



TAMPA BAY BANKRUPTCY CENTER, P.A.

PHONE: (813) 200-4133

TOLL FREE: (800) 965-5074

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Cities Learn from Vallejo's Bankruptcy

In May 2008, the city of Vallejo (population 120,000) filed for Chapter 9 bankruptcy after failing in negotiations with unions over salary cuts coupled with much lower tax revenue due to the recession. Chapter 9 allows municipalities to reorganize their debt rather than liquidate their assets. Vallejo is the largest city in California and the second-largest local government after Orange County to file for bankruptcy.

Since 2008, the city has spent \$9.5 million in legal fees with little to show for it. On November 30, the city council approved a five year budget that allows Vallejo to pay for \$195 million in unfunded pension obligations.

The budget also outlines plans to delay payments to bondholders, cut down employee benefits, allocates \$5 million for unsecured creditors and creates a rainy-day fund. The city must also submit a bankruptcy-exit plan that includes the budget to a Sacramento court by January 18, 2011.

One thing that comes up clearly from the Vallejo experience is that it is better to find a negotiated settlement out of court. One city that successfully found an out-of-court settlement is Tracy, a city of about 82,000 residents, 60 miles east of San Francisco. The city was faced with a budget deficit of \$7.5 million when it negotiated for its police union to

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cancel remaining raises and boost the retirement age from 50 to 55 for new hires even though its contract was not up for renewal.

But the ability of US cities to file for bankruptcy depends on whether the state has statutes authorizing the filing of bankruptcy under Chapter 9 of the bankruptcy code. 25 states in the US do not have such statutes. This year, 5 municipalities sought bankruptcy protection, a drop from 10 last year. Since 1937, 619 local government bodies have filed for bankruptcy, mostly among small sewer or utility districts. In contrast, over 11,000 companies filed for Chapter 11 bankruptcy protection in 2009 alone.

When Harrisburg, the capital of Pennsylvania was contemplating filing for Chapter 9 bankruptcy due to its inability to pay \$282 million on bonds it guaranteed for a trash incinerator, Governor Ed Rendell advanced a \$3.3 million to the city for a general-obligation debt payment last September 13.

The state of Pennsylvania is contemplating whether to grant Harrisburg's application to the state distressed municipality program. Under this program, the state will help with a recovery plan that finds ways to raise revenue and streamline operations.