors, particularly when the settling creditors are willing to share the upside with the debtor and not lock the debtor into a payment schedule that will result in a future default if revenues do not meet projections or if unexpected costs arise.

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[14] The relevant portions of the Reimbursement Agreement provide as follows:

> "Participating Creditors' Obligations" means (i) the [Pension Obligation] Bonds; and, (ii) in the event that the City enters into a settlement with Franklin that (x) is approved by the Bankruptcy Court at or before confirmation of the Plan of Adjustment and (y) includes participation in the Contingent General Fund Payments, the Stockton Public Financing Authority Lease Revenue Bonds, 2009 Series A (Capital Improvement Projects) (which had a principal amount as of June 28, 2012 of $35,080,000).
>
> "Allocable Share" means a fraction, the numerator of which is the principal amount of the [Pension Obligation] Bonds and the denominator of which is the sum of all the principal amounts of all Participating Creditors' Obligations as of July 1, 2012; provided, however, that with respect to the Contingent General Fund Payments (i) payable prior to June 1, 2039, the Allocable Share shall be no less than 78%; and (ii) payable on or after June 1, 2039, the Allocable Share shall be equal to 100%.

Supplemental Plan Supplement In Connection With The First Amended Plan For The Adjustment Of Debts Of City Of Stockton, California (November 15, 2013) [Dkt. No. 1259, Trial Ex. 3033], Ex. 1.a, at pages 2 and 5.

3. The Payment Of Franklin's Secured Claim Is Consistent With The LRFP.

Franklin claims that the City "miraculously found $4 million – in just the first year of its forecast – to pay Franklin's secured claim." Franklin Post-Trial Br., at 2. However, this is neither a new development, nor is it miraculous. The $4 million will be paid from the Bankruptcy Fund, which was created by the City specifically to pay all costs associated with the bankruptcy process, including payments to creditors as well as professional fees.

The Bankruptcy Fund has largely been funded by salary savings resulting from the City's difficulties in retaining employees and hiring a sufficient number of new employees, resulting in numerous vacancies during fiscal years 2011-12 and 2012-13. As both City Manager Kurt Wilson and Chief of Police Eric Jones testified, the City is struggling to attract and retain new employees. See Wilson DTD[15], ¶ 15 ("the City is currently unable to fully operate its new Delta Water Supply Project because of an inability to attract and retain qualified employees"); Jones DTD[16], ¶ 5 (of 365 budgeted positions, "the police department has so far been able to fill only 351", in part because "hiring has outpaced attrition at an extremely slow pace").[17]

The General Fund contributions to the Bankruptcy Fund for fiscal years 2011-12 and 2012-13 were disclosed on line 106 of Attachment A1 to Exhibit 2006 at EX 2006_0034 (CTY257708) and were discussed by Leland at trial. Conf. Tr., May 12, 2014 at 151:9-20 (testimony of Robert Leland). The Bankruptcy Fund is described at pages L30-L31 of the City's 2013-14 budget. Trial Ex. 2700 at EX 2700_0280-EX 2700_0281 (FRK-CM0001623—FRK-CM0001624).

City staff estimates that an amount comparable to the 2012-13 contribution will be made by the General Fund in 2013-14 due to the continuing excessive employee turnover and inability to fill vacant positions that have plagued the City. This number will not be finalized until the

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[15] Direct Testimony Declaration of Kurt Wilson in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1383, Trial Ex. 3068] ("**Wilson DTD**").

[16] Direct Testimony Declaration of Eric Jones in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1364, Trial Ex. 3056] ("**Jones DTD**").

[17] On September 16, 2014, the City added a new group of officers to its Police Department, bringing the City's total number of sworn police officers to 372. This still leaves the City with 113 unfilled sworn officer positions.

CAFR for 2013-14 is completed in late 2014 or early 2015. Even with this additional contribution, City staff expects that the resources of the Bankruptcy Fund will be fully consumed by chapter 9 legal and administrative costs, payments associated with settlements reached to date, and covering deficits in other funds, such as the grossly underfunded workers compensation fund.

Thus, the Court should draw no adverse inference from the fact that the City is able to pay Franklin its secured claim, as Franklin ironically suggests.

D. The Plan Does Not Discriminate Unfairly Against Franklin.

1. The Unfair Discrimination Test Does Not Apply.

At no fewer than 16 separate places in its Post-Trial Brief, Franklin complains that the City is attempting to "cram down" the Plan.[18] And Franklin uses the term "unfair discrimination" (or a variant thereof) 24 times.[19] Unfortunately for Franklin, repetition does not make cramdown, let alone one element of cramdown, relevant. While Franklin would rather ignore the "yes" votes of nearly 1,000 other Class 12 claimants, the unavoidable fact is that Class 12 accepted the Plan.[20] As a dissenting member of an accepting class, Franklin may not invoke the "discriminates unfairly" test because the clear and unambiguous language of Bankruptcy Code section 1129(b)(1) provides that it applies only with respect to a ***class*** of claims that has voted to reject the plan:

> . . . the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the ***plan does not discriminate unfairly***, and is fair and equitable, ***with respect to each class of claims*** or interests ***that is impaired under, and has not accepted, the plan***.

(emphasis added).[21]

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[18] Franklin Post-Trial Br., at 1, 3, 4, 6, 9, 35, 38 n. 113, 40, 41, 45, 47, 52, and 64 (some pages include multiple references).

[19] Franklin Post-Trial Br., at 2, 7, 9, 22, 31, 34, 39, 40, 41, and 63 (some pages include multiple references).

[20] Franklin's $4,052,000 secured claim comprises Class 20 under the Plan, and Franklin has not complained that it is being unfairly discriminated against with respect to the treatment of its secured claim. Nor can it, since it is receiving a cash payment in the full amount of its secured claim.

[21] The legislative history supports the plain meaning of the statute by providing:

> The criterion of unfair discrimination is not derived from the fair and equitable rule or from the best interests of creditors test. Rather it preserves just treatment of a ***dissenting class*** from the class's own perspective.

H.R. Report 95-595 at 417 (1977) (emphasis added).

Section 1129(b)(1) does not provide that the unfair discrimination test applies to a creditor within an accepting class that votes against a plan. Instead, the protection such an outvoted creditor receives is afforded by the best interests of creditors test, discussed above. Franklin cites no authority holding that the unfair discrimination test applies to any creditor or class other than a dissenting class as a whole.

