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San Bernardino's Exit from Municipal Bankruptcy

by Sam Johnson-Saeger '26

The City of San Bernardino filed for Chapter 9 bankruptcy protection on August 1, 2012. Its filing occurred as other cities in California – Stockton, Mammoth Lakes – and across the U.S. – most notably Detroit – sought Chapter 9 protections. A decade later, on September 8, 2022, San Bernardino finally exited bankruptcy. This article examines San Bernardino's bankruptcy from start to finish, analyzing the painstakingly developed Plan of Adjustment that allowed San Bernardino to resolve over 1,000 claims and 200 lawsuits.

San Bernardino filed for bankruptcy protection in a disastrous financial state. At the time, the state projected a $45 million annual budget deficit for San Bernardino for the next five years, on a total budget of only $130 million. Unemployment was at 12.7% and the city's workforce had been cut 20% in the past four years. Falling revenues resulting from the end of Redevelopment funding, sinking property tax inflows, and decreased vehicle license fees left the city wanting for cash. (The Rose Institute's Fall 2012 and Fall 2014 editions of the ***Inland Empire Outlook*** detailed the myriad factors that contributed to San Bernardino's insolvency.)

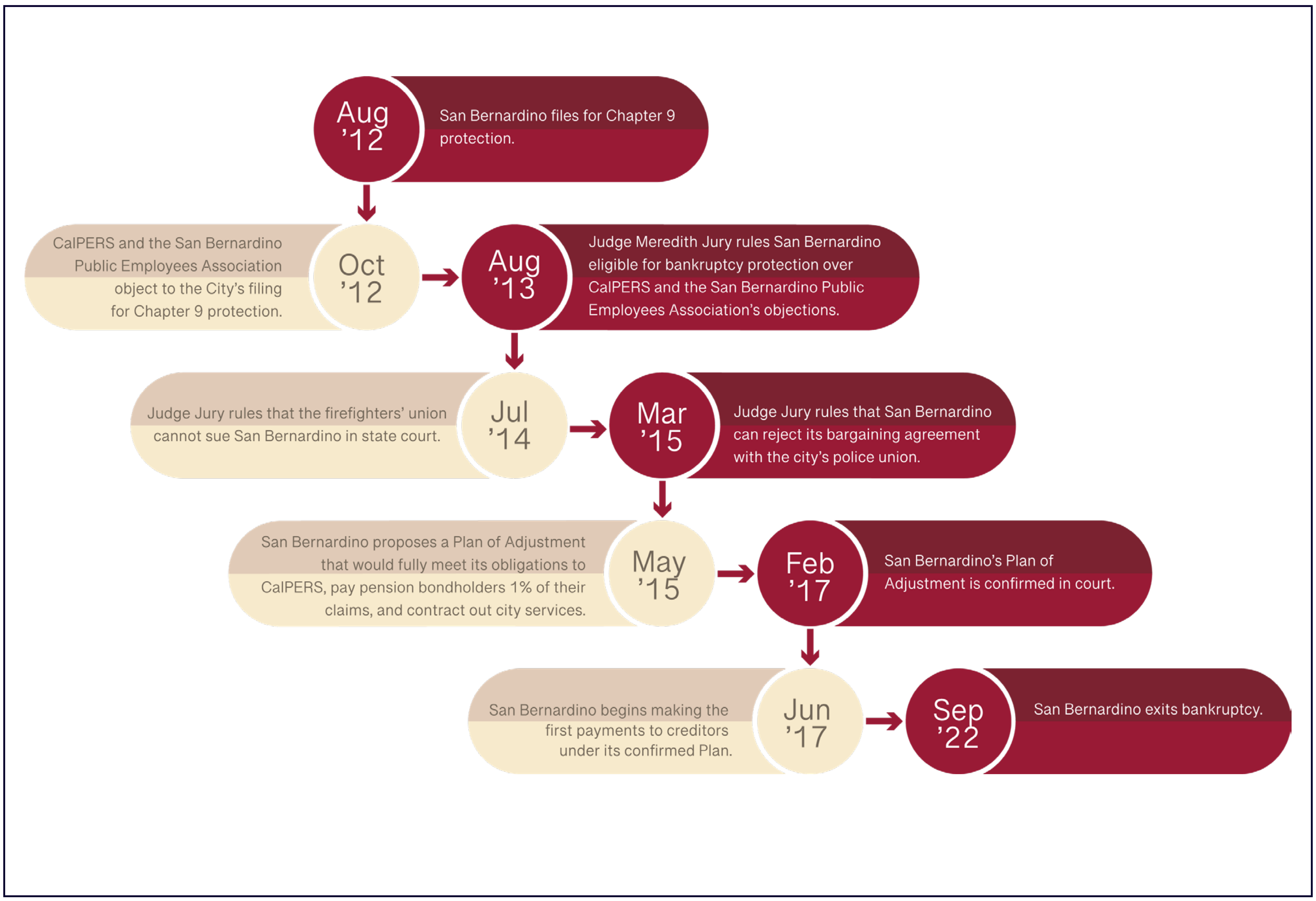
Upon filing for Chapter 9 protection, a locality receives an automatic stay that helps protect it against litigation and provides time to evaluate how to meet its obligations. The bankruptcy court then determines whether or not the locality is eligible for Chapter 9 protection, which is required for the case to continue. Once eligibility is settled, the locality works to develop a Plan of Adjustment that details how it will restructure its obligations to restore its financial stability. The Plan of Adjustment then requires approval of at least one class of impaired creditors, where-upon the locality can seek approval from the court even if other impaired creditors have not agreed to the Plan of Adjustment.

