FROM: James L. Day

DATE: Decembr 2, 2022

RE: *City Heights v. City of Cle Elum* – Preliminary Analysis of Chapter 9 Issues

This memorandum will provide an analysis of issues and challenges the City of Cle Elum (the "City") would face in the event it filed a chapter 9 bankruptcy case, and the significant difficulties it will have in satisfying eligibility and good faith requirements unless it dramatically changes its approach to the difficult circumstances it has created for itself.

Executive Summary: As detailed below, there are five enumerated eligibility requirements the City would need to satisfy as a prerequisite to chapter 9 relief. While the City can likely satisfy the first two, the remaining elements would require that the City had already engaged in substantive, good faith negotiations with City Heights to resolve issues under the Development Agreement ("DA") and the arbitration award that it has wholly failed to even commence. In other words, a chapter 9 petition by the City under the present circumstances would fail and be dismissed on the basis that the City had not satisfied the gatekeeper elements for chapter 9 relief. In addition, the City would have a difficult time satisfying the overarching requirement that its petition be filed in "good faith" if the sole reason for the filing was to shed the relatively light obligations under the DA, while retaining the benefits and after inducing City Heights to agree to an annexation. Finally, the cost to prosecute a chapter 9 would also easily exceed the City's remaining discretionary funds, and that near-term expense would likely exceed the total of its future longer-term expenses to administer the DA to completion, making the decision to file all the more indefensible.

Eligibility. A municipal debtor has the burden to establish its eligibility for relief under chapter 9. *See In re County of Orange*, 183 B.R. 594, 599 (Bankr. C.D. Cal. 1995). There are five requirements that a municipal entity must satisfy to be eligible for relief under chapter 9:

> (1) The debtor must be a "municipality" as defined under the Bankruptcy Code;
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> (2) The debtor must be specifically authorized to file bankruptcy under state law;

(3) The debtor must be "insolvent" as defined under the Bankruptcy Code;

(4) The debtor must "desire[] to effect a plan to adjust its debts;" and

(5) (a) Creditors holding the majority in amount of claims have already agreed to the terms of a plan; or (b) the debtor negotiated with such creditors in good faith but failed to obtain such an agreement; or (c) it would be "impracticable" to negotiate with creditors for whatever reason; or (d) a fourth option that would not apply here.

11 U.S.C. § 109(c). For purposes of furthering settlement discussions, we will assume without conceding that the City would be able to satisfy the first two of the enumerated requirements – that it is a "municipality" and that it is authorized by state law to file bankruptcy.

City is Not Insolvent. At this time, the City cannot satisfy the third requirement – that it is "insolvent." The Bankruptcy Code defines "insolvent" differently for a municipality than it does for other types of debtors, which in the latter case generally use the balance sheet test, comparing assets and liabilities. For municipalities, insolvency hinges on cash flow and current or future inability to pay debts. Specifically, the term "insolvent," as applied to a municipality, means a financial condition such that the debtor is "(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due." 11 U.S.C. § 101(32)(C). The first alternative definition looks at present circumstances; the second is a prospective determination. *See In re Pierce County Housing Authority*, 414 B.R. 702, 710-11 (Bankr. W.D. Wash. 2009); *In re City of Bridgeport,* 129 B.R. 332, 337 (Bankr. D. Conn. 1991).

At this point, we assume the City is currently paying its bills in the ordinary course of business as they come due, so its contentions as to insolvency would have to be prospective. However, the City has not presented any analysis of the future costs and expenses it would incur in administering the DA or how they might be defrayed if the DA went forward, especially given the increased revenues that would come from the construction and sale of additional homes. To the contrary, the City has confined its economic analysis to (i) its inability to pay its own attorney fees if an arbitration went forward; (ii) its inability to pay the fees City Heights would incur if it prevailed based on the attorney fee provision in the DA; and (iii) the City's inability to pay a judgment for the damages City Heights has sustained due to the City's multiple breaches of the DA. The City has not incurred the first two amounts, and the third does not yet exist as a liquidated amount and does not yet have any impact on the City's ability to "to pay its debts as they become due."