Franklin asserts that the Court should consider its unfair discrimination argument as part of its improper classification objection, citing as authority a passage from Collier, paragraph 1122.03[3][a], and *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 455 (Bankr. E.D. Cal. 1999). Franklin Post-Trial Br. at 40. Neither demonstrates that courts should consider these disparate requirements together. Although the Collier passage refers to the language of section 1129(b)(1) stating that it only applies to a class that has not accepted a plan as merely "technical[ ]," its only authority for that assertion is *In re Jersey City Med. Ctr.*, 817 F.2d 1055 (3d Cir. 1987). Franklin omits the citation to *Jersey City Med. Ctr.*, undoubtedly due to the fact the case held that because the dissenting creditor's class accepted the plan, as Class 12 has, "§ 1129(b)(1) affords [the dissenting creditor] no protection." 817 F.2d at 1062. The Third Circuit proceeded to hold that it "need not address whether the plan satisfies the 'cram down' provisions," *id.*, thereby reinforcing the point that a court should disregard unfair discrimination arguments if a dissenting creditor's class votes to accept the plan, which is directly *contrary* to Franklin's argument.

Corcoran, rather than helping Franklin's cause, instead further supports the City's argument. That case states that in considering classification issues, "courts must be guided by the mandate of § 1129(b)(1) that the plan not discriminate unfairly with respect to a *class* of creditors *that is impaired under the plan and has not voted to accept the plan.*" 233 B.R. at 455 (finding classification proper and no unfair discrimination) (emphasis added). It does not hold or opine that courts should apply section 1129(b)(1) to a class that votes to accept a plan, as Class 12 has here.

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Section 1129(b)(1) has no application to Class 12, because it has resoundingly voted to accept the plan, and the thus the Plan is not a cram down plan with respect to Class 12.[22]

2. Regardless, The Plan Does Not Unfairly Discriminate Against Franklin.

As noted above, in cases where an impaired class rejects a plan, it may nonetheless be confirmed if it, among other things, does not discriminate unfairly. In other words, a plan may discriminate against a class of creditors if the discrimination is "fair"; otherwise, courts would have to read the word "unfairly" out of the statute. *See In re Aztec Co.*, 107 B.R. 585, 588-89 (Bankr. M.D. Tenn. 1989) ("Section 1129(b)(1) prohibits only unfair discrimination, not all discrimination."); Collier ¶ 1129.03[3] ("[t]here can be 'discrimination,' so long as it is not 'unfair.'").

a. The Ninth Circuit's Four-Factor Test Sets Forth The Requirements For Fair Discrimination Under Section 1129(b)(1).

The Ninth Circuit has articulated a four-part test to determine whether discrimination between classes is fair:

> (1) the discrimination must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without the discrimination; (3) the discrimination is proposed in good faith; and (4) the degree of the discrimination is directly related to the basis or rationale for the discrimination.

In re Ambanc La Mesa Ltd., 115 F.3d 650, 656 (9th Cir. 1997), *cert. denied* 522 U.S. 1110 (1998) (citing *In re Wolff*, 22 B.R. 510, 5-12 (9th Cir. BAP 1981), a chapter 13 case) ("***Ambanc-Aztec* test**").[23]

Aztec is often cited as the source of this test. *See, e.g.*, Collier ¶ 1129.03[3][a].[24] There, the court drew heavily from chapter 13 case law in setting forth the various factors, stating that

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[22] However, in the event that the City is required to impair its pensions, the City expects that any subsequent plan would require a cram down because its retirees and employees will likely vote against the 60% pension reduction.

[23] *See In re Anderson*, 2012 WL 3133895, at *7-8 (Bankr. D. Mont. 2012) ("It is well settled in this Circuit that the *Wolff* test is applicable in cramdown situations under § 1129(b).") (citing *Ambanc*, 115 F.3d at 656-67) ; *In re Bashas' Inc.*, 437 B.R. 874, 925 (Bankr. D. Ariz. 2010); *In re Hawaiian Telecom Commc'ns, Inc.*, 430 B.R. 564, 605 (Bankr. D. Haw. 2009). Due to perceived redundancies, the test often boils down to "whether the proposed discrimination has a reasonable basis and is necessary for reorganization." *See* Collier ¶ 1129.03[3][a].

"[c]hapter 13 cases interpreting the fairness of discrimination among classes under § 1322(b)(1) provide guidelines and analysis useful for § 1129(b)(1) purposes." 107 B.R. at 589-90 and n.1 (acknowledging the distinction between the purpose of unfair discrimination under sections 1129(b)(1) and 1322(b)(1)). *Aztec* favorably cites both *In re Perskin*, 9 B.R. 626 (Bankr. N.D. Tex. 1981) and *In re Freshley*, 69 B.R. 96 (Bankr. N.D. Ga. 1987). *See Aztec*, 107 B.R. at 589. *In re Perskin* held that a chapter 13 debtor's plan discriminated fairly in favor of credit cards that were a "substantial benefit" to the debtor in his profession as a traveling salesman. *In re Perskin*, 9 B.R. at 632. Meanwhile, *In re Freshley* concluded that a chapter 13 debtor's plan fairly discriminated against unsecured creditors where it proposed to pay 1% of their claims and 100% of the debtor's student loan. *In re Freshley*, 69 B.R. 96. The *Freshley* debtor's justification for the discrimination, which the court approved as "reasonable," was his intent to return to school and desire to remain in the "good graces" of the school. 69 B.R. at 98.

Chapter 11 cases applying the *Ambanc-Aztec* test are in accord with these chapter 13 cases, whose theme is that business reasons can make discrimination "fair" under a plan. *Kliegl*, 149 B.R. at 307-09 (debtor engaged in fair discrimination when its plan proposed to pay a union's general unsecured claim at 75% and other general unsecured claims at 15% on the grounds that it was "necessary" because the debtor's business relied on union workers and its continued operation of a union shop was "absolutely critical to its ability to function successfully in its industry."); *In re Creekstone Apartments Assocs., L.P.*, 168 B.R. 639, 644-45 (Bankr. M.D. Tenn. 1994) (plan discriminated fairly where it proposed to pay 100% to unsecured class, which included "vendors whose services and products were essential to the successful operation" of the debtor's business, but only 10% on another class's unsecured claims).

Courts have also held discrimination to be fair when it arises due to pre-confirmation settlements. In *In re Western Real Estate Fund, Inc.*, creditors that settled with the debtor obtained more favorable plan treatment than creditors who did not settle. 75 B.R. 580, 586

[24] The fourth factor in the *Aztec* case is stated as "the treatment of the classes discriminated against," but courts and scholars often refer to the *Aztec* and *Ambanc* tests as synonymous. *See In re Kliegl Bros. Universal Elec. Stage Lighting Co.*, 149 B.R. 306, 308 (Bankr. E.D.N.Y. 1992) (citing *Aztec*, but articulating and applying the *Ambanc* test's fourth factor); Bruce A. Markell, *A New Perspective on Unfair Discrimination in Chapter 11* ("**Markell**"), 72 AM. BANKR. L.J. 227, 242 (1998) (treating the tests as synonymous).