A decade after filing for bankruptcy, San Bernardino proved to the court that it had taken all required actions, made all required payments, and would be able to continue meeting its obligations under the city's Plan of Adjustment. Understanding how San Bernardino – after ten years of negotiations and litigation – resolved its bankruptcy crisis and developed a budget that is projecting surpluses of $2.5 and $1.3 million for FY23 and FY24, respectively, requires careful analysis of the city's Third Amended Plan of Adjustment (the Plan).

The Plan was not confirmed by the United States Bankruptcy Court for the Central District of California, Riverside Division, until February 2017. Disputes with various claimants and litigants, the most important of which included CalPERS (the agency that administers California's public sector pension system) and several powerful public sector unions, specifically the firefighters and police unions, delayed the Plan's development and confirmation. Unsurprisingly, the Plan's confirmation, while a necessary step for the city to exit bankruptcy and begin the process of becoming solvent and meeting its claims, left some stakeholders disgruntled. But Chapter 9 was not designed to make stakeholders happy. As a 2011 Congressional Research Service report explained, instead of being designed to provide for asset liquidation and distribution to creditors, Chapter 9 "provides a legal mechanism through which municipalities may be protected from the claims of their creditors as they attempt to develop and negotiate a plan to adjust their debts." Moreover, Chapter 9 provides specific leeway to municipalities going through the bankruptcy process. Bankruptcy court provides little oversight of municipal bankruptcies compared to claims filed under Chapter 7 or 11 of U.S. Bankruptcy Code (the pathway for individuals or companies that become insolvent). In this sense, Chapter 9 has served its purpose. It enabled San Bernardino to restructure its debts in a way that provided a feasible path back to solvency. An important provision relates to how impaired claims are handled. While the insolvent city usually needs to obtain the agreement of a majority of claims in each impaired (and therefore voting) class, the city can seek for the court to override claimants who disagree if the city has negotiated in good faith, is unable to negotiate, or reasonably believes that a creditor may attempt to obtain an avoidable transfer under Section 547 of Bankruptcy Code (an abnormality that is not relevant to San Bernardino's case).

