Is Chapter 9 the Next Chapter in the Municipal Saga?

November/December 2011

Joseph M. Witalec
Mark G. Douglas

Fallout from the Great Recession continues to figure prominently in world headlines, as governments around the globe struggle to implement or extend programs designed to jump-start stalled economies and attempt to gauge the health of financial institutions deemed "too big to fail" or otherwise critical to long-term prospects for recovery. Amid the mayhem wrought in a broad spectrum ranging from sovereign states to the chronically unemployed, the plight of cities, towns, and other municipalities across the U.S. has received a significant amount of media exposure. A variety of factors—a reduction in the tax base caused by increased unemployment; plummeting real estate values and a high rate of mortgage foreclosures; questionable investments; underfunded pension plans and retiree benefits; decreased federal aid; and escalating costs (including the higher cost of borrowing due to the meltdown of the bond mortgage industry and the demise of the market for auction-rate securities)—have combined to create a maelstrom of woes for U.S. municipalities.

One option available to municipalities teetering on the brink of financial ruin is chapter 9 of the Bankruptcy Code, a once obscure legal framework that allows an eligible municipality to "adjust" its debts by means of a "plan of adjustment" that is in many respects similar to the plan of reorganization which a debtor can devise in a chapter 11 case. However, due to constitutional concerns rooted in the Tenth Amendment's preservation of each state's individual sovereignty over its internal affairs, the resemblance between chapter 9 and chapter 11 is limited. One significant difference pertains to the requirement that a municipal debtor be insolvent to be eligible for relief under chapter 9. This insolvency requirement was the subject of a ruling recently handed down by an Idaho bankruptcy court in *In re Boise County*, 2011 WL 3875639 (Bankr. D. Idaho Sept. 2, 2011).

Municipal Bankruptcy Law

Ushered in during the Great Depression to fill a vacuum that previously existed in both federal and state law, federal municipal bankruptcy law suffered from a constitutional flaw that endures in certain respects to this day—the Tenth Amendment reserves to the states sovereignty over their internal affairs. This reservation of rights caused the U.S. Supreme Court to strike down the first federal municipal bankruptcy law as unconstitutional in 1936, and it accounts for the limited scope of chapter 9, as well as the severely restricted role the bankruptcy court plays in presiding over a chapter 9 case and in overseeing the affairs of a municipal debtor.

The present-day legislative scheme for municipal debt reorganizations was implemented in the aftermath of New York City's financial crisis and bailout by the New York State government in 1975, but chapter 9 has proved to be of limited utility thus far. Few cities or counties have filed for chapter 9 protection. The vast majority of chapter 9 filings have involved municipal instrumentalities, such as irrigation districts, public-utility districts, waste-removal districts, and health-care or hospital districts. In fact, according to the Administrative Office of the U.S. Courts, fewer than 650 municipal bankruptcy petitions have been filed in the more than 70 years since Congress established a federal mechanism for the resolution of municipal debts. Fewer than 270 chapter 9 cases have been filed since the current version of the Bankruptcy Code was enacted in

1978—although the volume of chapter 9 cases has increased somewhat in recent years. By contrast, there were 13,500 chapter 11 cases filed in 2010 alone.

Filing Requirements

Access to chapter 9 is limited to municipalities under section 109(c)(1) of the Bankruptcy Code. A "municipality" is defined by section 101(40) as a "political subdivision or public agency or instrumentality of a State." Section 109(c)(2)–(c)(4) of the Bankruptcy Code sets forth three other mandatory prerequisites to relief under chapter 9:

- A state law or governmental entity empowered by state law must specifically authorize the municipality (in its capacity as such or by name) to file for relief under chapter 9;
- The municipality must be insolvent; and
- The municipality must "desire[] to effect a plan" to adjust its debts.

Finally, section 109(c)(5) provides that, prior to seeking chapter 9 relief, a municipality must either: (a) have obtained the consent of creditors holding at least a majority in amount of the claims in each class that will be impaired under the municipality's intended plan; (b) have failed to obtain such consent after negotiating with creditors in good faith; (c) be unable to negotiate with creditors because negotiation is "impracticable"; or (d) reasonably believe that "a creditor may attempt to obtain a transfer that is avoidable" as a preference.

