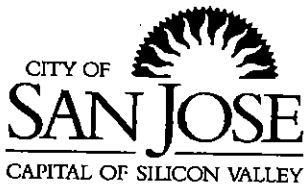
COUNCIL AGENDA: 10/03/06
ITEM: 9.1



Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: RICHARD DOYLE
City Attorney

SUBJECT: **San José Repertory Theatre**

DATE: September 26, 2006

Pursuant to Council direction on September 19, 2006, attached, as Attachment 1, is an Informational Memorandum from our bankruptcy counsel, discussing the advantages and disadvantages of the San Jose Repertory Theatre ("Rep") filing a petition for bankruptcy prior to the loan of City funds to the Rep.

In addition, in a separate Attachment 2, we've responded to the City Auditor's referral regarding the Rep's use of endowment funds to secure a line of credit with Comerica Bank.

RICHARD DOYLE
City Attorney

cc: Les White

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ATTACHMENT 1

McPharlin, Sprinkles & Thomas, LLP
Memorandum

To: Richard Doyle, City Attorney

From: Elaine M. Seid

Date: September 25, 2006

Subject: San Jose Repertory Theater/ Bankruptcy Issues

BACKGROUND FACTS

The San Jose Repertory Theater (the "Rep") is in financial crisis.

Council members have suggested the Rep consider bankruptcy and have asked the SJ City Attorney's office what effect bankruptcy would have on the Rep and its creditors under both Chapter 11 (reorganization) and Chapter 7 (liquidation).

SPECIFIC QUESTIONS

#1 Under what circumstances can an entity file for bankruptcy?

The Rep is qualified to file bankruptcy, either Chapter 11 or Chapter 7. The new bankruptcy laws that went into effect in August 2005 instituted a "threshold test" for individuals with consumer debts. 11 U.S.C. §707(b). However, the new threshold test does not apply to corporations.

#2 What are the differences between a Chapter 11 and Chapter 7 bankruptcy?

<u>Chapter 7</u> is referred to as a "straight liquidation." The debtor turns over its business and assets to a Chapter 7 trustee whose statutory duty is to reduce all assets to cash (for the "bankruptcy estate") and distribute the cash to creditors according to statutory priorities. 11 U.S.C. §704(a). Priority means the first in priority gets paid first and in full before the next in priority from the assets of the bankruptcy estate. The first in priority will be the administrative expenses of the

Chapter 7 trustee (e.g. statutory fees plus expenses of professionals, e.g. attorneys, accountants, etc.) The next in relevant priorities are wage claims, consumer deposit claims and tax claims. *See* 11 U.S.C. §507. The lowest in priority are the general unsecured creditors.

It should be noted that secured creditors have a claim against specific assets. The debtor's assets become available to the bankruptcy estate only if the value of an asset exceeds the amount of the allowed secured claim against the asset. To the extent the allowed secured claim exceeds the value of its collateral, the excess is unsecured and the unsecured portion becomes and is treated as a general unsecured claim.

Upon the filing of the bankruptcy petition, the debtor is relieved of its ownership and control of its assets. These are administered by the Chapter 7 trustee for the benefit of creditors. The debtor has no continued involvement in the bankruptcy estate, unless required to respond to questions of the Chapter 7 trustee, U.S. Trustee or creditors, often under a Bankruptcy Court order.

The debtor does not continue business. A Chapter 7 trustee may be authorized to continue a debtor's business if it is in the best interest of the estate and consistent with the orderly liquidation of the estate and then only for a limited period. 11 U.S.C. §721. Continued operation of the Rep does not appear likely as the Rep currently operates at a loss.

Chapter 11 is a reorganization. As a general rule, no trustee is appointed. Instead, the debtor (here, the Rep) remains in possession and control of its assets and acts as a fiduciary for the benefit of creditors[1].

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[1] The Bankruptcy Court may appoint a trustee to take over for the debtor in possession "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, . . ." 11 U.S.C.§1104 (a). Alternatively, if at trustee is not appointed, the Bankruptcy Court could appoint an examiner "to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor." 11 U.S.C. §1104(c).