The path that San Bernardino took is not an uncommon one. A 2015 Reuters article noted that employee pensions are usually left unscathed while unions and bondholders take major hits, a method of resolution that both

San Bernardino Bankruptcy Timeline



Sources: "San Bernardino Bankruptcy Timeline." *San Bernardino Sun*, July 31, 2014; "San Bernardino Exits Bankruptcy." City of San Bernardino, sbcity.org, September 12, 2022; Alan Zarembo and Joe Mozingo. "San Bernardino Offers Plan to Emerge from Bankruptcy." *Los Angeles Times*, May 16, 2015; "San Bernardino Bankruptcy: Judge Rules City Can Reject Police Contract - Labor Relations Information System." Labor Relations Information System, March 20, 2015. | Graphic: Jack Gladson, CMC'25

Stockton and Detroit pursued. But pensions cannot be ignored in identifying the causes of municipal bankruptcy. A report by the Pew Trusts notes that San Bernardino's insolvency was partially fueled by its sale of millions of dollars in pension obligation bonds, a move that would have helped it meet its obligations until interest costs exceeded the bonds' rate of return. San Bernardino's Plan leaves some creditors thankful that their debts have been or will be paid in full by the city; others, such as the city's public unions, only receive payment for 1% of their total claims. While pensions are untouched, San Bernardino's pension bondholders take a hit – roughly 50% – on their claims. A summary of the structure of the city's claims and the obligations it will meet to different classes of creditors is outlined in the table below

This analysis focuses primarily on the treatment of CalPERS, Consenting Unions (formally recognized bargaining units of city employees that have entered new claims by agreements with the city), and several bondholders because they were the classes impacted most by the Plan and presented the most serious obstacles in San Bernardino's exit from bankruptcy.

CalPERS Claims

CalPERS claims escaped the Plan essentially unscathed (though there were delays in payments, the claims are unimpaired and creditors have been or are in the process of being repaid in full by the city). While CalPERS emerged a winner among stakeholders to the Plan, it began by opposing San Bernardino's petition for Chapter 9 protection by suing the city; U.S. Bankruptcy Judge Meredith Jury ruled the city eligible for bankruptcy despite the pension fund's objections. Journalist Ed Mendel reported that San Bernardino took a more aggressive approach to handling CalPERS claims than other cities such as Stockton by ceasing to make payments to the fund during portions of its insolvency. Stockton continued to make payments despite declaring bankruptcy, and both cities ultimately left CalPERS unimpaired and covered its claims in full. CalPERS relative victory is partially due to the legal mechanisms that would have been triggered if it had been impaired by the Plan. An article in the Sacramento Bee explained that cities have little choice other than to fully cover CalPERS claims, as they would otherwise have to slash current and future retiree benefits to a degree that would likely cause city employees to leave en masse.

Consenting Union Claims

Consenting Union claims are treated as General Unsecured claims by the Plan, which leaves creditors with only 1% of their claim being covered. Low coverage is not the only impact that the Plan has on San Bernardino's public sector employees. The city was also annexed into the County Fire District and began contracting out certain city services to Burrtec, a waste industry provider. According to the Plan, the city is also "considering contracting out include fleet maintenance, business licensing, engineering, inspections, information technology, graffiti abatement, traffic signal maintenance, street maintenance, custodial maintenance, code enforcement and more." Agreement to the Plan by consenting unions was reached after they faced a number of setbacks: the firefighters union, for example, suffered a loss when Judge Jury ruled that it could not sue the city for cutting salaries and benefits after rejecting a proposed contract by the union. San Bernardino later exercised its rights estab-