A chapter 9 petitioner bears the burden of demonstrating compliance with each of the mandatory provisions of section 109(c)(1)–(4) and at least one of the disjunctive requirements set forth in section 109(c)(5). If the petitioner cannot do so, the bankruptcy court must dismiss the petition under section 921(c)—although that provision states that the court "may" dismiss the case of an ineligible petitioner, it has been construed by most courts to require dismissal.

No other chapter of the Bankruptcy Code includes insolvency among the criteria for relief. "Insolvency" in the context of chapter 9 eligibility, however, does not refer to balance-sheet insolvency. Instead, pursuant to section 101(32)(C) of the Bankruptcy Code, it requires a showing that, as of the filing date, the municipality is either: (i) generally not paying its undisputed debts as they become due; or (ii) unable to pay its debts as they become due. The bankruptcy court examined chapter 9's insolvency requirement in *Boise County*.

Boise County

Boise County (the "County") is a rural mountain county in the State of Idaho with a population of approximately 7,000. Despite its name, the City of Boise, the capital of Idaho, is not located in the County. Rather, the County seat, Idaho City, is located approximately 40 miles northeast of the City of Boise. In January 2009, Alamar Ranch, LLC, and YTC, LLC (collectively, "Alamar"), which operated a residential treatment facility and private school for at-risk youth on property located in the County, sued the County, alleging that conditions imposed by it in connection with a conditional-use permit were illegal and discriminatory under the Fair Housing Act.

In December 2010, a federal district court entered a judgment against the County in Alamar's favor in the amount of $4 million. The County appealed the award to the Ninth Circuit Court of Appeals. Subsequent negotiations with Alamar regarding the terms of payment broke down, and Alamar communicated its intention to levy a writ of execution on the County's bank accounts. The County responded by filing a chapter 9 petition on March 1, 2011. In the filing, the County listed total assets of more than $27 million and total debt of approximately $7.3 million. The liabilities included the $4 million Alamar judgment, which was designated as undisputed, as well as a disputed $1.5 million debt for Alamar's legal fees in connection with the litigation and approximately $550,000 in contingent claims for medical-indigency payments asserted by several health-care providers.

The County filed a chapter 9 plan in June 2011. The plan proposed to pay Alamar $500,000 in respect of its judgment claim, relying on a limitation on damages contained in the Idaho Tort Claims Act. Alamar filed a motion to dismiss the chapter 9 case, claiming, among other things, that the County had failed to demonstrate that it was insolvent, as required by section 109(c)(3).

The Bankruptcy Court's Ruling

The bankruptcy court concluded that: (i) the County qualified as a "municipality"; (ii) the County was authorized by state law to be a debtor in chapter 9; (iii) the County demonstrated a desire to implement a plan to adjust its debts; (iv) further negotiations with Alamar had become impracticable; and (v) the County had a reasonable belief that Alamar might attempt to obtain a transfer avoidable as a preference. However, the court ruled that the County had failed to demonstrate that it was insolvent at the time of the chapter 9 filing.

According to the County, the $550,000 in unpaid health-care-provider claims represented debts not paid when due, thus rendering the County insolvent under section 101(32)(C)(i). The bankruptcy court disagreed, ruling that "[t]he County's failure to process and pay a single category of claims, which represents only a small portion of its budgeted expenditures, from what appear to be adequate funds does not rise to the level of the general nonpayment contemplated by § 101(32)(C)(i)." Moreover, the court noted, the evidence showed that the monies in the County's indigent fund were more than sufficient to pay those claims and any similar claims projected for the remainder of the fiscal year. The court also found that the County had failed to show that the scheduled health-care-provider claims were in fact "due" for purposes of section 101(32)(C)(i).

The bankruptcy court similarly rejected the County's claim that it was insolvent under section 101(32)(C)(ii) because it could not pay both the Alamar judgment and its other expenses for supporting County operations. The test for insolvency under section 101(32)(C)(ii), the court explained, focuses on cash flow during the current (or a projected) fiscal year, rather than a budget deficit. After carefully examining the County's cash management rules and procedures (including the Idaho Constitution), the court concluded that the County was neither legally prohibited from nor incapable of paying the Alamar judgment without risking nonpayment of other essential County obligations. On the basis of its finding that the County failed to meet its burden of demonstrating insolvency, the bankruptcy court dismissed the chapter 9 case under section 921(c) of the Bankruptcy Code.

