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Municipal Bankruptcies: An Overview and Recent History of Chapter 9 of the Bankruptcy Code

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The City of Detroit filed for protection under chapter 9 of the Bankruptcy Code on July 18, 2013,¹ becoming the largest municipality to ever file for bankruptcy. Detroit's bankruptcy filing presents numerous complicated issues, which will be resolved over the course of the case.

This advisory provides an overview and history of chapter 9 of the Bankruptcy Code, beginning with a discussion of the various substantive provisions that govern (i) chapter 9's eligibility requirements, (ii) case administration issues that arise in chapter 9 cases and (iii) the requirements for confirming a chapter 9 plan of adjustment. Next, the advisory discusses significant chapter 9 cases since the Orange County bankruptcy case in 1994—the largest municipal bankruptcy at the time. Finally, since many municipal bonds are insured, the advisory provides an update on the major monoline insurance companies—most of which have been placed into rehabilitation proceedings due to their own financial challenges. At the end of this advisory is a chart that compares the key provisions of chapter 9 to counterparts of chapter 11.

I. Chapter 9 Case Issues

a. Eligibility Requirements (§ 109(c))

Section 109(c) of the Bankruptcy Code sets forth the requirements to be eligible to file as a chapter 9 debtor. Specifically, a debtor must establish that it (i) is a municipality, (ii) has specific authorization to file, (iii) is insolvent, (iv) wants to adjust its debts through a plan and (v) meets one of four creditor-negotiation requirements.²

i. Authorization to File (§ 109(c)(2))

Section 109(c)(2) of the Bankruptcy Code provides that in order to be a chapter 9 debtor a municipality must be “specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter.”

The degree to which state laws permit chapter 9 filings varies from state to state.³ Twelve states specifically authorize chapter 9 filings, while 12 others permit bankruptcy filings given a further action to be taken by a state, official or other entity.⁴ In addition, three other states authorize a limited subset of municipalities to file for bankruptcy. The remaining 23 states do not authorize municipal bankruptcy filings.

¹ The bankruptcy court docket for Detroit, including copies all documents filed in the case, is available without charge to the public at <http://www.kccllc.net/Detroit>.

² See 1 *Collier on Bankruptcy*, ¶109.04[1] (16th ed.).

³ Mike Maciag, “How Rare Are Municipal Bankruptcies?” *Governing*, Jan. 24, 2013.

⁴ Michigan is one of the states that conditionally authorizes chapter 9 filings. Specifically, MCL 141.1558 authorizes a local government for which an emergency manager has been appointed to become a chapter 9 debtor if the governor approves the emergency manager's recommendation that the local government commence a chapter 9 case. The statute further provides that “[t]he governor may place contingencies on a local government in order to proceed under chapter 9.” *Id.*

ii. *Negotiation with Creditors (§ 109(c)(5)(A)-(D))*

Section 109(c)(5) of the Bankruptcy Code provides that chapter 9 eligibility requires some element of pre-petition negotiation with creditors, which can be satisfied by complying with one of four alternative provisions. The first alternative is that the chapter 9 debtor “obtained the agreement of creditors holding at least a majority in amount of the claims of each class, that [the debtor] intends to impair under a plan in a case under [chapter 9].”⁵ Significantly, in order to satisfy this requirement, the chapter 9 debtor must obtain the creditors’ consent to the actual plan as filed, and, thus, the debtor cannot simultaneously file an amended plan of adjustment and satisfy the first alternative.⁶

The second alternative is that the chapter 9 debtor “has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that [the debtor] intends to impair.”⁷ In *In re Sullivan County Regional Refuse Disposal District*,⁸ the bankruptcy court interpreted this provision to require that the debtor present to creditors a comprehensive, but not formal, workout plan that the debtor can implement in its chapter 9 case.⁹ The negotiations must also “revolve around the negotiating of the terms of a plan that could be effectuated if resort is required to [c]hapter 9.”¹⁰ Chapter 9 debtors do not have to show that they have fully levied taxes to the maximum allowed by law.¹¹ However, bankruptcy courts have found that municipal debtors have not acted in good faith where the debtors never exercised their assessment powers prior to initiating proceedings in bankruptcy court.¹²

The third alternative is that the chapter 9 debtor demonstrate that it “is unable to negotiate with creditors because such negotiation is impracticable.”¹³ This alternative was inserted in the statute to deal with the problems created by major municipalities, whose bonds are numerous and are frequently in bearer form. Under such circumstances, negotiation is difficult at best, because of the difficulty in identifying the creditors with whom the municipality must negotiate.

The fourth alternative is that the debtor “reasonably believes that a creditor may attempt to obtain a preference.”¹⁴ As discussed below, pursuant to section 926(b) of the Bankruptcy Code it is important to note that payments on account of a bond or a note may not be avoided as a preference under section 547 of the Bankruptcy Code. Accordingly, a chapter 9 debtor cannot avoid entering into negotiations with its bondholders on the basis that the bondholders are attempting to obtain a preference.

b. Chapter 9 Case Administration

i. *Automatic Stay of Enforcement of Claims Against the Debtor (§ 922)*

Section 922(a) of the Bankruptcy Code provides for a stay of actions against entities other than the debtor itself. The additional stay is meant to supplement, and not replace, the automatic stay granted under section 362 of the Bankruptcy Code.

The additional stay prohibits a creditor from taking actions against an officer or inhabitant of the city. Accordingly, a creditor cannot bring a *mandamus* action against an officer on account of the creditor’s claims against the debtor, nor can a creditor seek to collect its debt by commencing an action against an inhabitant of the debtor for collection of taxes that are owed to the

⁵ 6 *Collier on Bankruptcy* ¶ 900.02[2][e][i] (16th ed.).

