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Chapter 9 Municipal Bankruptcy: The New "New Thing"? Part I

By Henry C. Kevane

Chapter 9 has entered the conversation again—municipal bond funds have swooned, Congress is considering whether to permit states to seek federal bankruptcy protection, and public employee wages, pensions, and benefits are in the crosshairs. The City of Harrisburg publicly flirted with a Chapter 9 filing and Boise County, Idaho, filed a Chapter 9 case on March 1, 2011, after suffering a $4 million judgment under the Fair Housing Act. Jefferson County in Alabama is also navigating murky waters after using complex derivatives to hedge interest rate risks on sewer revenue bonds. And Indiana is considering new legislation to permit its municipalities to seek bankruptcy protection. It is perhaps only a matter of time before residents and taxpayers begin to follow the fiscal travails of their cities on Twitter and Facebook.

For years, Chapter 9 was considered the option of last resort, triggered mainly by true emergencies (such as Orange County, in 1994), or when municipalities emulate businesses that are otherwise troubled (such as health care districts in rural or underprivileged areas). Indeed, over the past 77 years since the enactment of Chapter 9 in 1934 there have been only about 600 Chapter 9 filings. Now, Chapter 9 is back in vogue as a potential solution to long-term structural imbalances caused by ballooning public employee benefits and flattened revenues.

The Role of the Bankruptcy Court

Unlike private sector bankruptcies under Chapters 7 and 11 of the Bankruptcy Code, the bankruptcy case of a public agency under Chapter 9 is largely conducted without significant court involvement. Indeed, the term "bankruptcy" is really a misnomer for a Chapter 9 case. Bankruptcy courts do not hear and determine the various operating disputes common to corporate cases; rather, the principal functions of the Bankruptcy Court are to oversee the entry (by determining eligibility) and exit (by confirming a plan) of a municipality from federal bankruptcy protection. Otherwise, the court is mostly a bystander to the daily affairs of the Chapter 9 municipal debtor. By contrast, in a Chapter 11 case, the court and other parties in interest will review virtually every transaction outside the ordinary course of business. The U.S. Trustee, likewise, has only one function in a Chapter 9 case—to appoint a creditor's committee. (Actually, the legislative history suggests that since "Chapter 9 does not provide for involvement of the U.S. Trustee in the administration of municipal bankruptcies, in Chapter 9 cases, the court will be responsible for the appointment of members of creditor committees." S. Rep. No. 100-506, at 12 (1988)).

These limitations arise because of the interplay in a Chapter 9 case between two constitutional mandates. On the one hand, as instrumentalities of a state, Chapter 9 municipal debtors necessarily enjoy substantial freedom from federal interference. This freedom derives from the Tenth Amendment to the Constitution, which provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." According to the Supreme Court, the Tenth Amendment determines the boundary between state and federal authority and was designed to be declaratory of the relationship between the national and state governments. As the Court stated in New York v. United States, 112 S. Ct. 2408, 2418–19 (1992), the "Tenth Amendment itself is essentially a tautology. . . In the end, just as a cup may be half empty or half full, it makes no difference whether one views the question at issue . . . as one of ascertaining the limits of the power delegated to the Federal Government under the affirmative provisions of the Constitution or one of discerning the core of sovereignty retained by the States under the Tenth Amendment. Either way, . . . we must determine the boundary between federal and state authority."

On the other hand, only federal law can overcome the constitutional prohibition on the impairment by states of the obligation of contracts (U.S. Const., art. I, § 10, cl. 1), or otherwise override contrary state law. U.S. Const., art. I, § 8, cl. 4 (uniform laws on bankruptcies); and art. VI, cl. 2 (Supremacy Clause). Thus, the powerful debt restructuring tools under the Bankruptcy Code—such as the automatic stay, the avoidance of preferential transfers, the rejection of contracts, the disallowance of claims and the confirmation of plans through binding majority vote—are available exclusively in federal court.

Balancing State and Federal Powers

As a result of the tension between these two constitutional imperatives, Chapter 9 was carefully crafted by Congress to accommodate both the reserved sovereign rights of the states and the debt adjustment powers of federal law. This accommodation is reflected both in certain unique provisions of Chapter 9 and in the omission of selected bankruptcy provisions from Chapter 9. According to the legislative history, the 1978 amendments to Chapter 9 were drafted in deference to developing ideas of Federalism.