(Bankr. W.D. Okla. 1987). In approving the discrimination as fair, the court affirmed a policy favoring pre-confirmation mediation:

> [T]o hold as the objecting creditors suggest would discourage and remove any incentive for negotiation and resolution of differences prior to confirmation. Since the court believes that such "work outs" are fundamental to effective reorganization and rehabilitation . . . the position urged by the objecting creditors cannot be accepted.

Id.; *see also In re Coastal Equities Inc.*, 33 B.R. 898, 905 (Bankr. S.D. Cal. 1983) (forbidding a debtor from disfavoring holdouts would unfairly put holdouts in a "no-lose situation" and hinder negotiations).

b. <u>The City's Treatment Of Franklin And Its Other Creditors Satisfies The Ninth Circuit's Requirements For Fair Discrimination Under Section 1129(b)(1).</u>

The City's proposal to pay Franklin approximately 12% of its total claim, while other creditors receive between 52% and 100% on their claims, constitutes fair discrimination, even if section 1129(b)(1) applied.

(i) <u>The Plan's Treatment Of Franklin And Its Other Creditors Is Supported By Many Reasonable Bases Rooted In The City's Business Judgment.</u>

The Plan meets the *Ambanc-Aztec* requirement that "the discrimination must be supported by a reasonable basis" for several reasons. First, with respect to the City's pension obligations to its employees through CalPERS (as demonstrated throughout this case, CalPERS contends that the PERL requires it either to accept 100% of payments due or to invoke its termination procedure), the City exercised its business judgment to conclude that failing to fully fund its pension obligations would cause a mass exodus of its employees and irreparably damage its ability to hire new employees. The lack of an experienced and high quality work force—which would be the City's reality without the market standard CalPERS pension—would threaten the City's ability to provide for the health, safety, and welfare of its citizens. The City thus has a reasonable and legitimate basis for treating its pension obligations differently than other debts in the Plan. *See Kliegl*, 149 B.R. at 309; *Creekstone Apartments*, 168 B.R. at 644-45. Second, with respect to the other creditors to which Franklin compares itself, the City's reasonable basis for offering different treatment to them is two-fold. First, those creditors hold valuable collateral that

the City will need post-confirmation, unlike Franklin, which holds non-essential collateral – for which it is being paid in full. Second, the City settled with those creditors through mediation following the eligibility phase. Rewarding Franklin for being the sole holdout would "discourage and remove any incentive for negotiation and resolution of differences prior to confirmation." *Western Real Estate Fund*, 75 B.R. at 586; *see also Coastal Equities*, 33 B.R. at 905.

(ii) The Treatment Of Franklin And Its Other Creditors Is Necessary For The City's Adjustment Of Its Debts.

As described below, attempting to tinker with the City's pension obligations would, in the opinion of City leaders, threaten the stability of the workforce. The City has already made deep cuts to its services, Eligibility Opinion, 493 B.R. at 780-81; Disclosure Statement[25] at Summary and §§ I, II.C, and II.D, and making additional personnel or service cuts would threaten its viability. *See Kliegl*, 149 B.R. at 309; *Creekstone Apartments*, 168 B.R. at 645. Indeed, the City has eliminated retiree medical benefits, lowered its current pension costs by shifting 7-9% of pension payroll costs to employees and lowering salaries, implemented lower pensions for new hires, and made many other reductions in compensation for employees in order to not only pay its pension obligations but other creditors as well. Deis DTD[26], ¶ 32.

(iii) The City Proposed Its Treatment Of Franklin And Its Other Creditors In Good Faith.

The *Ambanc-Aztec* test next requires that the discrimination be proposed in good faith. As the case law set forth above demonstrates, disparate treatment in and of itself is not evidence of unfair discrimination proposed in bad faith. *See Creekstone Apartments*, 168 B.R. at 644-45. Franklin can conjure up no evidence other than its placement in Class 12, and the City's unwillingness to risk massive employee defections, to indicate that the City proposed its Plan in anything but good faith. And, as discussed in detail below and in the City's prior briefs, the City has numerous good faith business justifications for this disparate treatment.

[25] Modified Disclosure Statement with Respect to First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1215, Trial Ex. 3031] ("**Disclosure Statement**").
[26] Direct Testimony Declaration of Robert Deis in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1368, Trial Ex. 3046] ("**Deis DTD**").

(iv) The Degree Of Difference Between The City's Treatment Of Franklin and Its Treatment Of Its Other Creditors Is Directly Related To Its Business Reasons For Offering Them Different Recoveries.

The City has demonstrated that it cannot pay its pension obligations anything less than 100% without risking a mass exodus of its employees and impairing its ability to hire qualified employees going forward. So, to the extent the City's pension obligations constrain what it can pay Franklin, the City's degree of discrimination against Franklin in relation to pensions is directly related to the City's need to pay its pension obligations and its business justification for doing so, *i.e.*, maintaining its ability to retain and attract qualified employees. *See Kliegl*, 149 B.R. at 309. Second, the difference between what the City is offering Franklin and what it is offering other creditors to which Franklin compares itself is directly related to (i) the disparate legal character of Franklin's unsecured claim, (ii) the value to the City of the collateral properties associated with the other creditors' claims, and (iii) the City's need to facilitate negotiations with those creditors. *See Creekstone Apartments*, 168 B.R. at 644-45; *Western Real Estate Fund*, 75 B.R. at 586.

(v) Summary

As a result, even if section 1129(b)(1) applied, which it does not, the City's disparate treatment of Franklin's claim constitutes fair discrimination under the Ninth Circuit's test.[27]

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[27] Some courts outside of the Ninth Circuit have adopted an alternative test, set forth in Markell. *See, e.g., In re Dow Corning Corp.*, 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999). Under that test, there is a rebuttable presumption of unfair discrimination if there is:

> (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class (measured in terms of the net present value of all payments), or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution.