⁶ *Id.* (“In *New Smyrna-DeLand Drainage District v. Thomas*, in which the debtor filed an ‘amended plan,’ but relied on prior consents to the original plan, the court of appeals upheld the dismissal of the petition on the grounds that the plan was a new plan, and that the prior consents to one plan could not be counted toward the new plan.”).

⁷ *Id.* ¶ 900.02[2][e][ii].

⁸ 165 B.R. 60 (Bankr. D.N.H. 1994).

⁹ *Id.* at 78.

¹⁰ *Id.* (citing *In re Cottonwood Water & Sanitation Dist.*, 138 B.R. 973, 974, 979 (Bankr. D. Colo. 1992).

¹¹ *Id.*; *In re Villages at Castle Rock Metropolitan Dist. No. 4*, 145 B.R. 76, 84 (Bankr. D. Colo. 1990); 4 *Collier on Bankruptcy* ¶ 900.03.

¹² *Sullivan County*, 165 B.R. at 78.

¹³ 6 *Collier on Bankruptcy* ¶ 900.02[2][e][iii] (16th ed.).

¹⁴ *Id.* ¶ 900.02[2][e][iv].

municipality. Similarly, any attempt by a creditor to enforce a lien on taxes owed to the municipality is also stayed under section 922(a) of the Bankruptcy Code.

Section 922(d) of the Bankruptcy Code provides an exception to the additional stay for pledged funds. Specifically, under section 922, if an indenture trustee or paying agent is in possession of pledged funds from special revenue bonds, the trustee or agent may apply the pledged funds to payments as they come due and/or distribute the funds to the bondholders. In addition, a chapter 9 debtor's voluntary payment of such funds to an indenture trustee or paying agent on account of the special revenue bonds, and the application thereof, does not violate the stay and does not require court approval. In *Jefferson County*, however, the bankruptcy court allowed Jefferson County to withhold payment (at least on an interim basis) of special revenues pending determination of the scope of the county's interest in the special revenues and the county's actions in connection with its restructuring efforts.

ii. Avoidance Powers

Section 901 of the Bankruptcy Code provides, among other things, that a chapter 9 debtor has most of the avoidance powers granted to a chapter 11 debtor, including the ability to avoid preferences and fraudulent transfers.¹⁵ Further, section 926(a) of the Bankruptcy Code provides that “[i]f the debtor refuses to pursue a cause of action under section 544, 545, 547, 548, 549(a), or 550 of [the Bankruptcy Code], then on request of a creditor, the court may appoint a trustee to pursue such cause of action.” Notwithstanding a chapter 9 debtor's ability to commence an avoidance action, section 926(b) provides that a transfer on account of a bond or a note may not be avoided as a preference under section 547 of the Bankruptcy Code.

iii. Bankruptcy Judge (§ 921(b))

Pursuant to section 921(b) of the Bankruptcy Code, “[t]he chief judge of the court of appeals for the circuit embracing the district in which the case is commenced shall designate the bankruptcy judge to conduct the case.” The provision is designed to remove politics from the case of a major municipality and to ensure that the case is presided over by a competent judge.¹⁶ The provision also gives the chief judge the flexibility to appoint a retired judge or a judge who sits in a district other than the one where the case is pending, which allows the chief judge to manage the flow of judicial business in the various parts of the circuit.¹⁷

iv. Collective Bargaining Agreements (§ 365)

Like a chapter 11 debtor, a chapter 9 debtor has the power to assume and reject contracts under section 365 of the Bankruptcy Code. In chapter 11, if a debtor wishes to reject a collective bargaining agreement, the debtor must comply with the requirements of section 1113 of the Bankruptcy Code, which affords various protections to the union that is the counterparty to the collective bargaining agreement. Section 1113, however, does not apply in a chapter 9 case. Instead, section 365, as informed by the Supreme Court's decision in *NLRB v. Bildisco @ Bildisco*,¹⁸ applies when determining whether a chapter 9 debtor may reject or modify a union contract. *Bildisco*, which was decided prior to the enactment of section 1113, held that under section 365, a debtor could unilaterally reject or modify a collective bargaining agreement without complying with applicable state law.

Two California bankruptcy courts have clarified the ramifications of Congress's decision not to incorporate section 1113 in chapter 9 cases. In *Orange County*,¹⁹ a coalition of county employee organizations brought an action against the debtor to enforce their various labor agreements.²⁰ In connection with their action, the coalition also sought an emergency injunction enjoining the

¹⁵ Specifically, sections 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 555, 556, 557, 559, 560, 561, 562 of the Bankruptcy Code apply in a chapter 9 case.

¹⁶ 6 *Collier on Bankruptcy* ¶ 921.03 (16th ed.) (citing S. Rep. No. 94-458, 94th Cong., 1st Sess. 15 (1975)).

¹⁷ *Id.* (citing H.R. Rep. No. 94-686, 94th Cong., 1st Sess. 2 (1975)).

¹⁸ 465 U.S. 513 (1984). The three-part test articulated in *Bildisco* requires a debtor to establish that (a) the labor agreement burdens the estate; (b) after careful scrutiny, the equities balance in favor of contract rejection; and (c) “reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution.” *Bildisco*, 465 U.S. at 526.

¹⁹ *In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995).

²⁰ *Id.* at 179.

debtor from permanently laying off county employees represented by the various organizations composing the coalition.²¹ Although the *Orange County* court held that the standard articulated in *Bildisco* was applicable to the rejection of the labor agreements in chapter 9, the court also agreed with the coalition that the debtor should also be required to satisfy the standards of California law “if not as a legal matter, certainly from an equitable standpoint.”²² Accordingly, the *Orange County* court concluded that even under *Bildisco*, municipalities may only modify their labor contracts as a matter of last resort.