Outlook

Boise County demonstrates one of the reasons that chapter 9 is not a panacea for every kind of financial problem burdening U.S. municipalities. Unlike other chapters of the Bankruptcy Code, chapter 9 is expressly reserved for debtors genuinely facing financial extremis in the form of insolvency. Like the court in *Boise County*, other bankruptcy courts can be expected to subject a municipal debtor's claim of insolvency to exacting scrutiny, given the widespread perception that chapter 9 is a remedy of last recourse which should be invoked only under drastic circumstances. Indeed, the court's rejection of Boise County's chapter 9 case is not exceptional.

Nearly one-third of all chapter 9 cases filed since 1980 have been dismissed shortly after the petition date.

Unfortunately, an increasing number of municipalities are passing the test that Boise County failed. More than 30 chapter 9 cases have been filed during the last four years—four in 2008, 12 in 2009, seven in 2010, and 11 thus far in 2011.

Jefferson County, Alabama

Jefferson County, Alabama, a county perched in the foothills of the Appalachian Mountains with 660,000 residents and home to the state's largest city (Birmingham), recently supplanted Orange County, California, as the largest municipal debtor in our nation's history when it filed for chapter 9 protection on November 9, 2011. Jefferson County entered into a series of complex bond-swap transactions after incurring a mountain of debt to finance a new sewer system. The county is staggering under $3.2 billion in debt (or roughly $4,800 per resident) from that project, which it cannot afford to pay.

On September 16, 2011, county commissioners voted to accept a restructuring agreement that, with the approval of the state legislature (among others) prior to a June 30, 2012, restructuring deadline, would have allowed the county to shed about $1 billion in debt and lower the interest rate on roughly $2 billion of new, 40-year debt that would have been issued to replace the current debt. However, Jefferson County's governing board voted to file a chapter 9 petition after settlement talks broke down. The county's chapter 9 case involves more than $4 billion in debt, dwarfing the $1.7 billion bankruptcy of Orange County, California, in 1994 that had been the largest municipal bankruptcy case on record.

Vallejo, California

Vallejo, California, a San Francisco Bay Area city with approximately 116,000 residents, kicked off the recent uptick in municipal bankruptcy filings when it filed for chapter 9 protection in May 2008 at the inception of the current financial recession. In the long term, Vallejo fell victim to the closing of a U.S. Navy base in the 1990s. Its more immediate cause for distress, however, was unsupportable public-employee labor and legacy costs.

Vallejo successfully used chapter 9 to clean up its balance sheet and either renegotiate or reject unfavorable labor contracts. A bankruptcy court confirmed the city's plan of adjustment on August 4, 2011, after a three-year stay in chapter 9. Under the plan, Vallejo's largest creditor, a bank holding more than $45 million in unpaid certificates of participation, will recover roughly half of its claims. The claims of Vallejo's public employees will be paid in full over time, while unsecured creditors are to receive 30 cents on the dollar.

Central Falls, Rhode Island

Central Falls, Rhode Island, a tiny city of just over one square mile with 18,000 residents, filed for chapter 9 protection on August 1, 2011, to revamp its pension obligations after tax increases and austerity measures failed to restore the city to solvency. The filing came one year after the state took control of the city's finances. Central Falls, which was described as "impoverished" by *The New York Times*, was so crime-ridden in the mid-1980s after its textile industry collapsed that the city was crowned "Cocaine Capital of New England" by *Rolling Stone* magazine in 1986.

At the time of its chapter 9 filing, Central Falls had $21 million in general debt, a structural budget deficit of $5.6 million, and an unfunded liability of nearly $80 million for retiree benefits and pensions.

Harrisburg, Pennsylvania

Facing a state takeover of the city's finances, the city council of Harrisburg, the capital of Pennsylvania, authorized a chapter 9 filing for the city on October 11, 2011. The city of 49,500 residents faces a debt burden five times larger than its general-fund budget because of an overhaul and expansion of a trash-to-energy incinerator that does not generate enough revenue to service the $310 million in debt incurred to fund the project. The chapter 9 filing came four months after the Pennsylvania legislature passed a law in June preventing Harrisburg from filing for bankruptcy until the following month of July, and two weeks after Pennsylvania's House of Representatives overwhelmingly approved a scheme that would have placed Harrisburg under the control of a state-appointed receiver if its city council did not approve a plan to handle the city's debt crisis.

