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# Municipal Bankruptcy: Using and Avoiding Chapter 9 in Times of Fiscal Stress

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Status: **Maintained** | Jurisdiction: **United States**

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A Practice Note providing an overview of Chapter 9 for those who manage and govern municipalities and for their creditors. This Note discusses how to avoid a Chapter 9 bankruptcy filing, as well as how to successfully navigate a Chapter 9 bankruptcy case and emerge in stronger financial health.

Municipalities are increasingly caught between the cost of providing basic services, preserving and building infrastructure, paying debt service, and fulfilling their obligations to retirees on one hand, and declining property, sales, and other local tax revenues, exacerbated by the novel coronavirus disease (COVID-19) pandemic on the other. Raising taxes to satisfy such obligations is subject to additional obstacles, particularly when a public vote is mandated by law. In the face of these pressures several municipalities have sought protection under Chapter 9 of the Bankruptcy Code in recent years. For example, since 2008, the following municipalities have commenced Chapter 9 cases:

- City of Hillview, Kentucky, August 2015.
- City of Detroit, Michigan, July 2013.
- City of San Bernardino, California, August 2012.
- Town of Mammoth Lakes, California, July 2012.
- City of Stockton, California, June 2012.
- Jefferson County, Alabama, November 2011.
- City of Central Falls, Rhode Island, August 2011.
- City of Vallejo, California, May 2008.

This Note addresses strategic considerations for municipalities that are considering entering into Chapter 9. For information on creditor issues in a Chapter 9 case, see Practice Note, Representing Creditors in Chapter 9 Bankruptcy Cases.

## Avoiding Chapter 9

Filing for bankruptcy protection under Chapter 9 should be considered a last resort, only taken after every effort has been made to avoid it. There are significant downsides to a bankruptcy filing, including:

- Impaired access to the capital markets over a potentially extended period of time.
- The cost of professionals.
- The time that both staff and elected officials must spend on the process.
- The stigma and credit implications for the community going forward.

The problems that brought the municipality to the point of filing for bankruptcy eventually must be resolved, whether inside or outside of bankruptcy. It is far less costly and distracting if it can be done outside of bankruptcy.

### Assessing the Problems

The first step in avoiding Chapter 9 is to assess the underlying problems that may be pushing the municipality toward bankruptcy. The degree of self-awareness and transparency among municipalities can vary widely and, for some, the main impediment is getting a handle on the specific factors that are driving revenues down and expenses up, as well as acknowledging that temporary measures, creative accounting, and denial generally make a municipality's problems worse.

Municipalities that have been forced to the brink of, or into, bankruptcy, generally experience the challenge of either a one-time financial issue or systemic structural issues. The COVID-19 pandemic combines elements of both an extraordinary one-time financial crisis with the potential for longer-term structural deficits should revenue losses resulting from related economic and social dislocations be prolonged while needs, and associated



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costs, escalate. COVID-19 may, therefore, prove to be a unique driver of municipal bankruptcy.

### One-Time Financial Issue

A large, one-time financial hit that cannot be absorbed by the budget or paid for from reserves can force a municipality to seek bankruptcy protection. Fiscal stress related to one-time events generally can be resolved by financing the cure costs over a period long enough to absorb the costs over time. While bankruptcy protection may be necessary to buy time to accomplishing a financing and to delay disruptive collections efforts such as writs of mandate or the possible forced liquidation of collateral, the municipality should try to convince creditors to be patient so as to enable it to avoid incurring the significant costs associated with a bankruptcy filing.

Examples of these one-time events include:

- A sudden and catastrophic investment loss (as in Orange County, California).
- A large judgment rendered against the municipality (as in Town of Mammoth Lakes, California).
- Embezzlement of public funds by officers or employees of a small municipality.

### Structural Financial Issues

A bankruptcy filing may be precipitated by a structural operating deficit. An operating deficit can be catastrophic if it continues long enough to burn through reserves and is not resolved by revenue increases or quick spending cuts that enable the municipality to meet necessary and fixed expenses, such as debt service and payroll.

A municipality with a structural operating deficit could be pushed into bankruptcy by a relatively small, one-time expense or drop in revenues, as it may have little or no cushion available to absorb even a modest setback. Fiscal stress related to ongoing structural deficits and lack of reserves is much more difficult to tackle than a one-time event because a financing has little impact on solving underlying structural problems. In fact, this tactic can make things worse by postponing the issue, leading to increased overall monetary and nonmonetary costs to the municipality, such as painful cuts in service levels or in employee compensation, and increased professional fees.

If increasing revenues through higher taxes or fees is not possible, municipalities may need bankruptcy protection to avoid immediate sanctions for breach of contract, including for failing to honor labor agreements, missing debt service payments, or failing to provide required levels of service.

Examples of Chapter 9 cases filed because of structural financial issues include:

- City of Detroit, Michigan.
- City of Vallejo, California.
- City of Stockton, California.
- City of San Bernardino, California.