A Chapter 11 scenario usually contemplates the debtor continuing in business as usual but with pre petition creditors stayed from collecting pre petition claims. 11. U.S.C. §362(a). (Pre petition claims are essentially put on the "back burner" to be dealt with in a plan of reorganization.) The bankruptcy stay is to provide the debtor with breathing space to reorganize and hopefully improve its business performance. Debts incurred during the Chapter 11 bankruptcy are "costs of administration" and are given administrative priority. 11 U.S.C. §503. These should be paid in the ordinary course of the debtor's business. However, in many cases, if the debtor's business is not sufficiently viable, the debtor will soon become administratively insolvent (i.e. cannot pay for current post petition operations), justifying a conversion of the Chapter 11 case to a Chapter 7 liquidation case (see above discussion.) 11 U.S.C.§1112(b).

The longer range objective of a Chapter 11 reorganization is for the debtor (or an interested party should the debtor fail to propose a plan during the "exclusivity period") to propose a plan of reorganization to creditors to restructure the debtor's finances and allow the debtor to emerge from bankruptcy in a much stronger financial position. Often a reorganization plan eliminates the equity interest of shareholders (not applicable to the Rep as it is a nonprofit). A plan could pay pre petition claims in deferred payments or only a fraction of the claim amount, and frequently a combination of both. The confirmed plan of reorganization is essentially a multi-party contract that supersedes the pre petition rights and obligations of the parties.

A Chapter 11 is appropriate where the debtor has a viable business that can thrive once its pre petition financial burdens are modified or eliminated by a confirmable plan. In order to succeed in a reorganization, the debtor must have the financial resources to pay the administrative professional costs of a chapter 11 (the amount could be daunting) and a viable business to operate profitably in the future. Otherwise, a Chapter 11 makes little sense.

The customary means for implementing a bankruptcy plan of reorganization are normally (1) infusion of new capital (in the Rep's case, fundraising), (2) sale of assets, or (3) future profits, the later being the one most relied upon by hopeful debtors.

The City's auditor's report suggests the Rep's business may not be a suitable candidate for reorganization.

#3 What happens to the Rep's creditors under both?

Chapter 7. In a Chapter 7 bankruptcy, pre petition creditors must file a claim with the Bankruptcy Court. Once the Chapter 7 trustee has liquidated all assets into cash, the trustee will review claims to determine the priority and the "allowed amount" of each filed claim. The trustee will distribute cash on hand according to statutory priorities.

Given that Comerica Bank appears to have a secured interest in all of the Rep's cash and cash accounts, it is highly unlikely the liquidation of the Rep's assets will generate much cash for the bankruptcy estate. Accordingly, more likely than not, general unsecured creditors of the Rep will not receive any distribution from the Rep's bankruptcy estate.

It should be noted that to the extent the Rep has sold tickets for the 2006-2007 season, the ticket holders[2] are likely to become general unsecured creditors in the Rep's Chapter 7 bankruptcy.

Chapter 11. To confirm a Chapter 11 plan of reorganization, the debtor must show that creditors are being treated under the plan at least as well as creditors would be treated in a Chapter 7 liquidation. 11 U.S.C. §1129(a)(7).

It is always the hope of any debtor that creditors will be treated better (or at least as well) in a Chapter 11 than creditors would be treated in a Chapter 7 so the debtor will have creditor support to confirm a Chapter 11 plan of reorganization. In the Rep's case, where it is projected general unsecured creditors will receive nothing in a Chapter 7, general unsecured creditors are likely to vote in favor of any plan of reorganization that provides any hope of recovery. Accordingly, getting creditor support for a plan may not be problematic for the Rep.

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[2] Subscription holders could argue the monies paid for 2006-2007 season tickets are a "deposit . . . of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that are not delivered or provided" and therefore entitled to seventh priority under 11 U.S.C.§507(7). If so, the priority amount is limited to $1,800, with any sums in excess dropping to the lowest priority as a general unsecured claim.

However, the more important question is whether the Rep has a viable operation and whether any of the Rep's creditors (including subscribers) will continue to do business with the Rep in the future.

#4 What happens to the Rep under both?

Chapter 7. The Rep would cease to exist in its current form. The Chapter 7 trustee will administer the Rep's assets (if any), liquidate the assets to cash and pay creditors with the cash recovered according to statutory priorities. The Rep is out of business.

Chapter 11. Assuming the Rep has the financial resources and management talent to become a viable operation and to confirm a Chapter 11 plan of reorganization, the Rep will emerge from Chapter 11 and continue in business. Its obligation to pre petition creditors will be defined and modified by the confirmed plan, i.e. either eliminated, paid a discount, paid over time, or a combination of terms.

#5 What happens to the City's Operation and Maintenance Agreement with the Rep if it declares bankruptcy under Chapter 11 or Chapter 7?