Markell, 72 AM. BANKR. L.J., at 228. Franklin has not argued (3)(b) as a basis for discrimination, so the City will only discuss (3)(a). A plan proponent may rebut the presumption in the case of (3)(a), *i.e.*, differing percentage recoveries, by "showing that [the] lower recovery for the dissenting class is consistent with the results that would obtain outside of bankruptcy, or that a greater recovery for the other class is offset by contributions from that class to the reorganization." *Id.* Putting aside that Franklin is not a member of a dissenting class, and assuming that the rebuttable presumption of unfair discrimination would apply in this case, the City would be able to overcome that presumption. Outside of bankruptcy, Franklin could not possibly hope for a better recovery than it is currently being offered as it would have to get in line to sue the City with all of the City's other creditors behind CalPERS and the CalPERS Lien attaching to all of the City's assets to secure payment of an immediate $1.6 billion termination liability. *See* City's Post-Trial Br., at § II.C. Further, the greater recoveries to the other classes are offset by their contributions to the adjustment of the City's debts: their collateral has value to the City going forward, they

E. There Is No Viable, Less Costly Alternative To CalPERS That Would Allow The City To Offer Competitive Pension Benefits.

1. None Of The Alternatives Considered By The City Would Provide Competitive Pension Benefits At A Lower Cost.

As demonstrated by the City's August 11 Post-Trial Brief and by the testimony at the Evidentiary Hearing, there is no viable alternative pension system that would allow the City to offer competitive pensions at a lower cost than CalPERS. Per the testimony of Kim Nicholl, the reasons for this are several. For one, any new City pension system would not benefit from the economies of scale and established investment expertise that CalPERS enjoys. The City would not be able to diversify its investment portfolio to the same extent or take on as much risk as CalPERS, which has billions of dollars in assets. In fact, because a new City pension plan would start with no assets, it would be forced to assume a more conservative investment strategy. Conf. Tr., June 4, 2014, at 26:19-27:16, 50:13-21 (testimony of Kim Nicholl). An alternative pension plan would therefore almost certainly produce a lower rate of return than the City's current CalPERS Plan, resulting in higher contributions, lower benefits, or both. *Id.* Additionally, an independent City pension plan (or similar alternative) would be subject to greater volatility in its cost per member due to its smaller asset base and reduced diversification, resulting in a higher "normal cost" than the City is currently paying to CalPERS. Lamoureux DTD[28], ¶ 13.

The City also would incur numerous costs in establishing a new pension system and/or would have to pay a premium to a for-profit administrator. *See, e.g.* Conf. Tr., June 4, 2014, at 20:8-21:10 (Nicholl testimony discussing costs of establishing a City-run system). Such costs would have to be absorbed by the new system in the form of higher contributions or lower benefits. Moreover, there would be substantial delay in the establishment of a new system, particularly if the City were to create a new, independent pension plan. During that ramp-up period, City employees would be without a pension, and would be unlikely to remain with the

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negotiated and compromised with the City, and in the case of pensions, City employees and retirees have made substantial contributions to materially lower the City's costs of funding future pension obligations. As a result of the Plan's treatment of pension obligations, the City is able to retain and attract qualified employees, a necessity for Stockton's viability as a city.

[28] Direct Testimony Declaration of David Lamoureux in Support of CalPERS' Response to Franklin's Objection to Confirmation of the City of Stockton's First Amended Plan of Adjustment [Dkt. No. 1440, Trial Ex. 4015] ("**Lamoureux DTD**").

City in the hope that the City's new pension plan would be equivalent to the CalPERS plan. Moreover, the City would be required to enter its employees into the Social Security system (and the City, having entered Social Security as a covered employer, would then be unable to leave under current law) during the gap in coverage, incurring an ongoing cost to the City of 6.2% of payroll.[29] *See id.*, at 19:14-22. Finally, a new pension system would likely lack reciprocity with the CalPERS system. *Id.* at 28:15-29:8. This would put the City at a competitive disadvantage with other CalPERS or CalPERS-reciprocal agencies because potential employees prefer the flexibility of being able to transfer within CalPERS or CalPERS-reciprocal systems. *See id.* at 27:17-28:14 ("[Y]our benefit would be much lower from that first employer without reciprocity, so it's a very valuable benefit").

Franklin offered no evidence showing that these alternatives would allow the City to provide better or equal pension benefits at a lower cost. Instead, it speculates that these alternatives are viable, and dismisses Nicholl's extensive description of the problems and challenges of each as "hypothetical." Franklin Post-Trial Br., at 48.[30] Clearly, the fact that the City has not attempted to implement any of these alternatives in no way undercuts Nicholl's expert testimony as to the requirements, costs, and limitations of each alternative.

Franklin also misleadingly claims that the City "never seriously considered" these alternatives based on statements by the City's witnesses that they did not explore alternatives to CalPERS *prior to the petition date*. Franklin Post-Trial Br., at 44. Because the threat of the termination liability and the CalPERS Lien made any pre-petition termination completely infeasible, the City naturally focused on developing the Ask and attempting to avoid chapter 9, or

[29] Franklin suggests that the City could avoid the need to participate in Social Security by "tim[ing] its exit from bankruptcy to coincide with the establishment of a replacement retirement benefit." Franklin Post-Trial Br., at 49, n. 161. However, this purported solution would leave the City languishing in bankruptcy for months, if not years, while it established a new pension plan and negotiated and prosecuted a brand new plan of adjustment. During that time, the City would be unable to hire qualified new employees and would continue to struggle with retention. Moreover, it would do little to address the fact that whatever alternative pension plan was eventually established would almost certainly be less appealing to current and potential City employees than a CalPERS pension, particularly since the economic future of the City would be, charitably stated, uncertain. Furthermore, even if the City could avoid a gap in coverage, it would still be forced to enter Social Security if its new pension plan did not meet federal regulations.

[30] Throughout its Post-Trial Brief, Franklin repeatedly labels as "hypothetical" any testimony or argument it wishes the Court to dismiss out of hand, regardless of its factual bases. *See* Franklin Post-Trial Brief, at 12 (the actuarial risk of termination to CalPERS), 35 (mission critical expenses), 37 (same), 48 (Nicholl's testimony regarding alternative pension plans), 49 (testimony regarding the risk of employee departures).

at least reach agreement with some of its creditor constituencies. After the City entered chapter 9, however, it spent significant time considering its options, and concluded (based on the reasons described by Nicholl) that none of the pension alternatives were viable and cost-effective. Wilson DTD, ¶ 15; Deis DTD, ¶ 29; *see also* Conf. Tr., June 4, 2014 (testimony of Kim Nicholl), at 20:1-21:23 and 26:15-29:8 (City-run plan); 21:24-22:21 (plan administered by a third-party); 19:9-22 and 49:4-7 (Social Security).

