BY-LINED ARTICLE

# Harrisburg Filing Tests the Boundaries of Chapter 9

November 23, 2011 by Rudolph J. Di Massa, Jr. and Aaron J. Margolis

The insolvency of Pennsylvania's capital city of Harrisburg is unsurprising to anyone watching the disaster slowly unfold over the past several years. With the recent controversial filing, approved by a slim majority of the Harrisburg City Council, of a petition for bankruptcy protection under Chapter 9 of the Bankruptcy Code, the boundaries of Chapter 9 are being tested.

Aside from questions of municipal law, e.g., as to whether the Harrisburg City Council was authorized to file the petition over the objection of the mayor's office, and questions of state law, e.g., as to whether recently passed legislation barred the city's access to Chapter 9, the U.S. Bankruptcy Court for the Middle District of Pennsylvania faces a number of fundamental questions about a municipality's eligibility to file for Chapter 9.

These questions are particularly poignant, given the recent passage of state legislation authorizing the commonwealth to step in as a receiver of Harrisburg's finances, and receivership becoming a fait accompli on Nov. 14 with the city leaders' failure at a last-ditch effort to reach a consent agreement with creditors. And the questions are sure to have widespread implications, given the unprecedented degree of financial stress in the balance sheets of states and municipalities around the country.

Ultimately, the question of eligibility facing the Bankruptcy Court for the Middle District of Pennsylvania in the hearing scheduled today centers on the delicate balance, at the heart of Chapter 9, between the supremacy of federal law and the prerogative of states to manage their internal affairs.

## The Constitutional Basis of Eligibility

Chapter 9 involves the adjustment of debts of municipalities, which in turn are subject to the authority of states to manage their internal affairs. As such, principles of states'

rights pervade the text of Chapter 9 and the case law interpreting its provisions. Unless a Chapter 9 petition is voluntary, a bankruptcy court asserting jurisdiction over "powers reserved to the states" would violate the 10th Amendment.

Accordingly, bankruptcy courts are careful not to cross this jurisdictional line, as the U.S. Bankruptcy Court for the Southern District of New York explained in its 2010 opinion in *In re New York City Off-Track Betting Corp.* : "Bankruptcy courts should review Chapter 9 petitions with a jaded eye. Principles of dual sovereignty, deeply embedded in the fabric of this nation and commemorated in the 10th Amendment of the United States Constitution, severely curtail the power of bankruptcy courts to compel municipalities to act once a petition is approved."

Pursuant to these principles, there are several sections expressly limiting the court's powers once the municipality has become a Chapter 9 debtor. For example, Section 903 reserves to the states the power to control municipalities, and Section 904 limits the bankruptcy court's jurisdiction with respect to governmental powers, property or revenues, or the use or enjoyment of income-producing property.

However, as the Harrisburg petition illustrates, the filing of a bankruptcy petition alone can affect the negotiating dynamic, and raise uncertainty with respect to the authority of the state executive to address an imminent emergency; the state legislature's ability to move forward with workout mechanisms grounded in state law; and the state judiciary's jurisdiction over pending writs of mandamus. Arguably, the protections of state prerogatives in Sections 903 and 904 render additional protections in the form of a strong eligibility requirement redundant and unnecessary. To the contrary, opinions such as *Off-Track Betting* seek to harmonize the various provisions of Chapter 9 with the underlying 10th Amendment principles. Therefore, as both a functional and a formal matter, a municipality's eligibility to be a Chapter 9 debtor has important constitutional implications, which courts bear heavily in mind when scrutinizing Chapter 9 petitions.

## Eligibility Criteria Under Section 109(c)

The standard for Chapter 9 eligibility is set forth in Section 109(c), which provides that "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 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; (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; (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; (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."

The party filing the petition has the burden of establishing the elements of eligibility by a preponderance of the evidence. (See *In re City of Vallejo* , a 2008 Eastern District of California Bankruptcy Court opinion.) With respect to the Harrisburg filing, the key challenges to the city meeting its burden are first, whether under Subsection (2) the city was "specifically authorized" to file, and second, whether under Subsection (5)(B) the city negotiated in good faith with its major creditors.

Establishing specific authorization will be an uphill battle for the City Council: objections to the petition have been filed by (1) the commonwealth of Pennsylvania, arguing that the filing directly contravenes a state law prohibiting filing; and (2) the Harrisburg mayor's office, arguing that the majority of the City Council violated municipal procedures in retaining counsel and executing the filing without the mayor's authorization.

As a general matter, Pennsylvania's Financially Distressed Municipalities Act, 53 P.S. § 11701.101, et seq., commonly referred to as "Act 47," allows a municipality to avail itself of Chapter 9 if it complies with certain criteria set forth in Section 261. However, legislation passed by the Pennsylvania General Assembly and signed into law by Gov. Tom Corbett on June 30 specifically targets cities statutorily classified as "third class" cities (which include Harrisburg), and restricts these cities' access to Chapter 9 until July 1, 2012, on penalty of having their state funding suspended. The statute, known as "Act 26," provides as follows:

"(a) Scope of Article—This section applies to a city of the third class which is determined to be financially distressed under Section 203 of the act of July 10, 1987 (P.L. 246, No. 47), known as the Municipalities Financial Recovery Act.