In either Chapter 7 or Chapter 11, the trustee or the debtor in possession has the option of assuming or rejecting the Operation and Maintenance Agreement ("OM Agreement") 11 U.S.C. §365.

Under an assumption, all defaults must be cured and the ability to perform the OM Agreement in the future must be demonstrated as a condition to assumption of the OM Agreement. 11 U.S.C.§365(b). (As the OM Agreement does not require the Rep to pay rent, the Rep's default may not be as easy to identify as a rent default.)

Under a rejection, the trustee/debtor in possession is relieved from performing under the OM Agreement and the City would have a general unsecured claim for damages caused by the permitted breach. 11 U.S.C.§365(g). The claim would be subject to certain monetary limits (11 U.S.C. §365(b)(2)).

Until there is a rejection, the trustee/debtor in possession is obligated to perform under the OM Agreement. The City would have an administrative claim (entitled to administrative priority) for obligations accrued between the petition date and rejection date. 11 U.S.C§365 (d)(3).

However, the City's breach claim or administrative claim under the OM Agreement may be academic as the Rep pays nothing to the City under the OM Agreement. Instead, the City pays the Rep annual amounts to maintain the Theatre the Rep occupies.

#6 What happens to the endowment fund being used as collateral for Comerica's $885,000 line of credit to the Rep under Chapter 11 and Chapter 7? Presently, the Comerica agreement with Rep states that it can call the loan if the Rep becomes insolvent or is the subject of a voluntary or involuntary proceeding in bankruptcy. So, does this mean that Comerica can claim the collateral if Rep cannot pay the $885,000 line of credit? Does bankruptcy afford the Rep any protection?

Assuming Comerica has a valid perfected security interest in the endowment fund, it has the right to foreclose on its collateral to pay its secured claim. Bankruptcy does not trump a validly perfected security interest.

However, a bankruptcy could "stay" or delay Comerica's enforcement of its foreclosure rights, but not indefinitely. Comerica is entitled to "adequate protection" of its secured interest in the Rep's assets as a condition to the continuation of the bankruptcy automatic stay and can move for relief from the bankruptcy estate should it believe its secured interest is not adequately protected.

It may be possible in a confirmable Chapter 11 plan for the Rep to modify the payment terms of Comerica's secured claim provided Comerica's secured claim is eventually paid in full and Comerica is appropriately compensated for the delay in payment. 11 U.S.C. § 1129(b)(2)(A).

#7 What happens if the Rep (with the City's consent) assigns all or a portion of its operation and maintenance responsibilities under its current agreement with the City to another entity less than 90 days prior to filing for bankruptcy?

In a bankruptcy case the trustee (Chapter 7) or debtor in possession[3] (Chapter 11) is given certain "avoiding powers" to undo certain pre petition transactions. The most commonly used avoiding powers are to avoid (1) preferential transfers or (2) fraudulent transfers.

A preferential transfer occurs if a payment is made to a creditor for an antecedent debt during the preference period that allows the creditor to receive more than the creditor would receive in a hypothetical Chapter 7 liquidation. The described facts do not appear to fit a "preferential transfer" unless the transfer of the operation (assuming it is an asset, i.e. valuable) is to a creditor to pay a pre existing and somewhat delinquent debt.

A fraudulent transfer occurs if the transfer is made for less than fair consideration. Without more details of a proposed transaction, it is difficult to evaluate or determine whether or not the transaction could be avoidable as a fraudulent transfer. However, assuming the Rep has no ability to perform the OM Agreement with the City and would lose its rights under the agreement in any event, arguably the Rep has not lost anything of value by assigning the OM Agreement to another entity.

#8 What happens if the City makes a $1,000,000 loan to the Rep and the Rep declares bankruptcy? What protections, if any, does the City have against losing the entire $1,000,000? Would a personal guarantor protect the City's interest? Is there anything else?

If the City loans $1,000,000 to the Rep and the Rep files for bankruptcy afterwards, assuming the Rep has no assets to pledge as security for the loan, the City's loan is a general unsecured claim with equal standing with all of the Rep's other pre petition claims, including those currently existing.

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[3] A Chapter 11 trustee can be appointed "for cause", e.g. if debtor has grossly mismanaged its affairs or engaged in fraudulent conduct. 11 U.S.C. §1104.