When not ignoring or dismissing testimony as hypothetical, Franklin cites to selective snippets in an attempt to claim that the evidence offered by the City and CalPERS actually supports its conjecture. For instance, despite Nicholl testifying on multiple occasions that a City plan could not compete with CalPERS' retirement benefits, Franklin says that Nicholl "testified that she did not 'have any basis' for assessing whether the benefits under an alternative program might be more lucrative than benefits under the CalPERS system. Shockingly, neither she nor the City ever did the analysis." Franklin Post-Trial Br. 48. These allegations are untrue, and they mischaracterize Nicholl's testimony. What Nicholl said was that she did not "have any basis" for agreeing with Mr. Johnston's suggestion that "Stockton might even be able to offer a more lucrative plan, if it was freed from the burden of paying for pension-spiking and the sins of the past that had been the subject of the case." Conf. Tr., June 4, 2014, at 49:16-21 (testimony of Kim Nicholl). She did not say that she lacked a basis to determine whether an alternative pension program could provide equal or more lucrative benefits than CalPERS at a lower cost, a concept she had already analyzed and had discussed at length on direct examination. Nicholl's unrefuted testimony was that the City could not offer an equivalent or better retirement package than CalPERS for a number of reasons: (i) the City's system would have a lower discount rate, (ii) it would entail substantial start up, transition, and maintenance costs, and (iii) it would be hampered by Social Security contributions. *Id.*, at 38:20-39:12, 49:8-13, 52:23-53:1 (testimony of Kim Nicholl).

Perhaps worse than Franklin's strategy of ignoring or mischaracterizing Nicholl's testimony is its baseless assertion that the City "scrambled Ms. Nicholl – taking advantage of the three-week trial break," thus suggesting that the City used the break to manufacture new

testimony. Franklin Post-Trial Br., at 48. Nicholl was present, ready, and able to testify during the originally scheduled trial dates. The reason she could not testify in May, as the Court is well aware, was Franklin's decision to ignore the Court's ruling on trial time allotment. On the first day of trial, after hearing the argument of counsel, the Court clearly and unambiguously ruled that it was satisfied that a 50-50 split of the available trial time was fair. Conf. Tr., May 12, 2014 at 19:18-20:4 (comments of the Court). Rather than abide by that ruling, Franklin proceeded to use the lion's share of the allotted trial time. Then, when the City objected, counsel for Franklin's response was that "this was precisely why I said that the allocation of time at the beginning of the case would be completely prejudicial." Conf. Tr., May 14, 2014, 70:17-19 (comments of Franklin). Put simply, Franklin rejected the Court's decision because it disagreed with the result. Having caused the month-long delay was bad enough, but to suggest that the City used the delay (which the City sought to avoid) to create new testimony marks a new low for Franklin.

While Franklin is quick to cast aspersions and to dismiss testimony it does not like as hypothetical, it failed to proffer any evidence of its own to show that any of its suggested alternatives is superior to the CalPERS system. Instead, it defaults to vague speculation, bereft of any detail or analysis. Nicholl's testimony clearly and accurately describes the reasons why the City concluded that it could not provide a CalPERS-equivalent pension plan at a lower cost through any of these alternatives. If the City believed it could save money, retain its current employees, and attract new hires by leaving CalPERS, it would do so. As no such alternative has presented itself, the City has chosen the best available option.

2. <u>A Defined Contribution Plan Is Not A Viable Alternative.</u>

In addition to the other alternatives discussed by the City, Franklin speculates – with no analysis whatsoever – that the City could switch to a defined contribution retirement plan. Franklin Post-Trial Br., at 47. Franklin even goes so far as to deem such a plan "the most logical alternative", *id.*, yet it failed at the Evidentiary Hearing and in its brief to offer even one iota of evidence that a defined contribution plan would provide employees competitive pension benefits. This is because a defined contribution plan, when funded with the same contributions as a defined benefit plan, will provide lower benefits.

Nicholl testified that defined contribution plans tend to earn 1-2% less each year than defined benefit plans. Conf. Tr., June 4, 2014, at 38:10-19 (testimony of Kim Nicholl). Additionally, "in a defined contribution plan, all the risks of the plan have been shifted from the employer to the employee" including the risk that the investments will yield lower benefits. *Id.*, at 37:10-23. Franklin omits the first point, despite citing to that testimony, and dismisses the latter as "obvious". Franklin Post-Trial Brief, at 48-49. To a "rational" City employee or potential employee, however, a plan that provides lower benefits and that transfers all of the risks to him or her is hardly a meaningful alternative. Moreover, Franklin's unsupported claim that a defined contribution plan "suffers from none of the 'start up, transition and maintenance' costs" of other alternatives is patently incorrect. Franklin Post-Trial Br., at 47 (emphasis in original). For one, a defined contribution plan incurs its own administration costs, which would result either from the City setting up its own system or because the City would have to pay a private administrator, which would expect some amount of profit, to do so. The City also would have to spend significant time and money negotiating with its labor unions to adopt a defined contribution plan, with no guarantee of success and with the likely outcome that the City would have to make other significant concessions to make-up for the reduced benefits.

Defined contribution plans also suffer from other deficiencies compared to defined benefit plans. For instance, defined contribution plans do not include a disability retirement feature, which is of particular importance to the City's public safety employees. Defined contribution plans are limited to funds saved, whereas defined benefit plans are provided for the beneficiary's lifetime and include survival benefits. Defined contribution plans are also subject to caps on annual contributions. When these considerations are added to the generally lower benefits and the transfer of investment risk, it is no surprise that defined contribution plans are not the market standard for public agencies in California.[31]

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[31] Franklin suggests that Cal. Gov't Code § 20485 establishes defined contribution plans as the "desired alternative." Franklin Post-Trial Br., at 47. As is evident from its plain language, that section merely notes the Legislature's intent that agencies contracting with CalPERS have the option to supplement their CalPERS pensions with a defined contribution plan if they so choose.

3. The City Is Not "Shielding" Employees From The Burden Of The Restructuring.

Contrary to reams of evidence and the Court's own findings, Franklin asserts that the City is "shielding employees from the burden of this restructuring." Franklin Post-Trial Br., at 1. This could hardly be further from the truth. As the evidence presented at the Eligibility and Evidentiary Hearings has shown, employees already have borne a disproportionate share of the costs of the City's restructuring, both through unilateral cuts and through months of difficult negotiations. *See* City Post-Trial Br., at § II.A.4. Moreover, the Court's own findings of fact bear this out. *See* Eligibility Opinion, 493 B.R. at 779-780; *Ass'n of Retired Employees of City of Stockton* ("***ARECOS***") *v. City of Stockton*, 478 B.R. 8 (Bankr. E.D. Cal. 2012).

