

## Municipal Bankruptcy

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The economic sluggishness of the past few years has placed continuing pressures on local governments throughout the United States. Many communities have suffered unprecedented drops in tax revenue and economic activity. The problem in California is exacerbated by its peculiar constitutional framework, which makes raising property and income taxes almost impossible. The California Assembly recently considered a bill that would prohibit municipalities from filing for bankruptcy. That bill, ostensibly, was a reaction to the Chapter 9 bankruptcy filing by Vallejo, a small Northern California city that has been languishing in its Chapter 9 case for nearly three years. And San Diego, one of the largest cities in the nation, continues to be the subject of intense media attention over its dire financial circumstances. Although Chapter 9 filings – especially for true municipalities (as opposed to discrete quasi-governmental entities such as water districts) – are historically rare, that history may not be an accurate predictor of the future as communities face unprecedented financial crises.

### Chapter 9 Eligibility

Chapter 9 of the US Bankruptcy Code is the exclusive federal method for restructuring a municipality's debts. The statutory scheme embodied in Chapter 9 differs in both legal and practical respects from other bankruptcy reorganizations because:

1. Municipalities are subdivisions or instrumentalities of states and, as such, federal judicial control over municipal debts and assets must not offend constitutional guaranties of state sovereignty;
2. A municipality cannot "go out of business" or otherwise liquidate; and
3. Management (that is, elected municipal officials) cannot be ousted in favor of a trustee, receiver or other substitute fiduciary, absent a legal election by municipal voters.

Only a "municipality" is eligible to be a debtor under Chapter 9. A "municipality" is defined as including a city, a county or an "instrumentality of a State." An "instrumentality" has traditionally been understood to include special revenue and tax districts such as school, water or hospital districts. It can be regarded as including other entities that are created by but still legally distinct from a state – that is, not simply a state agency under the general authority of the state's executive branch.

Even those entities that qualify as a "municipality" for Chapter 9 purposes must be specifically authorized by state law (either statutory or constitutional) to file a Chapter 9 bankruptcy petition. California and several other states provide standing authority for municipalities to file Chapter 9 petitions. Other states, such as Ohio,

require a municipality to seek specific authority from a state governmental official before the municipality may file a Chapter 9 petition.

Unlike other chapters of the Bankruptcy Code, Chapter 9 requires that a municipality must be “insolvent” to be eligible for Chapter 9 relief. A municipality is “insolvent” if “it is generally not paying its debts as they become due unless such debts are the subject of *bona fide* dispute, or unable to pay its debts as they become due.” This has been the source of substantial litigation in past Chapter 9 cases. Bridgeport, Connecticut was notably held to be not sufficiently insolvent and had its Chapter 9 petition dismissed. Vallejo endured nearly a year of litigation with its public employee unions over the issue of Vallejo’s solvency and eligibility for Chapter 9 relief. Vallejo ultimately prevailed, but incurred substantial legal fees in doing so.

The question of insolvency may require a prospective analysis that seeks to determine whether the municipality will run out of cash in the current fiscal year or the next fiscal year. Because much of a municipality’s revenue ordinarily derives from tax receipts, the municipality’s ability to impose and collect tax revenue will be critical to any determination of present or prospective insolvency. Legal or political impediments to raising tax revenue may ultimately hasten or deepen municipal insolvency.

Finally, to be eligible for Chapter 9 relief, a municipality must demonstrate that it has negotiated, if possible, with its various creditor constituencies before seeking Chapter 9 relief. A municipality’s creditors typically include bondholder representatives such as indenture trustees or bond insurers and public employee unions. How much negotiation suffices can prove a highly-litigated issue, as it was with Vallejo, despite the city having negotiated unsuccessfully with its three service unions for more than a year before its Chapter 9 filing. Vallejo was able to convince the bankruptcy court that its efforts to renegotiate those collective bargaining agreements were robust and sincere enough to qualify for Chapter 9 eligibility but, again, the associated litigation on that issue was expensive.

## Filing

A municipality files a Chapter 9 petition in the federal judicial district in which it is geographically located. Unlike all other cases under the Bankruptcy Code, however, the bankruptcy judge that presides over a Chapter 9 case is not selected by random draw. Instead, the US Court of Appeals for the judicial circuit containing that municipality selects the bankruptcy judge to conduct the Chapter 9 case, theoretically allowing a judge that does not ordinarily sit in the judicial district containing the municipality.

