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Exiting Municipal Bankruptcy Only a Step in Road to Recovery.

Many cities that declare bankruptcy ultimately emerge from it in a year or two. But regaining the trust of their citizens is a long-term proposition.

A short walk down Weber Avenue, the main downtown street in Stockton, Calif., offers an unmistakable reminder of the ambition the city used to possess, and the reality that confronts it now.

At the head of the avenue, city hall, a Renaissance Revival building that was part of the City Beautiful movement, is a monument to public service. Above its frieze are words that proclaim the local government's purpose: "To inspire a nobler civic life; to fulfill justice; to serve the people." Those words were written nearly a century ago. Today, the roof leaks, the paint is peeling off the two-story columns and a digital sign out front reminds citizens of the upcoming Fridays the city government is closed.

Similar signs of distress present themselves throughout the commercial district. Private security guards stand on the street corners outside a downtown school because there aren't enough city cops to staff the high-crime area to the satisfaction of property owners. Look to the left or right off Weber Avenue, and there are more boarded-up buildings — beautiful relics from the city's early 20th-century heyday — than there are open ones.

Stockton has been in bankruptcy since the summer of 2012, the largest American city to declare that status other than Detroit. To get out, its leaders have done the things other distressed cities around the country have done. They have renegotiated debt and tried to fix overly generous compensation packages for retirees and employees that were loading down city budgets. This has shown some positive results. The city's water bond rating, for example, was upgraded this year. There are signs of life even in the beleaguered downtown, including rehab work on some of the landmark buildings and construction of a new 13-story courthouse for the county of San Joaquin. But more important, after nearly two and a half years, the city this October was released from the burdens of its restructuring by the referee in charge of its case, U.S. Bankruptcy Judge Christopher Klein.

City officials seem confident that their plan will not only keep Stockton solvent but also put it in a position to prosper. But they also know that exiting bankruptcy won't change anything overnight. The real challenge lies in the years — and decades — ahead. The crucial question is whether future politicians and citizens will have the patience to stick with the game plan.

There is no one reason for Stockton's fiscal demise; as in other cities, there was a whole series of flawed decisions, driven primarily by well-meaning but overzealous officials who lacked the ability to take any kind of financial long view. "Everybody wants a villain," says Councilmember Kathy Miller. "And there isn't one."

Stockton started on the road to trouble in the late 1990s, when the government of California and cities all over the state began increasing pension benefits for their employees. Stockton, with a population of just under 300,000, doesn't have the lure of the major metro centers in Northern

California when it comes to attracting public employees. But it’s close enough geographically that it draws from the same labor pool. In competing with bigger cities, Stockton upped the ante by giving its employees and retirees full health-care coverage for life. That coverage meant no premiums and unlimited benefits for dependents.

It was the cushiest benefit package in the state. But at the time, few people raised even the slightest objection. As in most California cities, there was an assumption that the money to pay for the benefits would always be there. The pension increases were far from the only lavish spending commitment the city undertook in its healthy years. Gripped by the idea that big projects downtown would spur development and attract more residents, Stockton in the 2000s invested heavily in waterfront revitalization. Along the water, it financed $135 million in bonds to build a 10,000-seat indoor arena and a minor league ballpark, on the notion that the projects would either break even or make money on an annual basis. But they turned out to need subsidies, and both stand today as symbols of the city’s attempt to grow too big too fast.

When the arena opened in 2005, Stockton paid a million dollars to have Neil Diamond sing at the opening party. In 2008, after shelling out $2.7 million to build a restaurant at the renovated Hotel Stockton, the city gave the space rent free to a chic Sacramento restaurateur. (The restaurant proved too pricey for Stockton and failed after one year.) A 650-space parking garage, a 66-slip marina and the purchase of an eight-story downtown office building for a new city hall capped the buying binge.

Altogether, between 2003 and 2009, the city of Stockton issued nearly $320 million in debt tied to its general fund, roughly twice as much as the city spent from that fund last year. The annual debt service for the fund increased by 600 percent between the start of the recession and 2012, thanks to a back-loaded interest payment schedule.

Meanwhile, pension and health-care costs kept rising. To deal with these costs, Stockton purchased $125 million in pension obligation bonds — and purchased them at precisely the wrong time. The bonds, which are used to shore up unfunded pension liabilities, were acquired in 2007 at the height of the market. When the market crashed, the city saw its investment drop almost immediately by nearly a quarter. Housing values plummeted by 70 percent, crushing revenues just when debt liabilities were ballooning.

In 2012, the Stockton City Council voted to enter mediation, a state condition prior to filing for bankruptcy. By that time, the city had been in a declared state of fiscal emergency for two years — services had been cut, along with $90 million in annual expenses; nearly half of non-safety city employees were laid off; and wages were reduced by as much as 23 percent. Even with those drastic measures, Stockton still didn’t have the funds to keep running.