In *City of Vallejo*,²³ the debtor moved to reject its collective bargaining agreements (CBAs) less than a month into the case. Agreeing with *Orange County* court, the Vallejo court held that section 1113 is inapplicable to a chapter 9 debtor’s motion to reject a CBA and that the correct standard is the one set forth in *Bildisco*.²⁴ The *Vallejo* court, however, was far less deferential to California state labor law than the *Orange County* court had been. The court emphasized that under section 903 of the Bankruptcy Code, states “act as gatekeepers to their municipalities’ access to relief under the Bankruptcy Code.”²⁵ Accordingly, the court reasoned that when a state authorizes its municipalities to file chapter 9 petitions, “it declares that benefits of chapter 9 are more important than state control over its municipalities” and, therefore, “must accept chapter 9 in its totality.”²⁶ Thus, if a state authorizes a municipality to file under chapter 9, the municipality “is entitled to fully utilize [section] 365 [of the Bankruptcy Code] to accept or reject its executory contracts.”²⁷ While the California law allowing Vallejo to file for bankruptcy purported to require that municipalities comply with state law while in bankruptcy, the bankruptcy court held that that portion of the law was preempted by the Bankruptcy Code.²⁸ Ultimately, the bankruptcy court did not grant Vallejo’s motion.²⁹ Instead, the court encouraged the parties to reach a settlement, which they did approximately five months later.

Ultimately, bankruptcy courts have consistently held that section 1113 does not apply in a chapter 9 case. Instead, section 365 of the Bankruptcy Code, as such section is applied in *Bildisco*, governs the rejection of CBAs in chapter 9. These courts, however, have issued inconsistent opinions as to whether the chapter 9 debtor must comply with state law when seeking to reject or modify a CBA.

v. *Official Committees* (§ 901(a))

Section 901(a) of the Bankruptcy Code provides that section 1102 applies in a chapter 9 case. Accordingly, official committees can be formed in a chapter 9 case. As discussed below, however, a chapter 9 debtor is not technically obligated to pay for the fees and expenses of an official committee through the debtor’s plan of adjustment.

c. **Plan of Adjustment Requirements**

i. *Confirmation Requirements* (§ 943)

A chapter 9 plan of adjustment is simply the document that provides for the treatment of the various classes of creditors’ claims against the municipal debtor. Similar to a chapter 11 debtor, a chapter 9 debtor submits a disclosure statement that describes the plan and related matters, and the disclosure statement is sent with a ballot to each impaired creditor with an opportunity to vote on the plan. Similar to a chapter 11 plan of reorganization, in order to be confirmed, the plan of adjustment must be accepted by a majority of creditors and two thirds in amount of claims within each class of claims that is impaired under the plan.

In addition to the voting requirements, the Bankruptcy Code contains several other requirements that a plan of adjustment must meet to be confirmed by the bankruptcy court. The requirements include the following: (i) the chapter 9 debtor must not be pro-

²¹ *Id.*

²² *Id.* at 184.

²³ 403 B.R. 72 (Bankr. E.D. Cal. 2009).

²⁴ *Id.* at 78.

²⁵ *Id.* at 76.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.* at 76–77.

²⁹ *Id.* at 78.

hibited by law from taking any action necessary to carry out the plan; (ii) all post-petition administrative expense claims must be paid in full; (iii) the chapter 9 debtor must have obtained all of the regulatory and electoral approvals necessary to consummate the plan; and (iv) the plan must be feasible. Importantly, the plan of adjustment must also be in the best interest of creditors. Since a chapter 9 debtor is ineligible to be a debtor in a chapter 7 liquidation, however, this test has been interpreted to mean that a plan of adjustment need only be “better than alternatives,” such as the dismissal of the chapter 9 case.

If an impaired class of creditors votes against a chapter 9 debtor’s plan of adjustment, the bankruptcy court can still confirm the plan through a “cram down” of the dissenting class (or classes) if the plan meets all of the other confirmation requirements set forth in section 943 of the Bankruptcy Code. In order to accomplish such a cram down, the debtor must show that at least one impaired class has accepted the plan and that the plan is fair and equitable and does not discriminate unfairly among creditors. In chapter 11, the fair and equitable requirement, often referred to as the “absolute priority rule,” requires that the debtor establish that no junior class of creditors is receiving any distribution under the plan of reorganization on account of its claims unless all senior classes of claims are paid in full. In chapter 9, however, a plan of adjustment is considered “fair and equitable” if the amount to be received by the dissenting class is “all they can reasonably expect to receive under the circumstances.”

If a plan of adjustment is not approved, the bankruptcy court may dismiss the chapter 9 case, thereby stripping the municipality of the protections of the Bankruptcy Code. A bankruptcy court may also dismiss a chapter 9 case for a variety of other reasons, such as the failure of a debtor to prosecute the case, unreasonable delay, the non-acceptance of a plan by creditors or a material default or termination of a plan.

ii. Professional Fees (§ 943(b)(3))

Section 943(b)(3) of the Bankruptcy Code requires that “all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable.” As such, a chapter 9 debtor must disclose any and all fees and expenses being paid to professionals. Section 943(b)(3) of the Bankruptcy Code, however, does not require the municipality to pay the fees and expenses of committee professionals. “Absent the debtor’s consent, there is nothing in chapter 9 that automatically requires a debtor to pay the fees and costs of an official committee, professionals employed by the committee or professionals employed by members of an official committee.”³⁰