Before filing its bankruptcy case, the City cut its workforce by a quarter[32] and slashed compensation by as much as 23%. Eligibility Opinion, 493 B.R. at 780; Montes Elig. Decl.[33], ¶ 20; Deis Elig. Decl.[34], ¶ 39. Then, the City further reduced compensation and benefits when it negotiated new collective bargaining agreements. Goodrich Elig. Reply Decl.[35], ¶ 8. Retiree medical benefits for both current and former employees have been completely eliminated. *ARECOS*, 478 B.R. at 14. City employees are now paying a greater portion of their pension costs, and the City has implemented its own lower retirement tier, in addition to the new PEPRA level. Leland DTD, ¶ 37 (City's elimination of employer-paid member contributions); *id.*, ¶ 18(e) (City's new pension tiers); Goodrich DTD[36], ¶ 17 (same). Moreover, the negotiated reductions to compensation in the City's collective bargaining agreements will result in reduced pension

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[32] Franklin reiterates its complaint that the concessions made by the City's employees "merely reduced 'above market' pay and benefits to a 'market' level" (without citing to any evidence of what it defines as the "market"). Franklin Post-Trial Br., at 45. Not only does this continue to ignore the reduction of compensation and benefits for many employees to below-market levels, it also disregards the impact on employees that were laid off. Compensation and benefits for those employees were not reduced to a 'market' level, they were reduced to nothing going forward.

[33] Declaration of Laurie Montes In Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 23, Trial Ex. 1054] ("**Montes Elig. Decl.**").

[34] Declaration of Robert Deis in Support of City of Stockton's Reply to Objections to Its Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 708, Trial Ex. 1377] ("**Deis Elig. Decl.**").

[35] Declaration of Ann Goodrich in Support of City of Stockton's Reply to Objections to Its Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 716, Trial Ex. 1384] ("**Goodrich Elig. Reply Decl.**").

[36] Direct Testimony Declaration of Ann Goodrich in Support of Confirmation of First Amended Plan for the Adjustment of Debts of City of Stockton, California (November 15, 2013) [Dkt. No. 1381, Trial Ex. 3055] ("**Goodrich DTD**").

payments for those employees in the future. *See* Eligibility Opinion, 493 B.R. at 785 ("[M]aterial reductions in compensation to employees correlatively will tend to reduce the City's future pension obligations.").

In the same vein, Franklin once again raises the specter of pension spiking, but continues to fail to place the issue in context. Franklin Post-Trial Br., at 1, 42. As the City has explained, while a handful of employees engaged in pension spiking, the typical retiree pension is modest. As of February 2012, retirees entitled to medical benefits received an average pension of $51,000, while retirees not entitled to medical benefits received an average pension of $24,000. Deis DTD, ¶ 32; Haase Elig. Decl.[37], ¶ 5; Millican Decl.[38], Ex. A at 40, Figure 1; *see* City Post-Trial Br., at 21. Moreover, in its Eligibility Opinion, the Court found that the City had taken measures to "dampen[] opportunities for 'pension spiking.'" Eligibility Opinion, 493 B.R. at 779-80. Thus, while Franklin would have the Court believe that impairing pensions is necessary to rectify pre-bankruptcy pension spiking, the real effect will be to push many of the City's pensioners below the poverty line. Deis DTD, ¶ 31. Franklin essentially acknowledged as much when it told the Court that it saw no way to remedy past pension spiking without also punishing retirees with average pensions. Conf. Tr., June 4, 2014, at 198:12-25 (Franklin closing argument) ("COURT: But what I'm still not getting is whether you have a solution for remedying past pension spiking that does not amount to getting so angry at a pension spiker that you are going to take a non-pension spiker out and shoot them. . . . MR. JOHNSTON: I don't believe that can be done.").

Despite this unavoidable concession, and despite the clear evidence of compensation and benefit reductions, Franklin does not hesitate to cast the City's workforce as unscathed by the bankruptcy. To the contrary, the City's employees and retirees have made real and meaningful sacrifices that have enabled the City to propose a plan of adjustment that will enable it to emerge from bankruptcy on solid fiscal footing.

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[37] Declaration of Teresia Haase In Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 21, Trial Ex. 1052] ("**Haase Elig. Decl.**").

[38] Declaration of David N. Millican in Support of City of Stockton's Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 454, Trial Ex. 1376] ("**Millican Decl.**").

4. If Pensions Are Cut, City Employees Will Leave And The City Will Struggle To Attract Qualified Replacements.

If the City impairs pensions in addition to the substantial compensation and benefits cuts it has already imposed, it faces the very real possibility that its employees will depart for greener pastures and that qualified replacements will be hard to find. As described in detail in the City's Post-Trial Brief, this concern is "neither speculative nor hypothetical." *See* City Post-Trial Br., at § II.A.3. To the contrary, it is based on the express statements of the City's labor unions, interviews of employees, the state of the market for public employees, the City's current hiring difficulties, and the systemic incentives for employees to transfer to other CalPERS agencies to preserve their future pension earnings.

CalPERS is the market standard for public employee pensions in California, and the testimony of the City's current and former City Managers makes clear that in order to adequately compete to hire and retain qualified employees, the City must be able to offer a CalPERS pension or reasonable equivalent. *See* Wilson DTD, ¶ 15; Deis DTD, ¶ 29; City Post-Trial Br., at 7-8. Chief of Police Eric Jones testified at length regarding morale in his department and his personal conversations with current police officers who have stated that they will leave the Department if further compensation or benefits cuts occur as well as with departing officers who cited financial concerns as their reason for leaving. Jones Elig. Reply Decl.[39], ¶¶ 13-15; Jones DTD, ¶ 7. Chief Jones also testified that the City is already having difficulty recruiting and retaining qualified officers, despite the passage of Measure A. Jones DTD, ¶ 5.[40] Particularly troubling is the loss of the City's more experienced officers. *Id.* (testifying that over 5 years, the average tenure of officers and sergeants at the City's police department dropped from 14.22 years to 9.34 years). Meanwhile, all of this has occurred while the City continues to struggle with a staggeringly high crime rate. Jones DTD, ¶¶ 4, 8; *see also* Eligibility Opinion, 493 B.R. at 781, 789-90 (finding that the City's high crime rate was due in part to the reduced number of police officers).

[39] Declaration of Eric Jones in Support of City of Stockton's Reply to Objections to Its Statement of Qualifications Under Section 109(c) of the United States Bankruptcy Code [Dkt. No. 710, Trial Ex. 1379] ("**Jones Elig. Reply Decl.**").

[40] *See also* footnote 17.