## Treasury Funds

Most municipalities maintain many separate funds within their treasuries. Some funds have a general purpose, and others have a particular function and source of revenue, that may be subject to legal or grantor restrictions regarding its use. Many states require that these special funds be held in trust and do not permit them to be diverted for unrelated uses. Similarly, some funds may be restricted for particular uses by the terms of grants, statutes, or regulations.

Counsel must carefully analyze the various funds held by the municipality to determine which, if any, may be legally used for other purposes, and how limitations on the uses of funds affect the municipality's true available cash position. While these funds often are commingled into a pooled cash account for investment purposes, a significant positive balance in pooled cash can mask a serious problem in the municipality's underlying financial condition.

This was the case in the City of Vallejo, California Chapter 9 case, in which several of the unions unsuccessfully contended that restricted funds could be lawfully used to pay employees (see *In re City of Vallejo*, 408 B.R. 280, 285 (B.A.P. 9th Cir. 2009)).

### General Funds

Typically, only the use of the municipality's general fund is completely unrestricted. Municipalities commonly use their pooled cash accounts as a source of cash flow within a fiscal year to carry funds that have intra-year cash inflows that do not match their cash outflows. However, the budget and reserves must be sufficient to ensure that at the end of the fiscal year, restricted funds are not in a position of having funded items not permitted by their restrictions.

For example, the general fund may receive large infusions of cash from property tax revenues twice a year but have a monthly cash outflow that is relatively even. The municipality might use pooled cash to cover cash outflow deficits during a single fiscal year but would need to ensure that the general fund makes up the difference from cash inflows by the end of the fiscal year.

### Restricted Funds

When the budgeted revenues for a general fund do not meet budgeted expenditures and there are insufficient reserves to cover the shortfall, the use of restricted funds in pooled cash could violate the restrictions imposed on the special funds. Often these imbalances are not apparent until the fiscal year is well underway and it becomes clear that projections of revenue and expense will not be met.

While municipal financial officers generally have immunity from personal liability for official acts, this immunity does not necessarily extend to knowing violations of the law. Therefore, a municipal finance officer should not permit advances from restricted funds from year to year if the amounts cannot be restored from budgeted revenues or reserves by the end of the fiscal year.

## Cash Position

A municipal official who requires or even permits employees to come to work when the official knows that the municipality will be unable to pay them may be violating state labor laws or committing common law fraud. In some states, this even may be a criminal offense. A municipality that appears to be headed for insolvency, therefore, must monitor its cash position, particularly in the funds that are projected to go negative before the end of the fiscal year, so that it can determine whether it will run out of operating funds. In such a case, use of restricted funds in pooled cash could be an unlawful violation of the restrictions imposed on the special funds.

For example, municipal employees are most often paid from general funds and cannot lawfully be paid from any restricted fund unless the employee's duties support the special fund's activities. If the general fund cannot achieve at least a zero year-end balance without using legally restricted funds in pooled cash, the municipality could face the choice of either breaking the law by:

- Using restricted funds for an impermissible purpose.
- Failing to pay contracted-for wages after work has been performed.

If either of these occurs with foreknowledge by the municipality's managers or governing body, normal governmental immunity for official acts may not protect such officials from personal liability. This issue becomes important with respect to the timing of a bankruptcy filing (see Timing).

## Acknowledgment by Stakeholders

A key ingredient to solving a municipality's fiscal problems is to clearly and transparently communicate the nature and scope of the challenges to all potentially affected stakeholders to enable them to understand and acknowledge the problems. Managers and political leaders should insist on clear and open disclosure of the financial data and related facts, and they should make sure that stakeholders receive all relevant information and have an opportunity to ask questions and offer solutions. The following are decisions that stakeholders must make:

- **Officers and governing body.** Leaders of the ailing municipality must make hard decisions about ongoing projects and programs that may have to be postponed, scaled back, or cancelled to free up cash. These are often painful political choices, but the looming possibility of a bankruptcy filing can serve as a catalyst for consensus.
- **Banks, bondholders, and credit enhancers.** Creditors may be willing to restructure long-term debt to avoid forcing a municipality into bankruptcy. Attempts should be made to approach these stakeholders with clear and transparent information. Often an intermediate forbearance agreement is reached under which the creditors agree not to declare a default or take remedial action against the municipality for a specified period of time while the parties attempt to reach a negotiated settlement (see Practice Note, Forbearance Agreements: Key Issues and Provisions).
- **Labor organizations.** If payroll costs or benefits are a key component of the municipality's fiscal stress, the municipality should engage its labor law advisors to assist in resolving these problems. There can be many restrictions on revising labor agreements outside of insolvency, even if the agreements are pushing the municipality toward bankruptcy. However, if all parties realize that failure to modify these agreements would likely land the municipality in bankruptcy, they may be willing to work together to modify the agreements. Although bankruptcy may provide more flexibility in dealing with labor agreements, it is not a complete solution. Therefore, every effort should be made to reach an agreement for a workable arrangement for the municipality before deciding to file. For example, in the City of Stockton, California, Chapter 9 case, the city was unable to avoid bankruptcy, but it did reach agreement with eight of its nine unions either immediately before or after the bankruptcy filing. The final union made a deal five months later. (See *In re City of Stockton*, 542 B.R. 261 (B.A.P. 9th Cir. 2015).)

