MUNICIPAL BANKRUPTCY

A Solution or a Nightmare?

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Detroit; Harrisburg; San Bernardino; Stockton; Jefferson County, Alabama. The mere mention of the names of these local governments may strike fear in the hearts of elected officials and a sense of sickened dread. If they are not yet causing sleepless nights for governmental budget directors, they will soon, as Detroit's plight continues to garner headlines.

While Chapter 9 bankruptcies (the chapter of the Bankruptcy Code[i] reserved for "municipalities") are still a relatively rare occurrence, the number of municipal filings and, more importantly, public mentions of a *possible* filing being under consideration have increased in recent years. Since Chapter 9 became law in 1938, only 640 municipal bankruptcies have been filed (an average of eight per year nationwide). There were 13 Chapter 9 filings in 2011 and 19 in 2012. Six Chapter 9 bankruptcies were filed in the first half of 2013, but many others have been cited in the press as one of the considered options. Chapter 9 filings are still rare: No elected official wants to be in the position to take the heat over a bankruptcy filing or to even utter the words.

"Bankruptcy" is not the boogeyman. It is one option among a spectrum of choices. Just like with all the debtors we work with, we strongly believe that it is imperative that elected officials be educated about what bankruptcy would actually look like in a particular situation before pronouncing it to be "good" or "bad." The public cries out for transparency and for informed officials. The sound bites must stop, and a deeper education must begin. For elected officials to fulfill their duties, they must be capable of making informed judgments about all options to best deal with their own unique municipal financial situations.

CAUSES OF MUNICIPAL BANKRUPTCIES

There are many different reasons why a municipal entity may find itself on the brink of (and sometimes well past) financial insolvency. However, there are common themes that run through the headlines and factual situations: an eroding tax base (property and employment) as a result of declining property values and higher unemployment; unfunded health and pension liabilities and increasing costs of health and pension obligations; large and unexpected onetime expenses, such as litigation judgments and consent decrees with state or federal agencies; declining support from state and federal funding sources; changing demographics of the community; and reliance on bond debt to cover operating expenses. As with our other debtor clients, both individuals and businesses, there is almost always some combination of causes, both within and outside of their control. Attempts to keep your head stuck in the

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sand usually don't pan out over the long run, and the more time a debtor gives for advance planning and thoughtful strategizing before getting to crisis stage, the better.

ELIGIBILITY

Unlike the other chapters of bankruptcy, where a debtor need only file a "petition" to obtain an "order for relief," which allows the case to move forward, a Chapter 9 debtor must first satisfy six separate prerequisites to be found by the court to be "eligible" for bankruptcy protection.[ii] This alone makes Chapter 9 quite different in its initial stages, because the debtor is immediately faced with mounting evidence and a possible fight to prove its eligibility by a "preponderance of the evidence" to even be in court in the first place. Adverse parties are given an extra stick to wield, and we have seen that often the biggest fight in a Chapter 9 bankruptcy is whether the debtor is even eligible for Chapter 9. For example, the California cities of San Bernardino and Stockton each spent months in bankruptcy court fighting with certain creditor groups for the right to be in such court.[iii]

First, only a "municipality," defined as a "political subdivision or public agency or instrumentality of a State,"[iv] may file for Chapter 9 bankruptcy relief.[v] Obviously, cities and counties fall within this definition. The line is not so clear when other types of entities, such as public utility districts, school districts, hospitals and transportation agencies, try to meet the definition. To our knowledge, there have only been two Chapter 9 bankruptcies filed in Kentucky: in 1984 by the Whitley County Water District and in 1985 by the Bell County Garbage and Refuse. Other types of similar entities have filed Chapter 11 and have not been challenged over whether that was appropriate. When a debtor bears characteristics of both public and private entities, courts have used various tests to determine eligibility. When an entity is not clearly a city, a county or another political subdivision of the state, parties should analyze under what authority the entity was established, its purpose, its treatment under state law, its ability to avail itself of traditional governmental powers and any limitations on its powers.

Second, a municipality may file for bankruptcy only if its state has voluntarily submitted to the exercise of that federal power.[vi] A Chapter 9 filing must be specifically authorized by name or by a governmental officer empowered to provide such authorization. The Commonwealth of Kentucky has authorized municipalities to file for Chapter 9 bankruptcy in KRS 66.400. That statute allows "any taxing agency" or "instrumentality," as defined in Title 11, to file Chapter 9. No county can file a bankruptcy petition unless the proposed plan is first approved by the state local debt officer (as defined in KRS 68.001). The state local debt officer must approve all changes and modifications to the bankruptcy plan, and the plan must be approved or disapproved under the same procedure and for the same reasons as bonds are approved or disapproved (as set forth in KRS 66.280 to 66.390).

Third, unlike other debtors, a municipality must show that it is insolvent as defined by the Bankruptcy Code (generally not paying undisputed debts as they become due or unable to pay debts as they become due).[vii] The timeframe involved in the inability to pay and whether the municipality has attempted to raise taxes are common arguments that take place in this context. Appellate courts have held that the Chapter 9 debtor should show that, based on a cash-flow basis, it cannot now or prospectively be able to pay its debts as they become due.

Fourth, the municipality must show a desire to effect a plan to adjust its debts.[viii] This requirement is met by simply showing that the filing was not done to simply buy time or to evade creditors. This can be shown by providing evidence of prepetition attempts to resolve claims or submission of a draft debt adjustment plan.

