

WHY (NOT) CHAPTER 9



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2011-2012 Chapter 9 Filings



- The past two years have been notable for the number of general purpose municipalities that have filed for bankruptcy
- Central Falls, RI
 - Retiree pensions and health benefits
- Harrisburg, PA
 - Case was dismissed due to lack of specific authorization from the state to file for Chapter 9
- Jefferson County, AL
 - Sewer financing project
 - State supreme court struck down a tax that county imposed
- Stockton, CA
 - Unfunded pensions
- Mammoth Lakes, CA
 - Chapter 9 filed because of large judgment awarded against the city
- San Bernardino, CA
 - Expensive union contracts
 - Fear of imminent collection actions against the city

CITIES IN DECLINE



- Reports of municipal financial distress fill the news almost daily. Reasons?
 - Declining tax base
 - ✦ Suburbanization
 - ✦ Mortgage crisis
 - Expensive projects
 - Unfunded pensions and retiree health care obligations

WHY CHAPTER 9 FILINGS REMAIN RARE



- Statutory Eligibility Requirements
 - 11 U.S.C. § 109 (c)
- Uncertainty
 - Paucity of Case Law makes prediction of Chapter 9 end result uncertain
- Questions regarding purpose of Chapter 9
 - Rehabilitation?
 - Fresh start?
- Questions about effect of a Chapter 9 on a city's ability to raise funds in the capital markets in the future.

ELIGIBILITY REQUIREMENTS



- In order to file for Chapter 9, an entity must (§ 109 (c)):
 - Be a municipality;
 - Be specifically authorized, by state law or by a competent state government official or organization to file for Chapter 9;
 - Be insolvent;
 - Desire to effect a plan to adjust its debts; and
 - Before filing, either
 - ✦ Obtain the agreement of creditors holding a majority in amount of claims that the entity intends to impair;
 - ✦ Negotiate in good faith with its creditors or show that such negotiation is impracticable; or
 - ✦ Believe that a creditor may attempt to obtain a transfer that is avoidable as a preference
- Debtor must file the petition in good faith (§ 921)

SPECIFIC AUTHORIZATION TO FILE



- Reason for the requirement?
 - Tenth Amendment concerns
 - ✦ Municipality is a creature of its state
 - ✦ A bankruptcy petition places a municipality under the jurisdiction of a federal court
- State(s) of authorization
 - 24 states have no authorizing legislation
 - One state, Georgia, has legislation prohibiting Chapter 9
 - The remaining states vary in their levels of authorization
 - ✦ No barriers additional to those in Chapter 9
 - ✦ Some cities barred, others not
 - ✦ Requirement of permission by Governor or other state official
 - ✦ Requirement of additional processes
 - Neutral evaluation (CA)
 - Three levels of fiscal oversight by state (RI)

RESTRICTIONS AS REACTION



- California
 - Passed law after Vallejo Chapter 9 filing; bill pushed by unions
- Rhode Island
 - Passed law to address Central Falls financial crisis
- Pennsylvania
 - Passed law to prevent Harrisburg from filing for bankruptcy
 - This is “Lesson from Harrisburg #1” – the state can act at any time to remove the authorization to file so long as it does not violate the state or U.S. Constitution in doing so. *In re City of Harrisburg*, 465 B.R. 744 (Bankr. M.D. Pa. 2011)

SO WHY CHAPTER 9?



DELICATE CONSTITUTIONAL BALANCE



- Tenth Amendment
 - Reserves to the states all powers not granted to the federal government nor prohibited to the states by the Constitution
 - ✦ Bankruptcy intrudes on a state's power to govern its cities
- Contract Clause
 - Prohibits states from “passing any Law impairing the Obligation of Contracts.”
- Bankruptcy Clause
 - “Congress shall have the power to . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”

STATE SOVEREIGNTY IS PARAMOUNT



- Nothing in Chapter 9 limits or impairs the power of a state to control a municipality in the exercise of that municipality's governmental or political powers - § 903
 - Exception: A state law that purports to bind a dissenting creditor to a plan of composition will be ineffective as to such a creditor
- Without the debtor's consent, the court cannot interfere with (§ 904):
 - Any of the political or governmental powers of the municipality;
 - Any of the property or revenues of the municipality; or
 - The municipality's use or enjoyment of any income-producing property

BUT . . .



- Sovereign immunity is abrogated to the extent that Code provisions are incorporated into Chapter 9 by § 901.