State Legislative and Executive Actions

Confronted with an increasing volume of actual or prospective municipal failures, state legislatures and executives have been anything but idle, in many cases scrambling to implement an array of tools designed to offer viable alternatives to a chapter 9 filing. For example, in Michigan, Governor Rick Snyder signed legislation in March 2011 that expands the power of state-appointed emergency financial managers to include the right to terminate union contracts. The law, which offers struggling local governments and school districts assistance at an earlier stage, is intended to head off fiscal emergencies in order to prevent bankruptcy filings by troubled cities like Detroit, which currently faces a budget deficit of more than $155 million.

Nine days after Harrisburg filed for chapter 9 protection, Pennsylvania governor Tom Corbett signed into law the Municipalities Financial Recovery Act (SB 1151), which gave Harrisburg's mayor and the city council 30 days to come up with a recovery plan, subject to approval by the Secretary of the Pennsylvania Department of Community and Economic Development. Failing the implementation of such a plan, the act authorizes the governor to appoint a receiver to take over the state capital's finances. On October 14, Harrisburg's mayor and the state government asked a bankruptcy judge to dismiss the city's chapter 9 petition, claiming it was filed without authorization and in violation of state law as well as the Tenth Amendment to the U.S. Constitution.

On October 24, 2011, Governor Corbett declared a fiscal emergency in Harrisburg, citing the need to ensure that municipal services are maintained and the public safety protected in the financially distressed state capital despite its leaders' failure to enact a recovery plan. As a result of the governor's declaration, the Pennsylvania Department of Community and Economic Development had 10 days to develop an emergency action plan to ensure the public safety and to coordinate services that included police and firefighting, water and wastewater, trash collection, payroll, and pension and debt payments. On November 8, Harrisburg's city council agreed to sell the city's trash incinerator and lease downtown parking garages in an effort to stave off the state takeover. On November 23, Judge Mary D. France of the U.S. Bankruptcy Court for the Middle District of Pennsylvania dismissed Harrisburg's chapter 9 case, ruling that the city council was not authorized to file the chapter 9 petition on the city's behalf. The ruling clears the way for the state to place Harrisburg into receivership.

Lawmakers in Indiana—one of 21 states without any specific procedures for authorizing a municipal bankruptcy filing—have been more equivocal on the issue. A bill recently introduced before both houses of the state legislature would have permitted fiscally distressed municipalities to request the appointment of an emergency financial manager with the authority to renegotiate contracts and slash spending. Under the Indiana Senate's version of the legislation, bankruptcy would have been an option if the financial manager failed to restore fiscal order. The Indiana House of Representatives, however, stripped the bankruptcy option from the bill. With lawmakers having failed to reach a consensus, the legislation died.

Three weeks before Central Falls filed for chapter 9 protection, Rhode Island governor Lincoln Chafee signed legislation providing that, in the event of a bankruptcy filing, lenders of a debtor municipality automatically receive a first-priority lien on both the municipality's general and property tax revenue. The bankruptcy-legislation package also includes a measure to indemnify fiscal overseers who take control of financially distressed cities or towns. It remains to be seen whether the new law will withstand challenge in the courts.

On October 10, 2011, California governor Jerry Brown gave his imprimatur to legislation designed to keep California cities, counties, special districts, and other public agencies from "rushing" into bankruptcy. The law, which takes effect in January 2012, bars local government agencies from filing for bankruptcy until they undergo mediation or hold a public hearing and declare a fiscal emergency threatening the health, safety, or well-being of residents.

Conclusion

The end result of these lessons from the past several years is that chapter 9 of the Bankruptcy Code is not a panacea for municipalities facing financial distress. Because Tenth Amendment restrictions ultimately place the power to allow chapter 9 filings with the individual states, a municipality must carefully examine applicable state laws, as well as assess the current political environment, to determine whether a chapter 9 filing is a realistic option for dealing with its financial situation.