

Chapter 9 Bankruptcy - A Tool for Municipalities When Raising Taxes Is No Longer an Option

90% of restructuring experts polled in an AlixPartners, LLP survey believe a major U.S. municipality will default on its debt in 2010 or 2011

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Financial pressures brought on by unfunded mandates, reduced funding by state and federal sources, long-term legacy obligations, collective bargaining agreements and over-taxed residents and businesses have increasingly confounded efforts by municipal governments and other political subdivisions to address funding obligations for operations and other commitments into the future. A long available, but frequently ignored, alternative for addressing these financial pressures is chapter 9 of the Bankruptcy Code. Chapter 9 is the least used chapter of the Bankruptcy Code, having historically been seen as vehicle of last resort for municipalities. However, the recent recession and economic downturn has forced many governmental and quasi-governmental units to actually consider filing for chapter 9 bankruptcy as a way through their financial difficulties. This article provides a summary of chapter 9 and how a municipality proceeds through the process of commencement of a bankruptcy case and the potential pitfalls that may be encountered. Included is a discussion of the following key issues: (1) what entities may use chapter 9; (2) the requirements for statutory authority and other conditions of individual state law for entities seeking chapter 9 relief; (3) the test for insolvency required for chapter 9 relief; and (4) the requirement on municipalities of good faith attempts to negotiate alternatives before filing for chapter 9 bankruptcy relief.

Background

Chapter 9 of the Bankruptcy Code¹ provides for the reorganization of a municipality's financial affairs, which is the "adjustment of its debts." Chapter 9 works similarly in some respects to chapter 11 of the Bankruptcy Code, which is the most commonly used vehicle to reorganize and adjust the financial obligations of a non-governmental debtor. Like chapter 11, chapter 9 provides a municipality with a breathing spell from its creditors during which it can formulate a plan for the adjustment of its debts that is acceptable to a majority of its creditors.

However, many facets of chapter 9 differ from chapter 11. For instance, only debtors that are insolvent governmental or quasi-governmental entities may utilize chapter 9, chapter 9 has no provisions that enable a liquidation of a debtor, and there are many provisions of chapter 9 that seek to affect the balance of power among debtors and creditors that are much different than the provisions found in chapter 11. Also, the Tenth Amendment of the United States Constitution places limitations on the involvement of bankruptcy courts that oversee the debt adjustment process in chapter 9.

Who Can Be a Chapter 9 Debtor?

Section 109 of the Bankruptcy Code, entitled, "Who may be a debtor," specifically provides as follows concerning municipalities:

- (c) An entity may be a debtor under chapter 9 of this title if and only if such entity—
1. is a municipality;
 2. is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter [9] 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 [9];
 3. is insolvent;
 4. desires to effect a plan to adjust such debts; and
 5.
 - A.) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter [9];
 - B.) 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 such entity intends to impair under a plan in a case under such chapter [9];
 - C.) is unable to negotiate with creditors because such negotiation is impracticable; or
 - D.) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.²

What is a Municipality?

There are a broad array of entities that constitute a "municipality" for purposes of chapter 9, defined under section 101(40) of the Bankruptcy Code³ to mean any "political subdivision or public agency or instrumentality of a [s]tate." A political subdivision includes a county, city, town, village, borough, township or other municipality.⁴ A public agency or instrumentality "includes, collectively, incorporated authorities, commissions, and the like which are organized for the purpose of constructing, maintaining and operating revenue producing enterprises."⁵

Authorization under State Law

The requirement under section 109 that a municipality be authorized to be a debtor under state law can be, for obvious reasons, the sole impediment for a municipality seeking to file chapter 9. State laws regarding authorization for municipality chapter 9 filings vary widely. Some expressly permit chapter 9 filings; others have no statutes and thereby do not permit chapter 9 filings; some limit the types of municipalities that may file; and still others permit filing subject to some sort of preliminary review by the particular state. There are currently 26 states that authorize municipality chapter 9 filings and 24 states, in addition to Washington, DC, that do not authorize such filings. The following chart shows which states authorize, in some fashion, municipality chapter 9 filings and which states do not:

Authorize Chapter 9 Filing	Do Not Authorize Chapter 9 Filing
AL, AZ, AR, CA, CO, CT, FL, ID, IA, KY, LA, MI, MN, MO, MT, NE, NJ, NY, NC, OH, OK, OR, PA, SC, TX, WA	AK, DE, DC, GA, HI, IL, IN, KS, ME, MD, MA, MS, NV, NH, NM, ND, RI, SD, TN, UT, VT, VA, WV, WI, WY

The following chart reflects some examples of state authorization statutes and how they can differ:

State	Breadth of Statute
California	Very broad. Statute authorizes filing for any "municipality" under the Bankruptcy Code. ⁶
Florida	Very broad. References Bankruptcy Code definition and authorizes filing for municipalities, taxing districts and political subdivisions. ⁷
New Jersey	Similar to Bankruptcy Code definition. Statute applies to any county, municipality, school district or other state political subdivision. Entity must obtain approval from municipal finance commission before filing. ⁸
New York	Statute authorizes filing for a municipality or its financial control board. "Municipality" is defined as a county, city, town or village. Therefore, entities such as school districts would be excluded. ⁹
Pennsylvania	Statute authorizes filing for any political subdivision. Written approval of the bankruptcy petition must be obtained from the State Department of Internal Affairs prior to filing. ¹⁰

As this chart reflects, there is a good deal of variation among the states that authorize chapter 9 filings. Interestingly, states such as New Jersey and Pennsylvania that require some sort of approval by a state agency do not delineate the factors that such agency is to consider when analyzing a request from a municipality for authority to file a chapter 9 bankruptcy petition. Ultimately, the lack of authorization statutes in half of the states means that for a great deal of municipalities, chapter 9 is not even an option. For municipalities in the other half of the states, the remaining requirements of section 109(c) must be satisfied in order to be eligible for chapter 9 relief.

Insolvency

As provided in section 109(c), the next requirement for chapter 9 relief is that the municipality must be insolvent. An analysis of the municipality's cash flow determines whether it is insolvent, meaning that the municipality must be: (1) generally not paying its debts as they become due unless such debtors are the subject of a *bona fide* dispute; or (2) unable to pay its debts as they become due.¹¹ The insolvency test is a prospective test, meaning that the courts look at future inability to pay starting at the petition date (date of the bankruptcy filing).¹² Courts look to the cash flow of the municipality instead of using a balance sheet test when considering whether or not the debtor can pay its debts as they become due.¹³

Furthermore, as part of the analysis, the debts of the municipality must be presently due and owing and enforceable, and not subject to contingencies.¹⁴ In addition, if a municipality has adequate cash reserves, or the ability, within reason, to raise taxes or reduce spending to meet current obligations, the bankruptcy court may find that the municipality is not insolvent and is thus ineligible for chapter 9 relief. Accordingly, the insolvency requirement is determined on a case-by-case basis depending on the specific financial circumstances of each municipality debtor.¹⁵

Good Faith Negotiations with Creditors

The good faith negotiation requirement is one of the four options available for a municipality to satisfy the final requirement under section 109(c) in order to be entitled to bankruptcy, and it represents the least clear cut of such options. Under prior bankruptcy law (pre-Bankruptcy Code), a municipality was required to have agreement over debt adjustment with a majority of its creditors in order to qualify for a debt adjustment under chapter 9. In other words, municipality debtors seeking chapter 9 relief were required to essentially file "prepackaged" or "pre-arranged" bankruptcies. Congress realized that such a requirement was impracticable in certain situations and could "seriously harm the municipality while it was attempting to obtain the necessary consents [from creditors]."¹⁶ Similar to the insolvency issues, the satisfaction of the requirement for good faith negotiation depends on the facts and circumstances of the particular municipality, its debt structure and its creditors, and will likely be the subject of an evidentiary hearing before the court.¹⁷ For example, courts have found that there needs to be a comprehensive, but not formal, restructuring plan presented to creditors before filing.¹⁸ Other courts have looked to the extent of meetings with key creditors and efforts to develop financial solutions in order to determine whether good faith negotiations were undertaken.¹⁹

Conclusion

Chapter 9 of the Bankruptcy Code provides a vehicle for financially stressed municipalities to seek relief in and assistance from the United States Bankruptcy Court to address the serious fiscal issues currently confronting all aspects of government in the United States. However, there are many hurdles to navigate, the process is quite different from that involving chapter 11 debtors, and relief is by no means certain. Nonetheless, government officials can use chapter 9 as a tool in confronting the dilemma brought on by continual cost increases and other spending demands, in an environment where constituencies are over-taxed and other revenue sources are limited or nonexistent.