NON-BANKRUPTCY DEBT COLLECTION



- Creditors do not have the same remedies against cities that they have against private parties
 - Municipal assets are generally exempt from seizure to satisfy claims
 - ✦ Theory: A municipality holds its property in trust for its residents
 - Only available relief is available through a mandamus action
 - ✦ Mandamus to force responsible city official to pay judgment
 - ✦ Mandamus to force city council to raise taxes
- Of course, creditors could agree to payment modifications
 - Original purpose of Chapter 9 was to solve the holdout problem

WHAT CHAPTER 9 PROVIDES



- **Automatic Stay - §§ 362, 922**
 - Stay is extended to actions against an officer or resident of debtor municipality that seek to enforce a claim against the municipality
 - ✦ Stops mandamus actions
 - Stay does not apply to special revenue bonds
- **Power to reject executory contracts - § 365**
 - Special protections for collective bargaining agreements under § 1113 do not apply in Chapter 9
 - Courts have held that rejection of a collective bargaining agreement must comply with standards set forth in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1994)
- **Cramdown - § 1129 (b)**

CHAPTER 9 GREY AREA #1



- In order to be confirmed, a plan of adjustment must be in the best interests of creditors - § 943
 - What does this mean?
 - ✦ In Chapter 11, it means that creditors must receive at least as much as they would in a Chapter 7 liquidation - § 1129 (a)(7)
 - ✦ This standard does not apply because there is no liquidation of a city
 - ✦ Common understanding? The plan is “better than the alternatives.”
 - *Matter of Sanitary Improvement District No. 7*, 98 B.R. 970 (Bankr. D. Neb. 1989)
 - *Very little* case law on the issue

CHAPTER 9 GREY AREA #2



- Cramdown Standard
 - In order for a plan of adjustment to be confirmed over the objection of impaired creditors, the plan must be “fair and equitable”
 - The Chapter 11 fair and equitable definition includes the absolute priority rule
 - ✦ Equity holders cannot be paid unless unsecured creditors are paid in full
 - ✦ Municipalities do not have stockholders
 - Commonly understood Chapter 9 standard?
 - ✦ Bondholders are receiving “all they can reasonably expect in the circumstances.” *Lorber v. Vista Irrigation Dist.*, 127 F. 2d 628 (9th Cir. 1942)

PERCEIVED CHAPTER 9 DEFICIENCIES



- Incomplete rehabilitation tool
 - Bankruptcy Code sections outside of Chapter 9 apply in Chapter 9 only if included under § 901, therefore:
 - ✦ Chapter 9 does not incorporate all of the provisions of Chapters 1,3 and 5
 - ✦ Chapter 9 incorporates some, but not all of Chapter 11
 - Debtor maintains exclusive control over filing, plan, use of its property
- No substitute for political will
- Poor substitute for *ex ante* state intervention

WHAT CHAPTER 9 DOES NOT PROVIDE



- No possibility of an involuntary petition against a city
- No possibility of a trustee or examiner appointment
- No possibility of competing plans – only the debtor municipality may propose a plan of adjustment
 - § 941 directs the debtor to file the plan
 - § 1121, which allows other parties in interest to file a plan, is not included in § 901 list of included sections

BENEFITS OF STATE INTERVENTION



- State can step in and provide oversight before a city's financial situation becomes dire
- State can address city's structural deficiencies

SHORTCOMINGS OF STATE INTERVENTION



- State intervention is rarely truly *ex ante*
 - As a result, it tends not to prevent municipal financial distress
- Although the state can exercise some political will over its cities, the power to do so is not without problems
 - Example: In Pennsylvania, an Act 47 plan is not effective until adopted by the City Council. What happens if it does not adopt?
 - ✦ This is “Lesson from Harrisburg #2.” The state never anticipated this.
 - In Pennsylvania, the City Council must vote to raise taxes. What if it refuses to do so?
 - ✦ “Lesson from Harrisburg #3.” In August, 2012, the Commonwealth Court granted the Receiver’s petition for a writ of mandamus to force the Council to raise the Earned Income Tax.

OPTIMAL BALANCE OF STATE/FEDERAL COOPERATION



- Outright prohibition of Chapter 9 not a good idea
 - Based on unsupported premises
 - ✦ Markets are concerned about probability of payment
 - ✦ The ability of cities to file for Chapter 9 in a state does not affect bond ratings throughout the state
 - Prohibition in itself does not rehabilitate cities; some complementary state plan is necessary
- State role in resolving municipal financial distress should:
 - Stand in for some of the checks on debtor behavior in Chapter 11
 - State should view bankruptcy as complementary to state intervention rather than as an alternative