II. Noteworthy Chapter 9 Bankruptcy Cases

Municipal bonds are traditionally viewed as safe investments because defaults are rare. From 1970 to 2012, only 71 rated municipal bond defaults occurred, and only five of those were by general purpose municipalities (*i.e.*, cities, villages, towns or counties).³¹ In fact, 78 percent of all municipal bond defaults came from health care- and housing-related projects issued by special entities.³²

Given this low default rate, it is hardly a surprise that municipal bankruptcies are also rare. Only 636 municipal bankruptcy cases have been filed since such cases were first authorized by Congress in 1937.³³ Moreover, only approximately 250 municipalities have filed under chapter 9 of the Bankruptcy Code,³⁴ as compared to the approximately 1.2 million individuals who filed personal bankruptcy proceedings in 2012 alone.³⁵ Only 17.5 percent of chapter 9 filings between 1980 and 2007 were by general purpose municipalities.³⁶ Approximately 61.8 percent of chapter 9 cases involved utilities and special purpose districts.³⁷ The remaining 20.7 percent of chapter 9 cases mainly involved schools, public hospitals and transportation authorities.³⁸

³⁰ 6 *Collier on Bankruptcy* ¶ 901.04[13][c] (16th ed.).

³¹ *National Governors’ Association et al., Facts You Should Know: State and Local Bankruptcy, Municipal Bonds, State and Local Pensions* 2 (2013).

³² *National Governors’ Association et al., Facts You Should Know: State and Local Bankruptcy, Municipal Bonds, State and Local Pensions* 2 (2011).

³³ Michael De Angelis & Xiaowei Tian, “[United States: Chapter 9 Municipal Bankruptcy—Utilization, Avoidance, and Impact](#)” 323 (2011).

³⁴ *Id.* at 321.

³⁵ See American Bankruptcy Institute, [Quarterly Non-business Filings by Chapter \(1994–2012\)](#).

³⁶ *Id.* at 321–22.

³⁷ *Id.* at 322.

³⁸ *Id.*

Historically, bondholders have fared well in chapter 9 cases, experiencing, at worst, some payment delays or relatively minor haircuts. Recently, however, the assumption that bondholders will be paid in full (or at least the vast majority of their claims) in a bankruptcy case has been called into question.³⁹ Below is a discussion of the major municipal bankruptcies from the past 20 years.

a. Orange County, California (1994)

In 1994, Orange County, California, was the fifth-largest county in the United States with an operating budget in excess of \$3.7 billion. Increasing demand for high-quality public services strained the county's finances since the California Constitution restricted the ability of local governments, including Orange County, to raise tax revenue. The County Treasurer tried to solve Orange County's financial problems by pooling the county's money with funds from nearly 200 local public agencies through an entity known as the Orange County Investment Pool (OCIP) and investing those funds. In particular, the OCIP used the pooled funds to borrow more money (the OCIP borrowed \$2 for every \$1 on deposit) to invest in derivatives and high-yield, long-term bonds. As a result of adverse market conditions, the OCIP lost \$1.64 billion by November 1994.⁴⁰

In December 1994, Orange County and the OCIP both filed for chapter 9 after many Wall Street investment firms commenced legal actions to seize their collateral. The bankruptcy court dismissed the OCIP's case after determining that such an entity did not qualify as a "municipality" under the Bankruptcy Code and, therefore, was ineligible to be a chapter 9 debtor. Although the dismissal allowed the creditors to continue their actions against the OCIP, the bankruptcy court enjoined such creditors from enforcing against the OCIP's funds, thereby preventing severe financial stress being placed on Orange County (and the other local agencies that had invested in the fund).⁴¹

Orange County initially submitted a plan of adjustment that called for a sales tax increase of one half of one percent, which would require voter approval under California law. As such, the voters of Orange County would effectively be voting on the plan. After the voters rejected the tax increase, it became apparent that the debtor's initial plan would not be confirmed. The bondholders, who risked having the debtor default on its principal payment obligation, agreed to rollover the county's debt for another year in exchange for increased interest payments. The county then developed another plan under which (i) the county would divert tax funds from other county agencies and use those funds to pay bondholders; (ii) the local governments that lost money would agree to wait for full payment until the county won the lawsuits it filed against Wall Street firms alleging that such firms were culpable as a result of their actions surrounding the bankruptcy; and (iii) the county would issue \$880 million in 30-year bonds that were insured by a municipal bond insurer to pay the debt on existing bonds, refinance other debt and pay for bankruptcy litigation and other expenses.⁴²

Orange County emerged from bankruptcy 18 months after it filed. From a fiscal perspective, the county's bankruptcy was very successful in that it reduced the county's debt to an affordable level. Indeed, Orange County was able to access the lending markets a mere two years after its bankruptcy. Seven years after the filing, Orange County had a AA bond rating.⁴³

b. Prichard, Alabama (1999 and 2009)

Prichard, Alabama, which experienced a population decline of approximately 50 percent over the past 50 years, filed for bankruptcy in 1999 after it was unable to pay approximately \$3.9 million in delinquent bills. In addition to the unpaid bills, Prichard also admitted to not making payments to its employees' pension funds and, even though the city had withheld taxes from employees' paychecks, the city failed to submit such withholdings to the state and federal governments.⁴⁴

³⁹ See Steven Church, "[Stockton Threatens to Be First City to Stiff Bondholders](#)," Bloomberg, June 30, 2012.

⁴⁰ See De Angelis & Tian, *supra* note 33, at 324.

⁴¹ See *id.* at 325.

⁴² See *id.* at 325-26.

⁴³ See *id.* at 326.

⁴⁴ See *id.* at 331.

