

Introduction to Municipal Bankruptcy

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Chapter 9 allows municipalities to restructure and reorganize their assets and debts while providing relief from current and future obligations. This enables municipalities to have a “fresh start.” There are three local governments in California that have filed for municipal bankruptcy: Orange County (1994), City of Desert Hot Springs (2001), and, most recently, the City of Vallejo.

This brief analysis will provide an overview of the vocabulary associated with Municipal Bankruptcy, the process involved with filing and reorganizing debt, and the “need-to-knows” of Chapter 9 proceedings. This review is an overview of municipal bankruptcy and is not meant to be an exhaustive look at Chapter 9.

Municipal Bankruptcy Vocabulary

Table 1 below explains some of the relevant vocabulary of municipal bankruptcy

Table 1	
Vocabulary of Municipal Bankruptcy	
Chapter 9	Title 11 of the U.S. Bankruptcy Code section that determines the ability of municipalities to file for bankruptcy.
Insolvency	Insolvency in Chapter 9 is on a cash flow basis. The condition is met when "the municipality is (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due." 11 U.S.C. § 101(32)(C)
Municipality	“A political subdivision or public agency or instrumentality of a State.” 11 U.S.C. § 101(40)
Executory Contract	A contract between a debtor and another party, which if ended would be a breach of contract, e.g. real estate agreement.
Plan of adjustment	A plan for the municipality filing bankruptcy to adjust debts.

Stage 1: Eligibility

To be eligible to file bankruptcy under Chapter 9 the following must be met:

1. The entity in question must be a municipality
2. The municipality must have authorization by the state to be a debtor

3. The municipality must be insolvent on a cash-flow basis
4. The municipality must desire to adjust its debts
5. The municipality must demonstrate one of the following:
 - a. Obtained the approval of a majority of creditors in each class ; or
 - b. Negotiated in good faith with creditors and failed to obtain their agreement; or
 - c. Be unable to negotiate with creditors because such negotiations are impracticable; or
 - d. Reasonably believe that a creditor may attempt to obtain a preferential transfer.

Stage 2: Bankruptcy Proceedings

Once a municipality determines it is eligible to file bankruptcy, proceedings commence through the filing of a voluntary petition, a schedule of creditors, and a pleading, which demonstrates eligibility to file.

From this initial filing, the following are important points to remember:

- A municipality is able to continue with its operations through expenditures and management and also maintains the full use of its property in the “ordinary course of business.” In addition, a municipality is able to borrow monies without Court consent.
- Creditors are able to file a proof of claim with the Bankruptcy Court on all amounts owed.
- Officials are able to remain in power without court-supervision of daily activities.
- Burdensome executory contracts may be rejected.
- A municipality is not exempt from State and Federal legislation and regulation.

Stage 3: Adjustment of Debt

The municipality must file a **plan of adjustment** for its debts shortly thereafter. This plan of adjustment classifies claims in accordance to priority placed upon them through State and Federal law. With each classification of claims, the plan of adjustment provides a way in which that class can be adjusted (through payment in full, payment over time, exchange, or rejection). Each classification of claims votes in favor of the plan of adjustment. Before a plan is confirmed, it must prove to be feasible and in the best interest of creditors. If these criteria are met, even without the required votes, a Court can confirm a plan.

Two things occur when a municipality's plan of adjustment is confirmed:

1. The municipality is discharged from claims not provided for; and
2. The municipality emerges as a new entity, in accordance with the terms of its plan of adjustment.

Chapter 9 “Need-To-Knows”

- The recent *Vallejo* bankruptcy case has shown that labor contracts can be voided in municipal bankruptcy proceedings. It was determined that collective bargaining contracts can be a burdensome executory contract.
- Entering into bankruptcy is not a low-cost endeavor. In the 1994-1996 Orange County bankruptcy, professional fees cost the County over \$100 million. With this, there are also risks to credit ratings, which could force the municipality into higher interest rates.

Suggested Reading

Adams, Frank C., Dennis Bezanson, and Michael Thomas. “Municipal Bankruptcy Hot Issues.” *The Public Law Journal* 32.3 (Summer 2009): pages 13-15.

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