On the other hand, if the City loans the $1,000,000 after the Rep files for bankruptcy relief (this presumes a Chapter 11 and the Rep continues its operations), the funding would be "debtor in possession (DIP) financing." The City would negotiate terms that require the Bankruptcy Court's approval, including giving the City's loan administrative priority so that it has priority over all pre existing pre petition claims. The City could require its loan be secured with post petition receivables. However, the administrative priority and/or secured interest have value only if the Rep has post petition unencumbered assets, e.g. from revenue. This appears unlikely given the Rep's past and current operations.

It is desirable for the City to obtain security for any loan it makes. However, it appears the Rep's assets are limited such that it is unable to provide the City with any security.

Personal guarantee, if available, would provide the City with the promise of other persons or entities to pay the City in the event the Rep is unable to repay its obligation. This would afford the City additional protection provided the individuals or entities themselves are solvent and have the ability and resources to repay the City.

#9 Can the Rep do something short of bankruptcy? Can it enter into separate agreements with vendors to delay payments? Anything else?

The Rep can enter into settlements or moratorium agreements with all of its vendors. However, the process of negotiating with every vendor and documenting the agreements is usually a labor intensive and time consuming process. To stabilize the Rep by settlement agreements to allow it to move forward requires 100% cooperation from all vendors to refrain from collection actions. It is unclear whether the Rep has the financial resources to devote its staff to this endeavor, particularly as the Rep has not had a qualified financial manager for some time due to monetary constraints. It is equally unclear whether the Rep's vendors would be willing to agree to settlements or moratorium agreements. In contrast, the bankruptcy automatic stay would impose a moratorium on pre petition creditors upon the filing of the bankruptcy petition without the need for the Rep to negotiate and document the moratorium.

#10 Can the board members be held personally liable for the debts of the Rep?

In general, the board members are not personally liable for the debts of the Rep as it is a corporation.

THE GLOBAL QUESTIONS

A. Whether the City should encourage the Rep file a Chapter 11 bankruptcy as a condition to the City advancing funding?

PROS:

- Encouraging the Rep to file for Chapter 11 relief prior to funding would result in the City's loan having a higher priority (administrative priority) than existing pre petition general unsecured claim.
- The City's loan would be devoted to post petition operations rather than paying existing pre petition claims resulting in potentially better use for the City's loan, i.e. funding current operations rather than paying past debts.
- It may be possible to legally distinguish vendor creditors from subscriber creditors to allow subscribers full use of tickets purchased prior to the bankruptcy. The potential advantage is to build subscriber loyalty and willingness to subscribe in the future.

CONS:

- The Rep will incur another layer of administrative costs in Chapter 11. The Rep will require competent bankruptcy professionals to assist it in navigating through the bankruptcy process. Additionally, substantial time and effort of management will be devoted to complying with the bankruptcy process, thereby diverting management's ability to deal with the business aspects of operating the Rep's business, e.g. fundraising, marketing.
- The public may be unwilling or reluctant to purchase tickets as the Rep is in financial distress, thereby diminishing the Rep's cash flow and ultimate revenue.

- The community may be unwilling or reluctant to contribute as the Rep's future is uncertain.

- It is unclear whether the $1 Million requested will be sufficient to get the Rep through another season. There appears to be a substantial likelihood the Rep will require further financial subsidies.

- The Rep has no bankruptcy exit plan other than its pledge to "work harder" and promise not to ask for more money. It is not advisable to expend the time and resources for Chapter 11 reorganization unless there is an identifiable and viable exit plan. It may only delay the unfortunate yet inevitable liquidation of the Rep.

B. Whether the City Should Encourage the Rep to File Chapter 7 and Support a Substitute Organization to Operate and Manage the Theatre.

PROS:

- Were the City to consider only the financial aspects (ignoring the political, social and community aspects) allowing the Rep to liquidate in a Chapter 7 has advantages. The City would regain possession of the Theatre and could seek another, hopefully financially stronger, organization to operate the Theatre.

- The money requested by the Rep could be devoted to a stronger organization.

- The City will not devote public funds and resources to what appears may be a financially losing proposition.

CONS:

- A more desirable organization to operate the Theatre may not be immediately available or identifiable.

- Whether or not the Rep should file for Chapter 7 bankruptcy relief is more appropriately a decision for the Rep to make rather than the City.

C. What Is A Middle Ground?

The City could provide interim funding in a more modest amount for the identified purpose of assisting the Rep in determining whether or not it has or could develop in the near future a financial turn around plan before the City commits more significant resources to the Rep.

Should the Rep have no viable turn around plan, it would be appropriate for the City to decline to provide further financial support for the Rep.