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¹ 11 U.S.C. §§ 101 *et seq.*

² 11 U.S.C. § 109(c).

³ 11 U.S.C. § 101(40).

⁴ *In re County of Orange*, 183 B.R. 594, 601 n. 16 (Bankr. C.D. Cal. 1995).

⁵ Collier on Bankruptcy, ¶ 900.02[2][a][ii] at 900-12 (15th Ed. Rev.).

⁶ Cal. Gov't Code § 53760 (2010).

⁷ Fla. Stat. Ann. § 218.01 (2010).

⁸ N.J. Stat. Ann. § 52:27-40 (2010).

⁹ N.Y. Local Fin. Law § 85.30 (2010).

¹⁰ 53 Pa. Cons. Stat. Ann. § 11701.261 (2010).

¹¹ 11 U.S.C. § 101(32)(C)(i)–(ii).

¹² *In re Hamilton Creek Metro Dist.*, 143 F.3d 1381, 1384–85 (10th Cir. 1998); *see also In re City of Bridgeport*, 129 B.R. 332, 336 (Bankr. D. Conn. 1991).

¹³ *In re City of Vallejo*, 408 B.R. 280, 290 (9th Cir. B.A.P. 2009) (requiring debtor to demonstrate, on a cash flow basis, an inability to pay debts due within the next year).

¹⁴ *Hamilton Creek Metro. Dist.*, 143 F.3d at 1385.

¹⁵ *City of Vallejo*, 408 B.R. 280 (found municipality debtor insolvent on cash flow basis based on next fiscal year budget, union negotiations, current financial activities and court also determined that municipality debtor had already cut most of its discretionary budget, reduced employee rolls and cut funding to services, and any further reductions would threaten the debtor's ability to provide the basic health and safety of its citizens); *Hamilton Creek Metro. Dist.*, 143 F.3d at 1381 (found municipality debtor not insolvent because bond interest payments were neither presently unconditionally owing nor presently enforceable and due to lack of evidence when debts were actually payable); *In re Town of Westlake, Texas*, 211 B.R. 860 (Bankr. N.D. Tex. 1997) (found municipality debtor not insolvent because it had other realistic avenues and scenarios to keep it out of insolvency, such as refiguring road expenses, negotiating with attorneys regarding attorneys fees, approaching developers, seeking business relocations and conserving and maximizing ample funds); *City of Bridgeport*, 129 B.R. at 332 (found municipality debtor not insolvent due to uncertainty of cash position due to lack of proposed budget and projections beyond two years were unreliable); *In re Pierce County Housing Author.*, 414 B.R. 702 (Bankr. W.D. Wash. 2009) (found municipality debtor insolvent with substantial personal injury based debts, expert testimony on cash shortfall and that even though it had substantial assets and cash reserves, it had limited actual funds that were not subject to pre-existing limitations and/or restrictions).

¹⁶ Collier on Bankruptcy, ¶ 900.02[2][e]] at 900-20 (15th Ed. Rev.).

¹⁷ *In re Cottonwood Water & Sanitation Dist.*, 138 B.R. 973, 979 (Bankr. D. Colo. 1992).

¹⁸ *In re Sullivan County Reg. Refuse Disposal Dist.*, 165 B.R. 60, 76–79 (Bankr. D.N.H. 1994) (finding lack of good faith where no proposed plan was presented to creditors).

¹⁹ *In re Villages at Castle Rock Metro. Dist. No. 4*, 145 B.R. 76, 84–86 (Bankr. D. Colo. 1994).