## Powers and Limitations

Most debtors under the Bankruptcy Code cede considerable control over their assets and business operations by commencing a bankruptcy case. In Chapter 9, however, municipalities retain almost complete control over their operations and assets, in keeping with federal constitutional notions of state sovereignty. The bankruptcy court has only limited jurisdiction over a municipality’s assets and contracts. The court may not interfere with

any of the municipality's political or governmental powers, any of the municipality's revenue or a municipality's use of its income-producing properties.

Court supervision over the "estate" in a Chapter 9 case is likewise limited. A municipality's legislative body and executive officers continue to exercise full control just as before the Chapter 9 filing and there is no provision under Chapter 9 for the removal of any municipal officials, even for cause.

Within these limitations, then, Chapter 9 provides a municipal debtor with significant tools to address its financial challenges. The Bankruptcy Code's "automatic stay" applies in Chapter 9 cases, serving to stop existing litigation, providing a means to centralize such litigation in the federal bankruptcy court and prohibiting actions against municipal officers. A municipality can retain and continue to access its existing credit facilities – something that corporate debtors in Chapter 11 typically cannot do.

Most significantly, Chapter 9 allows a municipality to reject burdensome contracts and leases, such as collective bargaining agreements, severance agreements and redevelopment contracts. The other parties to those contracts will have unsecured claims against the municipality arising from the rejections, and those claims will be dealt with as part of the plan of arrangement discussed below. Chapter 9 also allows a municipality to recover some pre-filing payments, such as preferences and fraudulent transfers, and allows a municipality to reduce its outstanding, disputed unsecured claims, such as those claims arising from the rejected contracts.

### Special Revenues

Most municipalities are issuers of specific project financing bonds, and the project revenues associated with those bonds are accorded special treatment under Chapter 9. A bond indenture for these types of issues will typically require payment of bonds from the special revenues generated by the project, such as water revenues used to pay bonds issued to finance the construction of the water system. Chapter 9 does not permit the municipality to divert or otherwise use special revenues to meet other, general obligations, and a bond creditor is usually not prohibited by the general automatic stay from continuing to receive special revenues during the pendency of the Chapter 9 case.

### Plan of Arrangement

The marshalling of assets, action on existing contracts and the management of claims ultimately leads to formulation of a plan of arrangement, the culmination of the Chapter 9 case. The plan proposes resolutions of all claims of all creditors and the treatment of all assets. The municipal debtor retains total plan "exclusivity" – only the debtor can propose the plan. The bankruptcy court will approve or "confirm" a plan if it is approved by the creditors in a voting process that operates much like voting on a plan of reorganization in the Chapter 11 context. All creditors are placed in classes; creditors vote as a class for or against the plan. Each secured creditor is placed in its own class while all unsecured creditors are generally placed in one class. Classes vote

by written ballot. A class votes to accept a plan if more than one half in number of creditors voting and two-thirds in amount of claims vote to accept the plan.

The bankruptcy court must confirm a plan if it meets five criteria derived from Chapter 11:

1. The municipality must comply with the applicable provisions of the Bankruptcy Code;
2. The plan must be proposed in good faith;
3. Any applicable regulatory authorities must have approved rate changes (this usually applies only to utility districts);
4. All classes of creditors deemed “impaired” (meaning their legal or equitable rights are altered) must vote to accept the plan; and
5. At least one impaired class must vote to accept the Plan. If an impaired class does not vote to accept a plan, the bankruptcy court can still approve the plan over that class’ dissenting vote as long as the Plan is “fair and equitable,” a process known as “cramdown.”

### Use of Professionals

The legal issues attending a Chapter 9 proceeding, especially one for a city or county, will likely require a specialized cadre of professionals. Experienced restructuring counsel is critical, but firms that also have lawyers with experience in organized labor matters and public finance will be most effective debtor’s counsel. Additionally, larger cities and counties will be best served by engaging sophisticated financial professionals as well as legal professionals to address the changing capital market landscape that a municipality will face when questions (or a default) arise with respect to one or more bond issues. Consulting with professionals as early in the restructuring process as possible will maximize opportunities for optimal results and will likely greatly reduce the fees associated with the Chapter 9 proceeding.

For more information please contact **The Squire Sanders Municipal Bankruptcy Task Force** co-chairs:

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