During the bankruptcy case, Prichard was able to make some progress enhancing social, financial and technological growth, as well as economic development. Its 2001 budget predicted a four percent increase in revenue over its 2000 budget, and the city exited from bankruptcy in 2001.⁴⁵

While in bankruptcy, the city successfully revised its budget so that it no longer operated at a deficit. However, Prichard was still unable to meet its pension obligations. In 2009, Prichard filed for bankruptcy for the second time in order to stay a pending suit brought by its pensioners after it failed to make pension payments for six months. In its chapter 9 petition, the city claimed that during the previous year it had operated a \$600,000 deficit on its \$10.7 million budget. Further, Prichard had failed to make a \$16.5 million payment to its pension fund under its previous plan of adjustment.⁴⁶

In August 2010, the bankruptcy court dismissed Prichard's chapter 9 case because the court held that the city was ineligible to be a chapter 9 debtor. In particular, the bankruptcy court determined that the Alabama statute authorizing chapter 9 filings only enabled permitted municipalities with bonded debt to file. Since Prichard did not have bond debt, the bankruptcy court found that it was ineligible to file.⁴⁷ Prichard appealed the bankruptcy court's decision to the district court, which in turn certified the eligibility question to the Alabama Supreme Court.⁴⁸ In April 2012, the Alabama Supreme Court ruled that municipalities did not need bond debt in order to file. The district court therefore reversed the bankruptcy court's decision and remanded the case.⁴⁹ The Alabama Supreme Court's decision has been viewed as opening the door for Jefferson County's bankruptcy case— which is discussed below in greater depth—because Jefferson County's debt was in the form of warrants, not bonds.⁵⁰

c. City of Vallejo, California (2008)

The City of Vallejo, with 120,000 residents, filed for bankruptcy in May 2008. Unlike most general purpose municipalities that file for bankruptcy, Vallejo's financial distress was not caused by excessive debt. Rather, the city's financial problems resulted from a budget issue. Vallejo's finances had a long-term structural imbalance resulting from a declining tax base, decreasing revenues from property and sales taxes, state funding cuts and satisfying its expensive labor contracts. The city's tax revenues decreased by \$20 million between 2007 and 2011 as a result of the recession and decreasing home values that caused property taxes to decrease. Vallejo's largest debt resulted from the city's pension liabilities and financial obligations under its various labor contracts. Prior to filing for bankruptcy, Vallejo attempted to negotiate with several of its labor unions, but the parties were unable to reach an agreement.⁵¹

Shortly after Vallejo filed for bankruptcy, the city filed a plan of adjustment that it thought was feasible at the time and sought to adjust its labor contracts. As discussed below, the labor unions objected to the plan on the ground that it impermissibly abrogated the unions' collective bargaining agreements. The bankruptcy court held that the labor agreements could be rejected under section 365 of the Bankruptcy Code. At the court's encouragement, the parties negotiated new labor agreements. However, Vallejo's finances continued to deteriorate during the chapter 9 case, causing the original plan of adjustment to no longer be feasible.⁵²

Three years and five months after Vallejo filed its bankruptcy petition, the bankruptcy court approved the city's new plan of adjustment. As part of the confirmed plan, the city closed fire stations, reduced public services, cut staffing requirements, laid off city workers, required new city workers to contribute more to their pensions and all employees to contribute more for their health insurance and sought new revenue.⁵³

⁴⁵ See *id.*

⁴⁶ See *id.*

⁴⁷ See *id.*

⁴⁸ See Katherine Sayre, "[Alabama Supreme Court Ruling Allows Prichard Bankruptcy to Move Forward](#)," April 20, 2012.

⁴⁹ See *id.*

⁵⁰ See *id.*

⁵¹ See De Angelis & Tian, *supra* note 33, at 326–27.

⁵² See *id.* at 327.

⁵³ See *id.* at 327–28.

It was noteworthy that during the bankruptcy proceedings, Vallejo continued to make all payments on its bond debt, which totaled approximately \$62 million, on time and in full. Likewise, the city's plan of adjustment did not adjust the city's bond debt. Under the plan, general unsecured claims received between 5 and 20 percent of their claims over a period of two years.⁵⁴

d. Westfall, Pennsylvania (2009)

Westfall, Pennsylvania, a small town with a population of 2,400 and a \$1.5 million operating budget in 2009, filed for bankruptcy in April 2009. The impetus for the bankruptcy filing was a \$20 million civil rights judgment obtained by a property developer against the town. Westfall and the developer entered into negotiations to settle the developer's claim, which proved unsuccessful.⁵⁵

The bankruptcy court ultimately approved Westfall's plan of adjustment, which reduced the developer's claim to \$6 million and provided that the claim would be paid over 20 years without interest. In order to pay for the settlement, the town raised the property tax rate by 48 percent (the property tax would gradually decrease each year over the 20-year period).⁵⁶

It is likely that the developer ultimately agreed to the plan of adjustment because he was concerned that the bankruptcy court would approve a less favorable plan. Specifically, the developer was aware that one class of the town's creditors would vote to confirm the plan, which would allow the debtor to cram down the plan over the developer's objection.⁵⁷

e. Jefferson County, Alabama (2011)

Jefferson County, the second-largest county in Alabama, filed for chapter 9 in November 2011, which at the time was the largest municipal bankruptcy case in US history, in order to resolve the indebtedness of the county's sewer system (a special purpose vehicle). In 1994, Jefferson County began a sewer restoration and rehabilitation program. Although the project was originally estimated to cost \$1 billion, the costs eventually ballooned to \$3.2 billion. In order to service its debt, the county increased sewer rates by 400 percent. In addition, the county lowered the costs of its debt service by entering into swap agreements under which the county would swap long-term fixed higher interest rate debt into short-term variable rate debt. The 2008 financial crisis destabilized the market for such swap agreements, which caused the county's debt service to increase. In 2008, Jefferson County defaulted on its debt obligations, which resulted in the acceleration of the debt.⁵⁸