On the other hand, if the Rep has a viable financial turn around plan, (i.e. realistic budget showing it can become financially stronger within a reasonable amount of time), continued financial support for the Rep may become more justifiable.

ATTACHMENT 2

REP's Use of Century Fund Endowment Monies

As part of his September 18, 2006, Memorandum to the City Council, the City Auditor questioned whether the Rep's use of restricted Century Fund Endowment monies to secure a line of credit with Comerica Bank was appropriate and referred the matter to this Office for further analysis. We have responded in a question and answer format based on our legal research as well as informal discussions with the Office of the Attorney General. We have not conducted an independent investigation regarding the REP's use of the Century Fund as collateral.

1. If endowment funds were used inappropriately, who has primary responsibility for enforcing the restrictions placed on the endowment?

Under the California Government Code, the Attorney General has the primary responsibility for investigating and enforcing the restrictions placed on the endowment. In general, the Attorney General has primary responsibility for regulating, enforcing, and supervising organizations and individuals that administer and/or solicit charitable funds or assets in California. The Attorney General has the duty to protect donors, charities themselves and beneficiaries of charities. In addition, the Attorney General has broad authority under State statutes to regulate charitable organizations and to commence law enforcement investigations and legal actions to protect the public interest. However, as one court has noted, there is no rule or policy against supplementing the Attorney General's power of enforcement by allowing other responsible individuals to sue on behalf of the nonprofit. For example, the nonprofit corporation itself or officer or director of the nonprofit corporation, or even a disgruntled donor, could file a lawsuit.

2. May restricted endowment funds be used for a purpose other than that contemplated by the original endowment?

In general, restricted endowment funds may only be used for the purposes or "restrictions" as set forth in the original endowment. Pursuant to the Rep's 2002 Financial Statements, it appears that the Century Fund Endowment funds are restricted to investments in perpetuity, the income from which is expendable to support current Rep operations. Similarly, the Auditor's Memorandum refers to the goal of the Century Fund which was to establish an endowment to use interest earnings to fund operational activities of the Rep. While the Rep argues that the purpose of the Comerica Bank line of credit was to fund operational activities and, therefore, used for the restricted purposes of the endowment, it could be argued that the purpose of the endowment -- long term prudent investing to generate interest earnings, is not necessarily consistent with using the Fund to collateralize a line of credit, even though the line of credit appears to have been used to reduce operational expenses.

3. Must a donor "unrestrict" a contribution prior to it being used for another purpose?

Yes. The California Probate Code §§ 18500 – 18509, governs the spending and investment of institutional funds and includes special provisions for the expenditure of endowment funds.

Section 18507 provides that any restriction on the use or investment of an institutional fund imposed by the gift instrument may be released by the written consent of the donor. Nick Nichols of the Rep has informed this Office that it is his understanding that contributors to the Century Endowment Fund consented to the use of the Fund as collateral for the Comerica Bank line of credit. Since it is unclear whether the consent was verbal or in writing, Mr. Nichols and his staff are in the process of contacting each donor to obtain his/her consent in writing. Whether any violation of the Probate Code has occurred as a result of the Rep obtaining written consent *after the fact* could be subject to review by the Attorney General.

Further, if the Rep is unable to obtain written consent from each of the donors because of the donor's death, disability, unavailability, or impossibility of identification, Section 18507 provides that the governing board (in this instance the Board of Directors of the Rep) may apply in the name of the institution to the superior court for a release of the restriction. The Attorney General must be added as a party to the proceedings.

4. Are board members of a nonprofit personally liable for the nonprofit's obligations?

In general, directors of nonprofit corporations, like directors of business corporations, are usually not personally liable for the debts, liabilities or obligations of the corporation.

A director who performs his or her duties in good faith, in a manner the director believes to be in the best interest of the corporation, and with reasonable care and inquiry under the circumstances has no personal monetary liability to the corporation in an action based on alleged failure to discharge the director's duties. However, the protection against liability does not apply to a director who engages in self-dealing.

A transaction involving self-dealing is a contract or other action affecting the assets or income of the corporation where the corporation is a party and one or more of its directors has a material financial interest. Such transactions may include payment of a salary, fee, commission, or other benefit of material economic value to one or more of its directors, or to a corporation or partnership in which a director has a material financial interest. In reviewing self-dealing transactions, the Attorney General considers a financial interest as "material" to a director if it is large enough to create an appearance of a conflict of interest. This is a question of fact in each case and one which is within the jurisdiction of the Attorney General to investigate.