By the fall of 2012, the initial shock of bankruptcy had worn off. Residents understood that their water would stay on and the streetlights would still work. Post-bankruptcy life in Stockton went on. But that life was one of closed libraries, closed public parks and most alarmingly, increased crime, as the city’s police force lost a quarter of its personnel in just three years. In 2012, Forbes named Stockton the eighth most dangerous city in the nation. A record 71 people were killed in the city that year and robberies and burglaries became more frequent as well.

“It’s taken a toll,” says Dari Sylvester, a professor at the University of the Pacific in Stockton, who was instructed to fill out a police report online when she called to report that her car had been broken into. “Everybody knows someone who’s been the victim of a crime and the few cops we have are going to focus on violent crime.” Indeed, homicides fell significantly last year to 32, thanks in part to neighborhood watch group activity and increased use of street cameras to ward off crimes.

But the first 10 months of this year saw 45 homicides, including a string of shootings on one weekend in October that left five people dead.

Crime has driven key decisions in the bankruptcy period. In the run-up to filing for Chapter 9 bankruptcy protection, the council voted to phase out the city's health-care plan (an unfunded liability of more than $500 million for retirees' health care alone) and replace it with a traditional HMO in order to avoid more police layoffs. It was a move that still weighs on those who made it. "It was heart-wrenching," says former City Manager Bob Deis, the driving force behind the decision. "But the alternative was to cut more police officers and I just couldn't put the city at risk."

Police pensions have been another politically treacherous issue. Police officers in California are trained by the state and their pensions are managed by CalPERS, the state retirement system. This means officers can easily transfer from one jurisdiction to another and maintain their benefits. Klein, Stockton's bankruptcy judge, ruled on Oct. 1 that California cities could cut ties with CalPERS in bankruptcy and reduce their pension liabilities, but Stockton has not been interested in cutting the roughly $30 million a year it pays to CalPERS. City officials have been fearful that cutting pension benefits would lead to an exodus of cops looking to keep their retirement plans with another city.

In November 2013, in a further effort to deal with the public safety problem, Stockton's leaders proposed a three-quarter-cent sales tax — Measure A — to raise an extra $28 million a year to help fund the hiring of more police officers. Despite a 16.6 percent unemployment rate in the city at the time, voters approved the tax, a clear signal that residents were sick of feeling unsafe. But thanks to the particulars of the plan, Stockton had to reach minimum staffing levels (365 cops) before so-called Measure A officers could be hired. As the bankruptcy has dragged on this year, police have resigned from the force in numbers significant enough to keep staff levels below the Measure A threshold. In September, the first few Measure A officers were hired, five months after the tax went into effect.

Employee compensation has been crucial to Stockton's bankruptcy in still another way. One creditor, Franklin Templeton Investments, held up approval of Stockton's bankruptcy exit plan, which the city submitted to the court more than a year ago. Stockton offered Franklin Templeton $350,000 — only 1 percent of the money it owed the firm on a $35 million unsecured loan that paid for fire stations, a police station, bridges, street improvements and parks. The firm pushed back, arguing that it was being treated unfairly when Stockton did not cut its employees' pensions at all. The city, however, reasoned that its health-care cuts — worth roughly $23,000 a year per person in lost benefits — impaired its employees and retirees enough. The issue forced a lengthy trial this spring and twice led Klein to delay issuing a decision on Stockton's overall plan to emerge from bankruptcy.

One of the few positive things about bankruptcy is that it forces a city to face its past. Deis, the now-retired city manager, likens it to a 12-step program in which city officials admit defeat, tally up the wrongs of the past, try to set them right and then move on. Indeed, there is an emotional cost to bankruptcy that can't immediately be squared away on paper in the same way the city has renegotiated much of its debt. Filing for bankruptcy embarrassed Stockton residents. They weren't prepared for the national and global attention. "Nothing but horrible things they wrote about us — how screwed up we were, how awful Stockton was," says Councilmember Miller, still visibly rattled about it more than two years after the fact. "It was so demoralizing for the people in this community [to see Stockton] be held up as the poster child of the municipal screwup of the century."

But for all the work officials have done trying to plan out the next 35 years of Stockton's financial future, the remaining steps and the inevitable delays in returning to real solvency will test an already impatient citizenry. "The public is feeling beset upon," says downtown developer Dan Cort, who is active in rehabbing downtown buildings. “Businesses are losing credibility because of the bankruptcy.”

Keeping those emotions in check will be one of the city’s biggest challenges in the years ahead. Deis worries that future public officials, voted in by distrustful residents, won’t stick to the exit plan and its elements of fiscal austerity. The public is skeptical for good reason — they’ve been misled before by politicians whose financial and policy decisions turned Stockton into a sinking ship. They point to the nearby city of Vallejo and note that it is still plagued by budget deficits and crime problems three years after emerging from bankruptcy. What residents of both cities need to remember, says Chris McKenzie of the League of California Cities, is that three years is not enough time for a complete fiscal recovery. In McKenzie’s view, Stockton is better prepared to face the next decade than most cities because it’s had to devote so much attention to its financial future. “These are people,” he says, “who are not wearing rose-colored glasses anymore.”

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