Over the next several years, Jefferson County considered a chapter 9 filing. The county opted, however, to enter into a forbearance agreement in 2009, which allowed the county to negotiate with its creditors. The parties' negotiations revolved around (i) the creditors forgiving a portion of the sewer debt, (ii) the parties restructuring the remaining debt at fixed rates and (iii) the county limiting sewer rate increases to the rate of inflation.⁵⁹

In June 2013, Jefferson County reached an agreement on a plan of adjustment, which still needs to be approved by the bankruptcy court, under which the county will pay its creditors \$1.84 billion, or 60 percent of what they are owed. JPMorgan Chase & Co., seven hedge funds and a group of bond insurers, which together hold \$2.4 billion, or approximately 78 percent, of the sewer debt, agreed to support the plan. Under the plan, JPMorgan, which holds \$1.22 billion of debt, will forgive \$842 million. Taken together with a previous settlement, the bank will have agreed to pay the county and waive sewer obligations totaling \$1.57 billion. Under the plan, the county will increase sewer rates by 7.4 percent annually for four years. The plan provides that Jefferson County will exit bankruptcy by the end of the year.⁶⁰

⁵⁴ See *id.*

⁵⁵ See *id.* at 330.

⁵⁶ See *id.*

⁵⁷ See *id.* at 330–31.

⁵⁸ See *id.* at 328.

⁵⁹ See *id.* at 328–29.

⁶⁰ See Steven Church, Margaret Newkirk and Kathleen Edwards, "[Jefferson County, Creditors Reach Deal to End Bankruptcy](#)," Bloomberg, June 5, 2013.

f. Harrisburg, Pennsylvania (2011)

The city of Harrisburg, Pennsylvania, the state capital, guaranteed debt issued by a special purpose vehicle that was formed in order to finance the construction of an incinerator plant. The construction and operation of the plant went over budget, and the original forecasts of the revenues that would be generated from the plant proved to be overly optimistic. Consequently, the special purpose vehicle defaulted triggering the city's guaranty of the bond debt. In 2010, Harrisburg owed \$68 million in interest payments—an amount that was \$3 million in excess of the city's yearly operating budget.⁶¹

Harrisburg sought a forbearance agreement with its creditors, which would permit the parties to negotiate a settlement. During this time, the city also began considering a chapter 9 filing in the face of the city mayor's resistance to such a filing. Notwithstanding the ongoing negotiations, in October 2011, the Harrisburg city council authorized the city to file for bankruptcy. The filing was met with disagreement from the mayor, the dissenting city council members and elected state officials.⁶²

In November 2011, the bankruptcy court dismissed the chapter 11 petition, holding that the city was not properly authorized to file under chapter 9 of the Bankruptcy Code and, therefore, was ineligible to be a chapter 9 debtor. Following the dismissal, Pennsylvania's governor commenced an action in state court seeking to have a receiver appointed for the city pursuant to the state intervention procedures for municipalities in fiscal distress.⁶³

g. Stockton, California (2012)

The City of Stockton, a city of 296,000 residents, filed for bankruptcy in June 2012, which at the time was the largest city ever to file for bankruptcy. Stockton was hard hit by the 2008 financial crisis. The collapse of the real estate market resulted in significant declines to the city's property and sales tax revenues. In addition, the city experienced budgetary stress as 75 percent of Stockton's general fund was used for the public safety payroll and to service debt, and satisfying pension obligations accounted for nearly 13 percent of the city's overall spending. These budgetary problems were exacerbated by Stockton's inability to generate new tax revenue, which was limited by California law. Stockton could not raise property taxes, and if the city wanted to levy a sales tax, like Orange County, it would need two-thirds voter approval in a special election.

At the time Stockton filed, the city stopped making debt service payments on its appropriation and pension obligation bonds. These bonds were, and still are, unsecured general fund obligations and have no specified tax revenues pledged for debt service. Stockton, however, has no general obligation bonds, which typically have better protections for bondholders.

Stockton has proposed to significantly reduce its bond debt while leaving its pension obligation owed to the California Public Employees' Retirement System (CalPERS), the pension fund for public workers in California, unimpaired. While bondholders have suffered minor losses or delayed payments in previous chapter 9 cases, if Stockton's case proceeds as planned, it would mark the first time that a municipality significantly impaired its obligations to bondholders.

Facing large losses, Assured Guaranty Corp., the monoline insurance company that insured Stockton's bonds, and other capital market creditors objected to Stockton's bankruptcy filing, arguing that Stockton had not negotiated with them in good faith. Specifically, the monoline argued that Stockton's demands fell "short of the fairness requirements of chapter 9." The bankruptcy court, however, overruled the objection, finding that the capital market creditors, not Stockton, had not negotiated in good faith prior to the bankruptcy filings when they "chose to take a we-have-nothing-to-talk-about position once the City indicated that it was not proposing to impair its obligations to CalPERS."⁶⁴ Stockton's bankruptcy case remains ongoing.

⁶¹ See De Angelis & Tian, *supra* note 33, at 329.

⁶² See *id.* at 329–30.

⁶³ See *id.* at 330.

⁶⁴ *In re City of Stockton*, Slip-Op Case No. 12-32118-C-9 (Bankr. E.D. Cal. June 12, 2013).

h. San Bernardino, California (2012)

San Bernardino, a city of 210,000 residents, filed for bankruptcy in July 2012 because of a \$48.5 million budget deficit that threatened the city's ability to make payroll. Prior to filing, the city obtained \$10 million in concessions from city employees and slashed its workforce by 20 percent over four years. Notwithstanding these efforts, San Bernardino's fiscal problems that resulted from a variety of issues including accounting errors, deficit spending, lack of revenue growth and increases in pension and debt costs, remained unresolved. In addition, following the 2008 economic crisis, San Bernardino's tax revenues declined by as much as \$16 million annually, primarily because of drops in sales and property taxes. At the time of filing, 73 percent of the city's general fund was being used to pay for public safety services.

