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Legal And Jurisdictional Issues: Focus On Municipal Bankruptcy

The Editor interviews ***Malani J. Cademartori****, Partner, Sheppard Mullin Richter & Hampton LLP.*

Editor: Please tell us about your background and experience.

Cademartori: I graduated from Fordham Law School in '99, and before that I attended NYU as an undergraduate. I took a couple of years off between undergraduate and law school, working in Bangkok for six months during part of that time. I worked as a summer associate and then full time associate with the firm of Coudert Brothers, LLP, which was over 150 years old when it closed its doors in 2005, and was the first international law firm in the U.S. When I began my career, I was an attorney in the IP and M&A practices and, frankly, not quite loving it. When Enron filed for bankruptcy on December 1, 2001 and I was asked to assist on the purchase of a liquid natural gas facility being sold as part of the Enron case, it also marked the beginning of my career as a bankruptcy lawyer.

I think Enron changed the world of bankruptcy forever. Suddenly, bankruptcy was getting a lot of attention and, in what seemed like a very short time, became a sort of banner practice to the uninitiated. Once I fell in, I never looked back. As a federal practice, bankruptcy involves a statutory framework based on certain, general theories on which a practitioner can rely when dealing with the bankruptcy courts. The best thing about bankruptcy is that it's one of those mysterious areas of the law that is difficult for even other lawyers to understand. Thus, most people don't really understand what "filing bankruptcy" entails and what it means in most cases for corporations. People don't know that most bankruptcies are reorganizations or don't understand the difference between chapter 11 and chapter 7 – and they understand chapter 9 municipal bankruptcies even less.

Malani J. Cademartori

I've been practicing for 11 years, and have been a partner at Sheppard Mullin for two and a half years.

Editor: What were the jurisdictional issues at stake in the June, 2011 U.S. Supreme Court decision in *Stern v. Marshall*?

Cademartori: *Stern v. Marshall* highlights what I believe is a long-standing, but very topical, issue regarding the struggle between state and federal law, as well as the jurisdiction and powers of federal courts over, and in terms of deciding issues in connection with, state law.

In *Stern*, the Supreme Court found that a federal court does not have jurisdiction to decide issues of state law in the bankruptcy context. To oversimplify, the federal court should defer to the state court in matters of state law. Such deferral can involve following the state's recommendation or simply abdicating its right to review and to decide that issue to the state court altogether.

Notwithstanding the Court's careful wording and a holding that appears to narrow its application to counterclaims made against a non-debtor party, the *Stern* decision is a major development and is causing some confusion in the courts as to what they can or should decide in the bankruptcy context. Some maintain that *Stern* applies only to the narrowly outlined situation, while others have agreed to expand its effect in other situations involving questions of state law.

Practically speaking, the *Stern* decision has made and will make it easier for claimants to move issues out of the bankruptcy court and to a potentially more friendly court that is not fettered by adhering to the purpose of the bankruptcy code, which is, first and foremost, to foster the rehabilitation of debtors under the bankruptcy code.

Editor: Have bankruptcy courts traditionally enjoyed discretion in applying state law? Is that dynamic changing?

Cademartori: Yes, they have, and some bankruptcy courts are concerned about the implications of *Stern* because of the potential for exploitation by creditors and non-debtor defendants. Bankruptcy courts tend to be debtor-friendly. Creditors now seem to be using *Stern* to claim lack of jurisdiction in the bankruptcy court and to seek relief in a different court that is not "tainted" by what is perceived as the debtor-friendly stance.

Editor: Will certain legal issues automatically become a matter of forum shopping as a result of *Stern*?

Cademartori: While *Stern* may implicate the need to bring the state court in on various issues, it is separate from the issue of forum shopping for the filing of a bankruptcy case.

Most parties like the bankruptcy court for its speedy case processing and its ability to handle a full spectrum of issues. Post *Stern*, bankruptcy courts may have to defer certain issues to certain state courts, which in turn may have to act more quickly than they are used to so as not to disrupt time-sensitive bankruptcy proceedings. This raises practical issues about managing the

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state court docket, which likely cannot be adjusted solely to accommodate the bankruptcy court. One possible solution may be that state courts will opt to write an advisory opinion so the federal bankruptcy court can resolve a state law issue and proceed on schedule.

Editor: Does managing this new dynamic potentially become a legal strategy in your practice?

Cademartori: The issues raised in *Stern* regarding the struggle and reach of federal jurisdiction over state law have emerged in the context of chapter 9 as well. Take as an example the case of Harrisburg, Pennsylvania, which filed for bankruptcy and then had that bankruptcy case dismissed by the bankruptcy court when the bankruptcy court recognized the state law that specifically prohibited such a filing by Harrisburg. Here, although federal law would make the filing of bankruptcy a right to which any municipality can avail itself, the state law prohibiting such a filing trumped this federal right.