The fifth criterion requires the municipality to show that it has obtained its creditors' consent to file a plan, failed to obtain consent notwithstanding good-faith negotiations or found negotiations to be impracticable.[ix] A fully formed plan of adjustment is not required; an outline or term sheet regarding creditor classification and treatment will suffice, along with documented efforts at good-faith negotiations.

Lastly, the sixth element for Chapter 9 eligibility requires a finding that the filing was made in good faith. The bankruptcy court must address whether, in light of the debtor's financial condition, its motives and its financial realities, the municipality is using Chapter 9 for a legitimate reorganizational purpose or simply to deter or harass creditors.[x]

CHAPTER 9 CHARACTERISTICS

Once found to be properly eligible for Chapter 9, the municipality in bankruptcy has a different road than other debtors. Due to the U.S. Constitution, which limits the degree in which the federal government may impose its power on a state without the state's consent, states retain ultimate control over municipalities.[xi] These laws restrict the abilities of the federal bankruptcy courts to affect the progress of a Chapter 9 case as much as they might be capable of in other chapters. For example, absent consent, the court may not prevent or condition the use, sale or lease of municipal property; restrict unsecured borrowing; appoint a trustee to replace the municipality's governing body; or prevent the municipality from spending its funds in any manner that the municipality desires.[xii]

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The ultimate question in a Chapter 9 is the same as in Chapter 11, and it is never an easy one: how to carve up a pie that is too small to go around while attempting to reach agreements with multiple parties in interest.

Chapter 9 is often compared to Chapter 11 cases. While there are some similarities, Chapter 9 is unique in many ways.[xiii] Chapter 9 debtors are not required to file a schedule of assets and liabilities or a statement of financial affairs, only a list of creditors.[xiv] While the automatic stay, a bedrock of bankruptcy principles, arises on the filing date, the stay is not applicable to pledged special revenues for payments of indebtedness secured by such revenues.[xv] Special-revenue bondholders have an advantage over general-obligation bondholders because bonds secured by special revenue will have continued access to the revenue stream, securing debt-service payments. Unsecured bonds are treated as unsecured claims. While creditors' committees have the same powers and duties of those in Chapter 11 cases, in a Chapter 9, the committees are not appointed until after the entry of the order for relief, and the debtor cannot be ordered to pay committee professionals. Further, in a Chapter 9, the municipal debtor has greater latitude to modify or reject labor agreements than a debtor in Chapter 11.

Chapter 11 cases can be very nuanced in how they move forward toward completion, with the goal always being a consensual emergence from bankruptcy, be it through an orderly liquidation or rehabilitation. The differences in Chapter 9 that we have mentioned make the process vastly different, which, in turn, changes the dynamics of how the parties behave and the respective leverages and pressure points in the course of a case.

THE PLAN OF ADJUSTMENT

Either on the petition date or at a later time determined by the court, the Chapter 9 debtor will file what is called a "plan of adjustment."[xvi] The plan will determine the treatment of the various types of debts and interests against the debtor. Unlike Chapter 11, where other parties might seek to file a proposed plan, only the municipality may file a plan of adjustment. The requirements for confirmation of a Chapter 9 plan are similar to those applicable in Chapter 11.[xvii]

It should be anticipated that the formulation of possible Chapter 9 plan terms would be negotiated with various stakeholders prior to the filing of the bankruptcy. The ultimate question in a Chapter 9 is the same as in Chapter 11, and it is never an easy one: how to carve up a pie that is too small to go around while attempting to reach agreements with multiple parties in interest. If it were that easy, then the entire added cost of the court process could be avoided in a consensual out-of-court restructuring. It only takes one holdout to make that impossible.

CONCLUSION

The economic climate since 2008 has created the "new normal" for governmental agencies and units, just like in the private sector. At some point, something has to give. We encourage municipal leaders to act responsibly by looking ahead, being realistic, and dealing head-on with their current and projected future financial situations while they still have options. The exploration of a Chapter 9 bankruptcy is merely one part of a complete analysis, not something to run from out of fear. KYC

References

i. The Bankruptcy Code is Title 11 of the United States Code; 11 U.S.C. § 101 et seq.
ii. The eligibility requirements for Chapter 9 are found in 11 U.S.C. § 109(c)(1)-(5).
iii. On June 12, 2013, almost one year after Stockton's petition date of June 28, 2013, the Bankruptcy Court for the Eastern District of California entered the order for relief (i.e., found that Stockton was eligible for Chapter 9). In re City of Stockton, Cal, *2013 B.R. 2629129 (Bankr. E.D. Cal. June 12, 2013).*
iv. 11 U.S.C. § 101(40).
v. 11 U.S.C. § 109(c)(1).
vi. 11U.S.C. § 109(c)(2).
vii. 11 U.S.C. § 109(c)(3).
viii. 11 U.S.C. § 109(c)(4).
ix. 11 U.S.C. § 109(c)(5).
x. 11 U.S.C. § 921(c).
xi. 11 U.S.C. § 903.
xii. 11 U.S.C. § 904.
xiii. There are many more differences between Chapter 9 and Chapter 11, and this article is not intended to provide an in-depth discussion of those differences.
xiv. 11 U.S.C. § 924.
xv. 11 U.S.C. § 922(d).
xvi. 11 U.S.C. § 941.
xvii. 11 U.S.C. § 943.

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