In October 2012, CalPERS preliminarily objected to San Bernardino's bankruptcy filing, arguing the city could not demonstrate that it was eligible to be a chapter 9 debtor. In particular, the pension fund argued that San Bernardino could not demonstrate that it (i) desired to effectuate a plan of adjustment, or (ii) negotiated with its creditors in good faith prior to the bankruptcy filing. The bankruptcy court ordered the parties to conduct discovery in respect of the eligibility issue. A hearing on the eligibility issue is scheduled for August 2013.

After filing for bankruptcy, San Bernardino, unlike Stockton, ceased making payments to CalPERS on account of the city's pension obligations. San Bernardino submitted a pendency plan, which would defer \$35 million of payments to CalPERS, which is necessary in light of the city's budget deficit. San Bernardino has indicated that it intends to resume making payments. Such payments, however, will not include any payments on account of the \$33 million owed to CalPERS in respect of the city's unpaid post-petition obligations.

III. Monoline Municipal Bond Insurers

In 2007, there were six AAA monolines that insured municipal bond debt. These companies, however, experienced various degrees of financial distress as a result of their structured finance obligations. Below is a brief summary of the current financial status of each company.

a. Ambac Assurance Corporation ("Ambac")

As of November 2007, Ambac had \$556 billion of insured obligations outstanding. In 2008, Ambac's financial condition began to be adversely affected by the effects of problems arising from mortgage lending practices in the United States because Ambac underwrote (i) direct financial guaranties of RMBS obligations and (ii) CDS on collateralized debt obligations backed primarily by RMBS. On March 24, 2010, at the request of the Wisconsin Office of the Commissioner of Insurance, Ambac formed a segregated account, which is a separate insurer from Ambac, and filed a petition for rehabilitation that limited the rehabilitation to only the segregated account, while leaving most policies in the general account with Ambac. Ambac's municipal bond obligations remained in the general account and, therefore, were not affected by the rehabilitation proceeding.

b. CIFG Guaranty (CIFG)

As of November 2007, CIFG had \$85 billion of insured obligations outstanding. Like Ambac, CIFG experienced financial strains as a result of the company guaranteeing large amounts of RMBS. On January 22, 2009, the New York Insurance Department approved two transactions meant to keep CIFG out of a rehabilitation proceeding. The transactions involved a commutation of approximately \$12 billion in troubled credit default swaps and reinsurance of \$13 billion of municipal bonds. As part of the transaction, Assured Guaranty Corp. (AGC) acquired the investment grade portion of now-defunct CIFG's municipal exposure through a reinsurance agreement. Most former CIFG bonds now carry the Aa3/AA+ ratings of AGC.

c. Financial Guaranty Insurance Company (FGIC)

As of November 2007, FGIC had \$315 billion of insured obligations outstanding. On June 28, 2012, the Court signed a rehabilitation order appointing the Superintendent of Financial Services of the State of New York as rehabilitator of FGIC. On June 11, 2013, the New York state court entered an order approving FGIC's plan of rehabilitation. Under the plan of rehabilitation, FGIC will make

an initial payment of 17.5 percent on allowed claims, and make later payments totaling 40 percent of the allowed claims. While the court confirmed the plan of rehabilitation, the plan has not yet become effective and will not do so until mid-August 2013, at the earliest.

d. Assured Guaranty Corp. (f/k/a Financial Security Assurance) (AGC)

As of November 2007, AGC had \$414 billion of insured obligations outstanding. In 2009, AGC's parent Assured Guaranty Ltd. acquired Financial Security Assurance and subsequently renamed it Assured Guaranty Municipal (AGM), thus combining under the same ownership the two most highly rated bond insurers at that time. Both monolines were rated AAA at the time of the acquisition, but were subsequently downgraded to AA in 2010. As a result of the real estate market deterioration, the RMBS portion of AGC's consolidated exposure was hit with significant claims in recent years. However, on a percentage basis the exposure was not as large as that of other insurers such as MBIA and Ambac, and fewer claims have resulted. As such AGM and AGC have retained their high investment grade ratings. The addition of the insured book of CIFG has increased the percentage of exposure accounted for by municipal bonds.

e. MBIA Insurance Corporation (MBIA)

As of November 2007, MBIA had \$652 billion of insured obligations outstanding. Like many of the other monolines, MBIA's credit rating was downgraded because of its RMBS exposure. Recently, however, the company's bond rating was upgraded from B- to BBB. More importantly, MBIA's municipal debt guaranty business unit, National Public Finance Guarantee Corp. (NPFGC), was upgraded from BBB to A. While MBIA retained Weil Gotshal & Manges LLP as restructuring counsel⁶⁵ in April 2013, such reports indicate that the firm's retention was part of an effort to avoid a possible rehabilitation of MBIA's structured finance unit, and not the municipal bond unit. There is no indication that a rehabilitation proceeding will be commenced against NPFGC.

f. Syncora Guarantee Inc. (f/k/a XL Capital Assurance (XLCA))

As of November 2007, Syncora, then known as XLCA, had \$143 billion of insured obligations outstanding. Unlike many of the other monoline insurers, Syncora has remained solvent. Syncora, however, is not underwriting any new policies.

⁶⁵ See, e.g., Shayndi Raice, "MBIA Hires Law Firm," *The Wall Street Journal*, April 27, 2013, at B2.