In other types of bankruptcy cases, parties cannot successfully subvert their rights under federal law in advance of a filing. For example, you cannot enforce even a voluntary contractual provision that eliminates your right to seek relief from a non-debtor entity for certain avoidance actions. Once a bankruptcy proceeding starts, the court may be said to view the debtor entity as different from the pre-debtor entity, and all such agreements become void since they take away the rights bestowed by the bankruptcy law. In addition, contractual provisions that prohibit the filing of bankruptcy, or seek to modify or terminate a contract on the basis of the filing of a bankruptcy, are unenforceable in the bankruptcy context. In the case of Harrisburg, the opposite has occurred. Harrisburg basically contracted away its right to file for bankruptcy, and the bankruptcy court upheld that provision as enforceable.

Editor: Please talk about chapter 9 municipal bankruptcy cases more specifically.

Cademartori: Chapter 7 and chapter 11 bankruptcies involve liquidation, reorganization or, in some chapter 11 matters, a strategic combination of the two. By contrast, municipalities can never liquidate and therefore must be reorganized through a chapter 9 proceeding. That said, it takes money to file for any form of bankruptcy, which raises the interesting question of what happens to municipalities that literally run out of money and cannot reorganize. I don't know if we have ever seen this, but I can imagine we will see this some time in the near future.

We tend to forget that municipalities, in essence, are businesses with debts to pay and expenses to shoulder, and bond issues tend to be a main culprit in municipal failures lately. This is why Harrisburg, Pennsylvania ended up in bankruptcy – the inability to meet and satisfy its bond debt in connection with a water treatment plant.

Other issues that can drive municipalities and other large debtors, such as airlines, into bankruptcy, relate to unions and pension plans. With a growing aging population, pension issues have become more prevalent and are very complex. The debt represented by pension plans can be massive and often cannot be dealt with outside of the bankruptcy context. This is how Central Falls, Rhode Island ended up in bankruptcy.

Editor: Please talk about collective bargaining as a part of the chapter 9 process.

Cademartori: It's relevant because the bankruptcy process can enable a municipality to shed substantial obligations by rejecting sometimes very expensive collective bargaining agreements (there was a decision on this in the Vallejo, California bankruptcy in 2009). Chapter 11 matters often involve such negotiations as a matter of course, but it's probably a more touchy issue in the chapter 9 context since those appearing to make the decisions also have to worry about voter perceptions and the desire to be re-elected. Municipalities outside of bankruptcy often may not have the same negotiating power as a corporation, which can reject a collective bargaining agreement on the basis that unions either must compromise or risk losing their jobs. Local governments cannot play that same game because they rely upon union workers to provide essential services for the public safety and community good, and they don't have the ability to leverage the possibility of the municipality actually liquidating in a chapter 9.

Editor: Can the community participate in avoiding financial disaster?

Cademartori: The community can participate to the extent that individuals recognize the need for self-sacrifice in order to achieve a greater goal. Such sacrifice might entail agreeing to service cuts, including to pensions and union wages, and demographics can play a substantial role, given an aging population's potential inability to keep up with increasing tax payments on a fixed income.

Another impediment to communal action is the traditional view about individual rights, particularly when people are used to enjoying certain benefits from their local government. At bottom, chapter 9 proceedings are intended to shed debt and nullify contracts that are no longer beneficial, which necessarily means reducing services; thus, it may be very difficult to achieve true community participation because people become emotionally involved.

Editor: What is the role of legal counsel in municipal bankruptcies, where the public good is at stake?

Cademartori: Once engaged, legal counsel has a duty to advise the debtor on how to maximize the estate for its creditors and, in a chapter 9 case, must of necessity also consider members of the tax-paying community. Legal counsel in chapter 9 matters has to meet the needs of its client, the municipality, and to balance that with the need to satisfy creditors (often bondholders as well as pensioners and other members of the community). Creating the right balance is very difficult when you're facing decisions to cut services that help the creditor but hurt the community. This situation really is unique to the municipal bankruptcy and the attorneys tasked with handling them.

Editor: What are the financing options to help municipalities pull through these reorganizations?

Cademartori: First, troubled municipalities must try to settle with their largest and most burdensome creditors at some discount. The beauty of reorganization versus liquidation is that, at some point, creditors are going to have to make a deal, and many chapter 9 filings have been completely avoided by using the threat of bankruptcy to force concessions from the large creditors. Today's negotiations are more difficult, and parties often need the shot of reality, i.e., the actual bankruptcy filing, to face the facts and move toward compromise. In the end, bankruptcy is about stopping the clock, taking a deep breath and sorting things out under the protection of the bankruptcy code.