First, the eligibility of a municipality to seek federal relief is committed to the exclusive control of each state. In 1994, Congress amended the Bankruptcy Code to require that municipalities be "specifically authorized" under state law to file a petition under Chapter 9. Previously, a municipality was eligible if it was "generally authorized" to file. Moreover, under In re County of Orange, 183 B.R. 594, 604-05 (Bankr. C.D. Cal. 1995), courts may "no longer find the requisite authorization for the filing by implication. The amendment requires that the state give the municipality express authority to file . . . . Since a state acts by statute, the authorization obviously would be recorded in writing. It also must be exact, plain, and direct with well-defined limits so that nothing is left to inference or implication." A prior legislative act is not strictly necessary, however—authorization to file may also derive from a governmental officer otherwise empowered by state law to permit a particular entity to commence a Chapter 9 case. *In re New York City Off-Track Betting Corp.*, 27 B.R. 256 (Bankr. S.D.N.Y. 2010).

By amending the eligibility statute, Congress expressly invited each state to revisit the types of local agencies that may seek federal relief. Although many states currently permit Chapter 9 cases, some with detailed pre-conditions or prior consent, almost half the states either prohibit or do not expressly permit the bankruptcy option. Various states currently use a gatekeeper to regulate entry to Chapter 9. Connecticut requires the prior written consent of the governor and New Jersey requires the prior approval of a municipal finance commission. Kentucky requires the pre-approval of a proposed plan by certain state officers before a county may file; Louisiana requires the pre-approval of the bankruptcy petition by the governor and the attorney general; and Pennsylvania has a detailed list of bankruptcy triggers. Given the extraordinary proliferation of local agencies in California (according to some estimates, California has over 7,000 local government agencies), certain special or limited purpose entities are expressly barred from access to federal bankruptcy courts. For example, the California Earthquake Authority "is not and shall never be authorized to become a debtor in a case under the United States Bankruptcy Code."

Second, Chapter 9 is designed to permit, if not encourage, active state involvement in the post-bankruptcy affairs of the municipality. Section 903 of the Bankruptcy Code, for example, provides that (with certain limited exceptions) the provisions of Chapter 9 do not "limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise." Bankruptcy Rule 2018 also permits the state to freely intervene in any Chapter 9 case "with respect to matters specified by the court." And section 943(b)(6) prohibits confirmation of a plan of adjustment unless the debtor has obtained any electoral approval necessary to carry out the plan.

It is a fundamental precept of municipal law that local agencies, created by the state, exist principally as instrumentalities for the orderly and convenient exercise of state powers and the delivery of state services. According to the California Constitution, for example (Cal. Const. art. XI, § 1(b)), the "Legislature shall provide for county powers." Local agencies, thus, are creatures of only limited and enumerated powers. As put forth in 121 Cong. Rec. H39412 (daily ed. Dec. 9, 1975), "the municipality is a creature of State law, and operates by virtue of the delegation of power from the State." Based on this precept, it seems indisputable that the state may, at its pleasure, modify or withdraw any delegated powers and exercise them directly. During the Orange County Chapter 9 case, this principle, in conjunction with section 903, was used to pass legislation authorizing the appointment of a trustee over both the county and its creditors in order to promote a consensual plan.

The Orange County statute specified the conditions for the appointment of a trustee by the governor and further provided that, in that event, "all powers granted to the county board of supervisors shall be withdrawn and delegated to the trustee." Cal. Gov't Code §§ 30402(a). The trustee was specifically empowered to oversee the Chapter 9 case and file a plan of adjustment. In recognition of the fact that the county's day-to-day affairs were likely beyond the scope of a trustee's expertise, the statute authorized the trustee to retain or re-delegate specified powers to the board of supervisors, as necessary or appropriate to the "most effective action for resolving the pending case." Further, and most importantly, the trustee was authorized to assume and exercise certain powers of the (over 200) local agencies asserting claims against the county based on losses stemming from the failure of its investment pool. Specifically, the trustee would have the ability to vote, on behalf of the affected local agencies, to accept or reject the county's plan of adjustment and subordinate or otherwise restructure the claims against the county. Although seemingly broad, these powers were limited to those actions necessary and proper to achieve the timely confirmation of the county's plan. Ultimately, no trustee was appointed and the county confirmed a consensual plan—the potential, however, for the state to accelerate the plan process by essentially agreeing with itself was probably helpful.