Appendix A – Comparing Chapter 9 and Chapter 11

Bankruptcy Code/ Rules Provision	Chapter 9	Chapter 11
Commencing a Case (§§ 301 and 303)	A chapter 9 case can only be commenced by filing of a voluntary petition.	A chapter 11 case can be commenced by the filing of a voluntary or involuntary petition.
Eligibility to be a Debtor (§ 109)	<p>A chapter 9 debtor must demonstrate that it is eligible to be a chapter 9 debtor by establishing that it:</p> <ul style="list-style-type: none"> • is a municipality; • has specific authorization to file; • is insolvent; • wants to adjust its debts through a plan; and • meets one of four creditor-negotiation requirements. <p>A group of creditors often object to a chapter 9 debtor’s petition on the grounds that the debtor is not eligible to file.</p>	<p>Generally, any individual, corporation, partnership or LLC is eligible to be a chapter 11 debtor.</p> <p>Exceptions include:</p> <ul style="list-style-type: none"> • insurance companies; • insured banks; • stockbrokers; • commodity brokers; and • municipalities. <p>It is rare for a group of creditors to challenge an entity’s eligibility to be a chapter 11 debtor.</p>
Automatic Stay and Additional Stay (§§ 362 and 922(a))	<p>The automatic stay applies in a chapter 9 case and stays all actions filed against the debtor and its property.</p> <p>Section 922(a) of the Bankruptcy Code also stays actions against officers and inhabitants of the chapter 9 debtor if such actions seek to enforce a claim against the debtor.</p>	<p>The automatic stay only acts to stay actions against the chapter 11 debtor and its property.</p> <p>Generally, actions against non-debtors are not stayed as a result of a bankruptcy filing.</p>
Schedules and Statements (§§ 501, 924 and 925; Bankruptcy Rule 1007)	<p>A chapter 9 debtor does not need to file any schedules of assets and liabilities or a statement of financial affairs.</p> <p>However, a chapter 9 debtor is required to file a list of the creditors holding the 20-largest unsecured claims.</p> <p>A chapter 9 debtor also must file a list of all of its creditors.</p> <p>Any claim listed on the list of creditors is a proof of claim deemed filed under § 501, unless filed as contingent, disputed or unliquidated.</p>	A chapter 11 must file schedules and a statement of financial affairs.
Retention of Professionals (§ 327)	A chapter 9 debtor does not need bankruptcy court approval in order to retain professionals.	A chapter 11 debtor does need bankruptcy court approval in order to retain professionals.
Professionals’ Compensation (§§ 327–330, 901(a) and 943)	A chapter 9 debtor is not required to pay for the professionals employed by an official committee or the costs of the committee.	In a chapter 11 case, sections 328 through 331 provide the statutory basis for allowing administrative claims for professionals, including those retained by creditors committees.

Bankruptcy Code/ Rules Provision	Chapter 9	Chapter 11
Use, Sale or Lease of Property (§ 363)	A chapter 9 debtor can use, sell or lease its property without bankruptcy court approval or oversight.	A chapter 11 debtor cannot use, sell or lease property outside of the ordinary course without bankruptcy court approval.
Rejecting Collective Bargaining Agreements (§§ 365 and 1113)	Section 1113 of the Bankruptcy Code does not apply in a chapter 9 case. The rejection of collective bargaining agreements is governed by section 365 of the Bankruptcy Code, as informed by <i>NLRB v. Bildisco @ Bildisco</i> .	Section 1113 of the Bankruptcy Code limits a chapter 11 debtor's ability to unilaterally reject a collective bargaining agreement.
Retiree Benefits (§ 1114)	Section 1114 of the Bankruptcy Code does not apply in a chapter 9 case. A chapter 9 debtor may unilaterally stop paying for or otherwise modify retiree benefits.	A chapter 11 debtor must timely pay retiree benefits or satisfy various requirements in order to modify such benefits.
Preference Actions (§§ 547 and 926(b))	While a chapter 9 debtor may generally avoid preferential transfers, there is an exception for payments or transfers of property to bondholders.	A chapter 11 debtor may avoid preferential transfers made to bondholders.
Post-Petition Effect of Security Interest (§ 552)	A pre-petition pledge (or security interest) in special revenue bonds continues to attach to revenue acquired post-petition.	Generally, property acquired after the commencement of a case is not subject to any lien resulting from a pre-petition security agreement.
Nonrecourse Claims (§§ 927 and 1111)	Section 1111(b) of the Bankruptcy Code does not apply in chapter 9 cases. Special revenue bondholders do not have recourse against chapter 9 debtors and, therefore, will not have allowed claims.	A nonrecourse claim secured by a lien on property of the estate is allowed or disallowed pursuant to section 502 of the Bankruptcy Code unless the holder of such claim makes an 1111(b) election.
Priority Wage Claims (§ 502(a)(4))	Section 502(a)(4) of the Bankruptcy Code does not apply in chapter 9 cases. Claims for unpaid wages are not entitled to priority in a chapter 9 case.	Claims for up to \$11,275 in unpaid wages, salaries or commissions, including severance, are entitled to priority.
Exclusivity (§§ 941 and 1121)	Only a chapter 9 debtor may file a plan of adjustment. There is no deadline for filing a plan of adjustment unless the bankruptcy court orders one.	A chapter 11 debtor has the exclusive right to file a plan of reorganization during the first 120 days of the case. The chapter 11 debtor's exclusivity period may be extended or terminated for cause.
Plan Requirements (§§ 943 and 1129)	A chapter 9 debtor can only adjust its debts through a plan. A municipality cannot liquidate in chapter 9.	A chapter 11 debtor may either reorganize or liquidate through a plan.

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