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BANKRUPTCY - CALIFORNIA

In re Mendocino Coast Recreation and Park District

United States District Court, N.D. California - September 27, 2013 - Not Reported in F.Supp.2d - 2013 WL 5423788

Creditor Westamerica Bank (the "Bank") appealed the Order of the United States Bankruptcy overruling the Bank's objection regarding Debtor Mendocino Coastal Recreation and Park District's (the "District") Chapter 9 eligibility. At issue was whether the Bankruptcy Court erred in concluding that the District complied with 11 U.S.C. § 1 09(c)(5)(B)'s requirements for eligibility as a municipal debtor under Chapter 9.

The District Court affirmed the Bankruptcy Court's order determining Chapter 9 eligibility.

In 2008, the District entered into a lease related to a parkland property with a third party that subsequently assigned all of its rights to Bank, entitling the Bank to the lease payments.

In 2011, the District's Counsel sent a "settlement outline and proposal" (the "Workout Proposal") to the Bank's Counsel, describing the District's insolvent financial situation and notifying the Bank that if it could not work out a satisfactory alternative it would file a Chapter 9 bankruptcy petition. The Workout Proposal concluded by proposing three resolutions: (1) transferring the leased property to the Bank in full satisfaction of the lease obligation, (2) paying the Bank $1.1 million in full satisfaction of the lease obligation, or (3) entering into a forbearance agreement. The Bank declined to accept, or even discuss, the Workout Proposal.

The District subsequently filed its Chapter 9 voluntary petition (the "Petition"). The Bank objected to the Petition on the ground that the District failed to meet the Chapter 9 eligibility requirements in Section 109(c)(5)(B) of the Bankruptcy Code, 11 U.S.C. § 109(c)(5)(B). The Bankruptcy Court overruled the Bank's objection, holding that the Workout Proposal satisfied Section 109(c)(5)(B).

Section 109(c) of the Bankruptcy Code provides that "[a] n entity may be a debtor under Chapter 9 of this title if and only if such entity—" (1) is a municipality; (2) is specifically authorized to be a debtor; (3) is insolvent; (4) desires to effect a plan to adjust such debts; and

(5) (a) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(b) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(c) is unable to negotiate with creditors because such negotiation is impracticable; or

(d) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

The Bank and the District disagreed about whether the District "negotiated in good faith." The

question on appeal was whether Section 109(c)(5)(B) requires more than what the District did. The District Court concluded that Section 109(c)(5)(B) requires municipalities not just to negotiate generally in good faith with their creditors, but also to negotiate in good faith with creditors over a proposed plan, at least in concept, for bankruptcy under Chapter 9.

"From this body of law, the Court draws two conclusions. First, courts may consider, based on the unique circumstances of each case and applying their best judgment, whether a debtor has satisfied an obligation to have "negotiated in good faith." Second, while the Bankruptcy Code places the overwhelming weight of its burdens on petitioners, the provisions that call for negotiation contemplate that at least some very minimal burden of reciprocity be placed on parties with whom a debtor must negotiate.

In this case, the negotiation contemplated in Section 109(c)(5)(B) never happened, and the fault for that lay primarily with the Bank. Had the Bank responded with even the slightest indication of a willingness to negotiate, or even merely requested more time to consider the District's proposal, the door might well be open for it to claim that the District did not negotiate in good faith

This case did not present the issue of what must occur in a negotiation that satisfies 109(c)(5)(B). It presented the issue of what information, if missing from the debtor's first attempt to negotiate, bars a municipality from filing from Chapter 9 even if a creditor rejects the overture and declines to negotiate. In answering that question, one bright-line rule suggests itself. The possibility of imminent bankruptcy proceeding must be disclosed in the first effort to communicate, in order to ensure that, as the Bankruptcy Court put it in the Order Below, the municipality does not "blind-side a creditor by failing to mention that a Chapter 9 filing is contemplated."

Beyond that, the Court declined to prescribe any rigid per se rule for what qualifies as a good-faith effort to begin negotiations. That determination will depend on several factors, of which the Court here considered only three.

First, the greater the disclosure about the proposed bankruptcy plan, the stronger the debtor's claim to have attempted to negotiate in good faith. A creditor might be justified in rejecting the overture of a debtor proposing a frivolous or unclearly described adjustment plan, but a creditor is less justified in ignoring a substantive proposal.

Second, the municipality's need to immediately disclose classes of creditors and their treatment in the first communication will depend upon how material that information would be to the creditor's decision about whether to negotiate.

Third, the creditor's response, and the amount of time the creditor has had to respond, may also be factors. If a creditor has had a relatively short time to respond to the municipality's offer to negotiate, a lack of detail in the opening communication might weigh against a municipality rushing to file. On the other hand, where a creditor has been apprised of the possibility of a debt adjustment and declined to respond after a reasonable period of time, or where the creditor has explicitly responded with a refusal to negotiate, its position as an objector is significantly weakened.