Claim Resolution in San Bernardino's Third Amended Plan of Adjustment

Resolution	Claims settled via this mechanism
Paid in full	Administrative Claims (claims against the City for the administration of the Bankruptcy case), CIEDB Harriman Project Claims, CIEDB Pavement Project Claims, Claims on Restricted Revenue Bonds and Note Payable Obligations, CalPERS Claims, Convenience Class Claims
Reasonability determined by Bankruptcy Court	Professional claims (claims for services rendered to the City during its bankruptcy)
Claims are amended and supplemented in external sources	1996 Refunding Bonds Claims, 1999 Refunding Certificates of Participation Claims, Burgess Claims, PARS (Public Agency Retirement System) Claims, Retiree Health Benefit Claims, POB (Pension Obligation Bond) Claims
1% Distribution (potentially with other provisions)	Police Station AC Financing Claims, Consenting Union Claims, General Unsecured Claims

*For a detailed explanation of the impaired and unimpaired classes impacted by the Plan, see the Definitions and Treatment of Claims sections of the Plan (Exhibit A).

lished by Judge Jury and imposed a contract on its firefighters' union. A similar story played out with San Bernardino's police union: Judge Jury likewise agreed to let the city reject police union contracts. The dynamic with local public safety unions is complex: under its city charter, San Bernardino cannot directly reduce their pay (which is on par with other mid-sized municipalities, which are often much wealthier than San Bernardino). Its approach to reducing spending during bankruptcy has therefore focused on attempting to require fire and police unions to agree to employee contributions to their pension funds. Both unions strongly opposed this move. San Bernardino Police Officers Association attorney Ron Oliner contended that such 'cost-sharing' violates state law and said the union intend[ed] to press 'substantial' claims for rejection damages and an administrative claim.

Both the extensive litigation proceedings and the confirmed Plan demonstrate the intense conflict between San Bernardino, a city beset by public safety challenges, and its public safety employees over the course of the city's insolvency. San Bernardino came out on top in a process that, by design, favors the city.

Bondholder Claims

While CalPERS received payment in full, the entities that loaned tens of millions to San Bernardino in the form of Pension Obligation Bonds (POBs) will only receive partial repayment. Under an earlier version of the Plan, EEPK (a Luxembourg-based bank and a creditor of $50 million to the city) was set to receive only a 1% payout, along with Ambac Insurance Corp and Wells Fargo. In the confirmed plan, however, POB claims are set to be paid back at roughly a 50% rate. Specifically, "The City will make payments of $1.6 to $2.5 million per fiscal year until 2046 instead of the $3.3 million to $4.7 million per fiscal year owed under the terms of the 2005 pension bond agreement." This dramatic shift represents a middle-ground between the payouts for Consenting Unions and CalPERS – but still serves as an example of the pension agency's power, in contrast to that of most other creditors.

Implications

San Bernardino's exit path aligns with a broader pattern that has become common in municipal bankruptcy cases, an implication worth discussing. The pattern has arisen as most municipal bankruptcies have considered two primary classes of debt: pensions and bonds. As Diane Lourdes Dick wrote for the Brookings Institution, pensions have consistently won under principles of fairness and equity that have been lauded in public statements – retirees, after all, face much greater risk from non-repayment than major bondholders (such as EEPK and Wells Fargo in San Bernardino's case). Lourdes Dick attributes these dynamics not to principled moral arguments made by cities, but to the political economy of Chapter 9. A powerful negotiator such as CalPERS was uniquely able to advance its interests, while San Bernardino slashed retiree health benefits, which are more decentralized and less politically charged. These outcomes

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suggest that the Plan is not solely deferential to retirees above all others, but that it focuses on reaching a restructuring that is agreed to by powerful negotiators such as CalPERS. This trend, as Lourdes Dick argues, also helps explain the broader pattern of municipal bankruptcy restructurings and will likely continue to do so without changes to Chapter 9.

More than a decade after becoming insolvent and a year after exiting bankruptcy, San Bernardino is running a projected budget surplus for Fiscal Years 2022/2023 and 2023/2024, a result of changes made through its long-awaited Plan of Adjustment. While the city will need to continue responding to governance and fiscal health challenges, San Bernardino today seems to be on sound financial ground. ◆

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