The testimony of Deis, Wilson and Jones was confirmed by the City's labor unions. The briefs filed by the Stockton City Employees Association, *et al.*, and the Stockton Police Officers Association and Stockton Police Managers Association assert that terminating the CalPERS relationship will cause employees to leave. *See* Memorandum of Stockton City Employees Association, et al., Regarding Impairment of Pensions and in Support of Stockton's Plan of Adjustment [Dkt. No. 1650] at 8-10 and fn 11 ("The suggestion that, having made substantial compensation and benefits sacrifices and then having their pensions substantially impaired, the City's employees would simply settle in and accept these financial blows is more than risible."); Supplemental Memorandum of the Stockton Police Officers Association and Stockton Police Managers Association in Support of Confirmation of the City's First Amended Plan of Adjustment, as Modified [Dkt. No. 1659] at 2, 6, 8-11, and 14 ("If Stockton terminated its CalPERS relationship, any police officer hired before January 1, 2013, would be foolish to stay at Stockton longer than six months after the termination, rather than moving to another agency as a classic member"; "Stockton is already struggling to attract and retain police officers; a difficult situation would become effectively impossible if the City's relationship with CalPERS were terminated. Even the current discussions about the *potential* rejection of the CalPERS 'contract' is causing safety employees to seriously consider their options.") (emphasis in original).

Furthermore, the Nicholl testimony described in detail the key incentives that City employees will have to seek other employment in the event that their pensions are impaired. Franklin's argument is essentially that because employees would be unable to recover any impairment of accrued benefits, they will stay. The critical flaw in this criticism is that it ignores not only the lost goodwill of those employees, but also the clear incentives presented to employees looking *forward*.[41] First, as Nicholl testified, employees will have a strong incentive to flee to another CalPERS agency within six months of the termination of their CalPERS benefits in order to avoid being permanently consigned to a lower benefits level under PEPRA.[42]

[41] Despite Franklin's insistence that it is taking a forward-looking approach for employees, *see* Franklin Post-Trial Br., at 50, its refusal to consider the tangible incentives facing employees belies its argument.

[42] Franklin implies that recent changes to PEPRA, as described in the various media reports it cites, will eliminate this incentive. Franklin Post-Trial Br., at 50. As has become its practice, Franklin offers no specifics and no explanation as to why this would be the case, and quickly moves on. Put simply, Franklin's insinuation greatly

See Conf. Tr., June 4, 2014, at 29:20-37:1 (testimony of Kim Nicholl) and Trial Ex. 3085. Second, Nicholl testified that it is extremely unlikely that the City would be able to offer a competitive pension through any of the alternative pension plans the City might choose. Third, because of the delay inherent in establishing an alternative pension system, City employees are unlikely to wait and see what sort of plan the City could create. Instead, employees will use that time to seek other employment, particularly in light of the six-month window to maintain their "classic" CalPERS standing. Finally, Franklin disregards the loss of trust between the City and its employees that would result from the impairment of pensions (in addition to all of the other cuts that have been imposed), and argues that City employees will simply make the "rational" decision to remain with the City. Based on the clear import of the evidence, however, the "rational" employee whose pension is impaired is much more likely to leave than to stay.

Franklin remains true to form and attempts to dismiss this evidence out of hand as "completely hypothetical" and "self-serving."[43] Franklin Post-Trial Br., at 49. The City's evidence consists of conversations with current and departing employees, an analysis of the incentives actually facing the City's workforce, the costs and benefits of the City's pension alternatives, and the experience of those who run the City day-to-day. In contrast, Franklin failed to present any meaningful, substantive evidence to counter the testimony of the City's Police Chief, City Managers, Human Resources Director, labor consultants, and pension expert regarding the likelihood that City employees will depart en masse if their pensions are reduced. Franklin bases its assertion that the City's concern with the possibility of employee flight is "hypothetical" on the ground that "the City has never even hinted that it might seek to terminate its relationship with CalPERS." Franklin Post-Trial Br., at 49. Essentially, Franklin wants the City to cut pensions and see what happens, despite the clear statements of City staff, City

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overstates the referenced changes, and City employees would still be subject to the six-month transfer window in the event the City's CalPERS contract is terminated in order to avoid being permanently relegated to a lower benefit level.

[43] In contrast to its glowing support of the testimony of Charles Moore, its paid expert, Franklin chidingly refers to the testimony of Chief Jones regarding his conversations with current and former City police officers regarding their motivations and incentives as "self-serving." Franklin Post-Trial Br., at 49. The City stipulates that the Chief of Police has an interest in keeping police officers on the street.

employees and the City labor unions that cuts will lead to employee departures. The City cannot abide such a risk.

The sole evidence offered by Franklin to support its speculation is the anecdotal testimony of Charles Moore about what he believes happened in Detroit.[44] Moore's testimony regarding the threat of employee departures – which is presented essentially in its entirety at pages 51-52 of Franklin's brief – includes no specifics, no corroborating evidence, and no concrete suggestions as to what alternative pension plan the City could provide in order to retain its employees. Neither Franklin nor Moore offers any evidence or analysis showing how the City could provide competitive pensions outside of CalPERS; nor do they provide any tangible evidence to show that City employees will not depart if their pensions are terminated. Moreover, Moore's claim that there will be no employee exodus is based on the assumption that employees will be better off if they stay. As demonstrated by the testimony of numerous City employees and the City's pension expert, as well as the briefs of the City's labor unions, that assumption is clearly and definitively disproved by the evidence.[45] The evidence before the Court shows that the City has a real and legitimate concern that impairing its pensions will have a disastrous effect on its ability to hire and retain qualified employees, and, consequently, on its ability to provide a basic level of public safety and services.

5. The City Cannot Use Savings From Slashed Accrued Benefits To Increase Benefits In The Future.

Franklin asserts that the City has not shown that alleged savings from impairing accrued benefits would not exceed the additional costs and delays created by switching to an alternative pension plan. Franklin Post-Trial Br., at 48. Franklin offers no evidence or analysis of its own on

[44] Moore's testimony with respect to the City's employees should be afforded no weight since he did not speak with a single City officer when conducting his due diligence. *See* Conf. Tr., May 14, 2014, at 19:18-20:3, 88:1-89:16 (testimony of Charles Moore). So, too, with respect to his views on the operation of a California local government, as he admitted ignorance of nearly all of the California statutes and propositions that might bear on the City's financial situation. *Id.* at 103:13-105:8.