Third, other provisions of Chapter 9 render certain municipal decisions largely immune from court review or creditor scrutiny. A Chapter 9 case may neither be commenced involuntarily by creditors nor converted to another case under the Bankruptcy Code. Section 904 prohibits the Bankruptcy Court from interfering, "unless the debtor consents or the plan so provides," with any of the debtor's political or governmental powers, property or revenues, or use or enjoyment of income producing property. In addition, section 363 of the Bankruptcy Code, concerning the use or sale of property, is omitted from Chapter 9, as are sections 327 and 330 (concerning the employment and compensation of professionals), and section 1107 (concerning reporting duties). Hence, a Chapter 9 debtor has significant latitude to pay pre-petition claims on a current basis or to defer payment until the effective date of the plan. The Bankruptcy Court may not appoint a trustee to manage or control the debtor (except in very limited circumstances to pursue avoidance actions) or compel a liquidation of municipal assets. Nor can the Bankruptcy Court appoint a receiver in a Chapter 9 case (or in any other case for that matter—11 U.S.C. § 105(b)). Moreover, only the municipality can propose a plan of adjustment; creditor plans are not permitted. The sole effective remedy for disgruntled creditors is dismissal of the case.

Commencing a Chapter 9 Case

Section 904 presents a formidable constraint on creditors' remedies. In the Orange County case, for example, although the county often sought court approval for certain actions taken in the case, it seldom missed an opportunity to remind potential objecting parties that, under section 904, it likely could proceed with the planned action absent court approval. And section 904, coupled with the absence of section 331 from Chapter 9, was the basis for the Bankruptcy Court's early opinion that it lacked the power to compel interim payments to professionals without the County's consent. *In re County of Orange*, 179 B.R. 195 (Bankr. C.D. Cal. 1995). In another opinion in the Orange County case, however, 179 B.R. 185, 190 (Bankr. C.D. Cal. 1995), the Bankruptcy Court concluded that it had the power to order the County to provide adequate protection without "unduly encroaching on the county's ability to conduct its affairs free from court interference."

A Chapter 9 debtor, thus, has the virtually unfettered right (1) to determine whether and when a bankruptcy case will be filed, (2) to manage its own affairs and property during the pendency of the case, and (3) to file a plan of adjustment during a virtually perpetual exclusive period. Although a municipality controls its decision to commence a case, an order for relief does not follow automatically from the filing of a petition, like other chapters of the Bankruptcy Code, but is subject to creditor review and court ratification.

An entity must meet fairly stringent eligibility requirements in order to commence a Chapter 9 case, and must file its petition in good faith. If the entity is not eligible to file, the Chapter 9 petition must be dismissed. The eligibility requirements are set forth in a 5-prong test under section 109(c) of the Bankruptcy Code: (1) the debtor must qualify as a municipality (a political subdivision or public agency or instrumentality of a state that, generally speaking, exhibits the traditional attributes of sovereignty, such as the police power, the power to tax, or the right of eminent domain), (2) the debtor must be specifically authorized by state law to file, (3) the debtor must be insolvent, (4) the debtor must genuinely seek to effect a plan, not merely frustrate or delay creditors; and (5) the debtor must have first tried to avoid filing for bankruptcy (by negotiating with creditors, unless impractical or infeasible).

Recently, in 2008, the City of Vallejo filed a Chapter 9 petition that was vigorously contested by certain of its public employee unions. After a trial, the Bankruptcy Court determined that the city was eligible to be a debtor under Chapter 9—the unions appealed on the principal ground that Vallejo was not insolvent. For a municipality, the insolvency test focuses on the debtor's failure or inability to pay its debts as they become due, a rather fact-intensive, totality-of-the-circumstances inquiry. The unions claimed that, through a combination of budget cuts, wage compromises and contract modifications, the city could have operated for at least another year or possibly longer and, hence, was not definitively insolvent as of the petition date. The Bankruptcy Court and the appellate panel each rejected this "stopgap" approach to solvency, taking a prospective, long term view that a municipality is not required to run out of funds and actually default before it is deemed insolvent. In re City of Vallejo, 408 B.R. 280 (B.A.P. 9th Cir. 2009).

Creating an Exit Plan

Once it passes the eligibility gauntlet, the municipality must then turn its attention to its exit strategy. Despite the recent dire prediction by a prominent financial analyst of a wave of municipal defaults totaling "hundreds of billions of dollars," it remains unclear whether Chapter 9 is an effective tool to comprehensively restructure municipal bond debt. Several common forms of bond debt are largely insulated from the impact of a Chapter 9 filing. Moreover, the ability to restructure public employee obligations, while possible under Chapter 9, would likely entail the acceleration of claims that would then require treatment under a plan, and be subject to a vote by the same public employees whose obligations were modified. These topics will be further explored in Part II of this article.

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