(b) Limitation on Bankruptcy —Notwithstanding any other provision of law, including Section 261 of the Municipalities Financial Recovery Act, no distressed city may file a petition for relief under 11 U.S.C. Ch. 9 (relating to adjustment of debts of a municipality) or any other federal bankruptcy law, and no government agency may authorize the distressed city to become a debtor under 11 U.S.C. Ch. 9 or any other federal bankruptcy law.

(c) Penalty—If a city subject to this section fails to comply with Subsection (b), all commonwealth funding to the city shall be suspended.

(d) Expiration— This section shall expire July 1, 2012."

The commonwealth has argued that this statute is a specific prohibition on the filing of a bankruptcy petition, and therefore negates the requirement for specific authorization. The City Council members who filed Harrisburg's bankruptcy petition have argued that Act 26 is invalid because it violates the Equal Protection and other clauses of the Pennsylvania and U.S. constitutions, and therefore Act 47, which does specifically authorize the city to file for bankruptcy, should control.

The second key challenge is whether the city obtained the consent of the creditors; negotiated in good faith to no avail; was unable to pursue such negotiations; or reasonably believed the petition is needed to block a preferential transfer. As each of the city's creditors stands in opposition to the bankruptcy filing, negotiations with such creditors are probably not impracticable, and there does not appear to be a need to block a preferential transfer, the question comes down to whether the city has negotiated in good faith with creditors holding a majority of the total amount of claims against the city.

Negotiations in the context of various versions of an Act 47 plan have been ongoing for some time, and in this context the city—at least the constituency in favor of the Act 47 avenue— has participated in negotiations with creditors. However, it is the creditors' position that the constituency responsible for the Chapter 9 filing has consistently rejected the various Act 47 proposals, and therefore has failed to engage in good-faith negotiations. The City Council members responsible for the filing maintain that they have pursued negotiations in good faith on behalf of the city, but that the creditors have proven intransigent.

### Creditor Consent Under Act 47 Versus Chapter 9

There are a number of distinctions between a workout under Act 47 and bankruptcy under Chapter 9, but perhaps most critical is that Act 47 is consensual on the part of creditors, whereas Chapter 9 offers the potential for a "cram down" of the debtor's plan over the objections of nonconsenting creditors. To the extent the City Council members responsible for the bankruptcy filing acted within their legal authority and the city meets the standards for eligibility, the city would have a strengthened hand at the negotiating table with respect to creditors in general, and with unions in particular.

Under Act 47, creditors objecting to adjustments, e.g., in the form of extension of maturities, or reduction in the amount of principal or interest, effectively have veto power over a settlement. However, as noted above, Section 109(c)(5)(B) requires only that a

potential debtor "has negotiated in good faith with creditors and has failed to obtain the agreement of creditors" in order to meet the eligibility requirement.

Thus, the power of a recalcitrant creditor may be limited insofar as an otherwise eligible city attempts in good faith to negotiate, but the creditors are found to be unreasonable. Arguably, the move by the City Council to file for bankruptcy is a rational attempt to move the negotiations into a forum structurally more favorable to the debtor. Nonetheless, even if the City Council were to succeed in establishing eligibility and a nonconsensual plan were ultimately confirmed, this would likely prove to be a Pyrrhic victory: Investors' perception of the city's heightened risk profile would likely result in depressed prices for the city's bonds, increasing the cost of capital going forward.

Chapter 9 also provides increased leverage in negotiations surrounding collective bargaining agreements (CBAs). Section 1113 of the Bankruptcy Code, which imposes procedural protections and limitations on the rejection of CBAs in a Chapter 11 bankruptcy, does not apply in a Chapter 9 case. (See the Central District of California Bankrupcty Court's 1995 opinion in *In re County of Orange*.) Thus, rejection of a CBA in a Chapter 9 case is governed only by Section 365 and the Supreme Court's 1984 decision in *NLRB v. Bildisco & Bildisco*, which grants debtors broad discretion to reject their CBA obligations.

Again, though, this legal power exists within an institutional context that imposes major constraints on its application. As the recent experiences of the city of Vallejo, Calif., illustrate, rejection of CBAs with workers (such as policemen, teachers, firefighters, etc.) providing essential services bears a heavy cost in terms of political capital, a cost that can in certain circumstances prove prohibitive.

### Seeking A 'Less Worse' Option

The question for Harrisburg at this point is not what is the best option, but what is the "less worse" option. The city's insolvency arises not merely from cyclical factors that will presumably be resolved with an economic rebound, but also from deep structural imbalances in the city's income statement and balance sheet.

Under appropriate circumstances, where the city is specifically authorized by the state to file for bankruptcy and there is some level of consent on the part of the major creditors, Chapter 9 could provide a forum conducive to making some of the difficult decisions that need to be made. In contrast, the current circumstances place the bankruptcy court on a crash course with the commonwealth of Pennsylvania, as the commonwealth stands in direct opposition to Harrisburg's eligibility to be a Chapter 9 debtor — precisely the type of conflict between federal and state authority that Chapter 9 seeks to avoid.

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