[45] Franklin also cites to Lamoureux's testimony that "***there is nothing that a City employee could do to eliminate or lessen the benefit reduction***." (emphasis in original). Franklin Post-Trial Br., at 49. However, Franklin is careful to omit Lamoureux's testimony that while City employees could not affect the reduction of Stockton benefits, the employees could leave the City in order to not be subject to reduced benefits going forward. Conf. Tr., May 14, 2014, at 205:19-23 (testimony of David Lamoureux). Franklin's citation to this supposedly "devastating" testimony, *see* Franklin Post-Trial Br., at 48, is another instance of Franklin assuming City employees will just take their lumps while ignoring the prospective incentives for them to leave.

the matter, and instead bases its implication on the fact that the City cannot, without going through the process of actually adopting an alternative, establish an exact amount for the additional cost. Such speculation ignores the obvious problems with depending on cutting accrued benefits in order to pay for future benefits.

As Nicholl explained, any of the alternative pension plans the City might chose would likely result in a substantial additional cost to provide comparable benefits. Moreover, it is not as if the City could simply impair its pensions and then use all of the extra money to pay Franklin and its new pensions. At a minimum, as described above, a large chunk of that money would have to be spent on covering the newly created claims. In addition to going back to the drawing board with its nine labor unions, the City also would be required to renegotiate any number of its current settlements, most notably its one-cent-on-the-dollar settlement with the Retirees Committee. Franklin also ignores the likelihood that the City, as part of its negotiations with its unions, would have to make additional concessions in order to compensate employees for the cut benefits if it were to have any chance of keeping those employees. Thus, it is likely that any savings that did accrue from slashing pensions would be consumed by the combination of higher pension costs, additional bankruptcy claims, renegotiated settlements and the need to fund higher compensation in light of lost benefits. Franklin has offered no evidence that there would be any "leftover" amount to pay creditors, and even if the City could save money in the short-term by cutting accrued benefits enough to cover the costs of a more expensive pension plan, those savings will eventually be used up, and the City will be left with a more expensive pension plan in perpetuity.

Franklin also ignores the other ways in which a non-CalPERS pension would be less attractive to employees, such as the lack of reciprocity with the CalPERS system and the greater investment risks associated with a City-only system. If offered a choice between a CalPERS pension and a non-CalPERS pension with the same annual benefit, current and potential employees will opt for the greater freedom, security, and portability provided by the CalPERS system. Based on these considerations, Franklin's implication that the City can simply slash past benefits in order to fund higher future benefits is mere speculation.

F. The City Has Proposed The Plan In Good Faith.

Franklin makes the bizarre claim that "the City's entire argument proceeds on the assumption that there is a 'good faith' or 'business judgment' exemption from the Bankruptcy Code's statutory prerequisites to confirmation." Franklin Post-Trial Br., at 34. The City's good faith in proposing the Plan is not an exemption, but an *affirmative requirement* of Bankruptcy Code § 1129(a)(3).[46] Franklin clearly understands this and has challenged the City's good faith. *See* Franklin Post-Trial Br., at 7 (listing alleged bases for objection). Franklin can thus hardly be surprised that the City offered evidence of its good faith in support of confirmation.

As described above, the evidence overwhelmingly establishes that the City has a real and imminent concern that impairing pensions would critically damage its ability to hire and retain qualified employees. The inescapable reality is that CalPERS remains the market standard for public employee pensions in California, and there is no viable, cost-effective alternative to remaining in the CalPERS system. Additionally, the City's decision not to impair pensions was also based on its need to maintain its labor agreements, as well as its mediated settlement with the Retirees Committee. Those agreements were the result of long and difficult negotiations, and created substantial savings for the City. However, each requires the maintenance of the City's pension obligations. If the City is forced to impair pensions, months of negotiations would be wiped out, putting the City back at square one with these creditors, and further eroding the City's relationship with its employees.

This does not mean that the City has done nothing to address its pension and other post-employment benefit costs. As the Court has recognized, the substantial reductions in the City's workforce and compensation will result in lower pension costs down the road. Eligibility Opinion, 493 B.R. at 785. So, too, will the City's implementation of new, lower pension tiers and its shifting of a portion of its pension costs to employees. On top of those reductions, the City has completely eliminated its massive retiree health liability. And in addition to those compensation and benefit reductions, the City's voters passed Measure A, which will raise substantial additional funds for the payment of creditors.

[46] The relevance of the City's "business judgment" is discussed below.

The City's decision not to impair pensions is not some mean-spirited ploy designed to punish Franklin, despite its protestations.[47] At every stage of its bankruptcy case, the City has sought to cut costs, increase revenues, and strike deals with its creditors. With regard to its pension liabilities, the City thoughtfully considered its options and came to the conclusion that it simply could not impair pensions without risking the wholesale flight of its employees. That decision was not made lightly, and was not the result of any ill-will on the City's part. Rather, the City came to the good faith conclusion that remaining with CalPERS was the only feasible option.

G. Even If The Court Were To Rule That The City's Relationship With CalPERS Was An Executory Contract, The City's Decision To Assume That Contract Would Be A Reasonable Exercise Of Its Business Judgment.

As with the issue of good faith, Franklin makes the perplexing argument that the City is attempting to create a "business judgment exemption" to the requirements of chapter 9. Franklin Post-Trial Br., at 34. Once again, this contention misapprehends the City's briefing. In the event that the Court rules that the City's relationship with CalPERS constitutes an executory contract, the reasonableness of the City's decision to assume said contract under § 365 would be placed at issue. *See In re Pomona Valley Medical Group, Inc.*, 476 F.3d 665, 670 (9th Cir. 2007) (bankruptcy courts apply the "business judgment rule" to evaluate a debtor's assumption or rejection of an executory contract); *Orion Pictures Corp. v. Showtime Networks (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1099 (2d Cir. 1993). This is plainly Franklin's objective, as it argues in no uncertain terms that the City's pension obligations should be deemed an executory contract. Franklin Post-Trial Br., at 14-15 (twice stating that CalPERS is "plainly wrong" to argue otherwise). The City's discussion of its business judgment is therefore part and parcel of its contention that the Court can confirm the Plan regardless of its decision on the issue of impairing pensions. Even if Franklin were to succeed in convincing the Court that the City's pensions can be impaired as an executory contract, the evidence demonstrates that the City has made a completely justified business decision to assume that agreement. Franklin's attempt to cast the

[47] Franklin repeatedly refers to its treatment under the City's Plan as "punitive", notwithstanding the fact that such treatment was overwhelmingly consented to by the rest of Class 12. Franklin Post-Trial Br., at 9, 46, 47, 63.

City's argument as to its business judgment as relating to a non-existent "exemption" is simply nonsensical.

III. CONCLUSION

Based on the foregoing, the City respectfully requests that the Court confirm the Plan.

Dated: September 18, 2014

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