City Has Only Recently Evinced A Desire to Effect a Plan. A chapter 9 case can only survive "if and only if" the debtor actually "desires to effect a plan to adjust [its] debts," and has "negotiated with [its] creditors in good faith" towards that end, even if such negotiations are ultimately unsuccessful. 11 U.S.C. §§ 109(c)(4), (5). The City cannot satisfy either requirement.[1]

[1] As identified above, the City could potentially satisfy the fifth eligibility requirement by one of four alternatives. However, only the second one – whether it negotiated in good faith with City Heights prior to

The City has said that, if City Heights files a motion to restart proceedings in the arbitration, the City would immediately file chapter 9 and is therefore preparing for the filing now. That statement is shockingly contrary to any ability to qualify for chapter 9 relief, especially when it has been coupled with the threat to reject the DA. Congress intended chapter 9 to be a last resort after substantive negotiations have been unsuccessful – a shield against creditors actions – and not a sword to be wielded in a vacuum. It would be wholly at odds with both the City's obligation to engage in pre-filing negotiations with creditors, and contrary to any subjective desire to come up with a plan of adjustment.

The obligation imposed on a prospective chapter 9 debtor to negotiate with its creditors prior to filing requires that it actually propose plan terms, and not just claim poverty. "[Wjhile a complete plan is not required, some outline or term sheet of a plan which designates classes of creditors and their treatment is necessary." *Pierce County Housing Authority,* 414 B.R at 713, quoting *In re City of Vallejo,* 408 B.R. 280, 297 (9th Cir. BAP 2009). The City has not even sought to initiate substantive negotiations with City Heights, let alone negotiations based on the outline of a possible plan of adjustment.

Under the circumstances, the City will have no access to chapter 9 relief until – at a minimum – it initiates and substantively participates in meaningful negotiations to address both the City's exposure on a judgment and the expenses that it would incur along the way, and the preservation and continued implementation of the DA.

Independent Good Faith Obligation. In addition to the five eligibility requirements under 11 U.S.C. 109(c), there is an independent requirement that the petition be filed "in good faith." Section 921(c) of the Bankruptcy Code states, "After any objection to the petition, the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title." In reviewing a motion to dismiss on the basis that the debtor did not file its petition in good faith, a court will typically look to the following factors:

> (i) the debtor's subjective beliefs; (ii) whether the debtor's financial problems fall within the situations contemplated by chapter 9; (iii) whether the debtor filed its chapter 9 petition for reasons consistent with the purposes of chapter 9; (iv) the extent of the debtor's prepetition negotiations, if practical; (v) the extent that alternatives to chapter 9 were considered; and (vi) the scope and nature of the debtor's financial problems.

City of Detroit, 504 B.R. at 180.

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filing – applies here. The first, that the City has already negotiated a plan that a majority of creditors has accepted, is certainly not in play at this point. The third alternative – that negotiations would be "impracticable" – would also not apply. This alternative applies when, unlike here, the creditor groups are so numerous that a municipality could not reasonably be expected to successfully negotiate with a majority of them. *Pierce County Housing Authority*, 414 B.R. at 713; *In re City of Detroit,* 504 B.R. 97, 176-77 (Bankr. E.D. Mich. 2013). Finally, the fourth alternative to satisfy the fifth eligibility requirement deals with circumstances that will not apply here.

A precipitous near-term chapter 9 filing would bring good faith into question under most of the factors identified above, separate from and in addition to the City's inability to satisfy basic eligibility requirements. In this case, the City's problems are not the sort of municipal challenges that typically cause chapter 9 filings, such as declining populations and revenues, aging infrastructure, out of control obligations on pension plans, or other financial challenges mostly outside a city's control. Rather, the City's problems here are largely self-inflicted, by way of its serial breaches of the DA. It entered into an agreement, implicitly asked City Heights to rely on its terms, and then did all it could to not perform. In the face of that history, no court will determine that a chapter 9 filing by the City – without extensive (even if unsuccessful) pre-filing negotiations – would have occurred in good faith, especially given the City's threat to use the bankruptcy process to terminate the DA.

Attorney Fees and Other Expenses. An enormous challenge the City would face that makes a chapter 9 filing even less likely is the cost. The City will not be able to engage local counsel at local rates that would be competent to represent the City in a chapter 9 case. These cases are fairly rare and require a skill set that likely does not exist in Eastern Washington. Rather, the City would need to hire a law firm from outside the area whose billing rates would quickly make the case much more expensive to prosecute than the City has in the way of remaining cash. The City will also need to engage a financial advisor to provide testimony in support of each of the financial eligibility requirements. The cost factor alone – especially given the City's as-yet failure to engage in negotiations towards a consensual solution – further militates against a good faith finding if the City were nevertheless to file chapter 9.

Finally, a somewhat less obvious consequence of a chapter 9 filing is that any borrowing the City wants to do will become more expensive. If the City has any plans to finance municipal improvements through bond financing, its rating will go down and the cost of funds will increase. This may not be a current need, but the down-rating will likely follow the City for some time.