- **Retirees.** A municipality's largest claims often are held by retirees, including pensions and other postretirement employment benefits, such as health care. Resolving these claims is critical to both the municipality, due to the size of the claims, and to the claim holders, many of whom cannot offset the losses by obtaining new employment. Since retirees are no longer represented by unions, they are treated as individual creditors in bankruptcy. And while a committee may be appointed to represent retirees' interests, the committee cannot bind them. Each retiree must individually vote to accept or reject whatever treatment is eventually proposed in a plan of adjustment. Therefore, due to sheer numbers (there were over 1,000 retirees in each of the Vallejo, Stockton, and Detroit cases) pre-bankruptcy negotiations with retirees may be impossible.

## Advantages of a Chapter 9 Filing

Filing a Chapter 9 case initially provides a municipality with some breathing room to address and restructure its financial and other related obligations without having to fend off multiple creditor lawsuits, including those that seek the appointment of a receiver regarding assets such as cash flow or interests in leases that have been pledged to support bonds or other financings. It also provides a single forum in which all creditors must participate to resolve the municipality's fiscal problems.

### Automatic Stay

The filing of a Chapter 9 bankruptcy case triggers an injunction against actions that might have been taken in the past or might be taken in the future by creditors or others against any of the following:

- The municipality itself.
- The municipality's:
  - officers; and
  - inhabitants.

The automatic stay applies to any act (that is, not just to new and existing lawsuits) that could otherwise be taken against the municipality, its officers, or others on account of a debt of the municipality (§§ 362(a) and 901(a), Bankruptcy Code). The Chapter 9 automatic stay is broader than that under Chapter 11, extending the injunction to acts against officers and to all inhabitants of the debtor municipality (§ 922(a), Bankruptcy Code). Even if the municipality or other protected person takes (or fails to take) actions related to claims against the municipality that would otherwise subject them to sanctions or liability in state or federal court or by regulatory bodies, those actions may not proceed without the claimants first obtaining relief from the automatic stay in the bankruptcy court. The stay lasts throughout the Chapter 9 case, but the bankruptcy judge can modify or terminate the stay for cause shown.

For more information on the mechanics of the automatic stay in Chapter 11, see Practice Note, Automatic Stay: Overview. For a comparison of the automatic stay under Chapter 9 and Chapter 11, see Chapter 9 v. Chapter 11 Comparison Chart: Case Administration.

### Breathing Space

Bankruptcy affords the debtor breathing space during which it can continue to function while it tries to work out its creditor and cash flow problems, including time to:

- Raise new revenues.
- Renegotiate contracts.
- Restructure debt obligations.

If a municipality is forced to breach contracts or face other legal claims caused by fiscal stress outside of bankruptcy, it may have to spend time fighting off creditors trying to seize assets or obtain writs of mandate. The municipality could even be forced into regulatory or other state fora to answer for these actions and redress grievances before it can fashion a workable solution for the benefit of all creditors and residents.

The Chapter 9 case serves as the vehicle for all these disputes to be addressed in one forum, and the automatic stay provides the municipality the opportunity to focus on a comprehensive solution rather than simultaneously fighting battles on multiple fronts.

### Access to an Expert Arbiter

Bankruptcy judges are experts in financial restructuring, including negotiating and arbitrating complex debtor/creditor and intercreditor disputes. While Chapter 9 filings are rare, bankruptcy judges consistently see similar issues in the private sector and generally are well-equipped to help the parties arrive at workable compromises. The judge who presides over a Chapter 9 case is appointed by the chief judge of the relevant circuit court of appeals. Unlike how judges are assigned randomly in cases under other chapters of the Bankruptcy Code, a Chapter 9 case will likely be assigned to one of the most qualified and experienced judges within the applicable federal circuit. The value of a highly qualified and experienced judge in helping the stakeholders get to a solution should not be underestimated. For a comparison on the assignment of a bankruptcy judge under Chapter 9 and Chapter 11, see Chapter 9 v. Chapter 11 Comparison Chart: Commencing the Case.

In many Chapter 9 cases (i.e. Vallejo, San Bernardino, Stockton, Mammoth Lakes, and Detroit), the judge appointed a mediator or mediators. The mediators are often bankruptcy judges from another district or retired bankruptcy judges. As Judge Christopher Klein, who oversaw the Stockton, California Chapter 9 case, said, "Given the restrictions that are in Chapter 9, it's the Chapter 11 negotiating model on steroids" (Bankruptcy Judges Share Insight on Chapter 9 Eligibility, Wall Street Journal, Aug. 12, 2013). Having an experienced and respected neutral party to help guide and push along these negotiations can be effective in getting the parties to understand the strengths and weaknesses of their positions and reach a reasonable settlement before confirming a plan of adjustment.

### Ability to Adjust Obligations

Most bankruptcy and municipal finance experts view the ability to adjust debts and other obligations as the prime benefit of a bankruptcy filing. If a Chapter 9 plan of adjustment can be confirmed, it may provide that creditors' unpaid claims be reduced or extended and restructured. There are limitations on how these adjustments can be made, and creditors could block a debtor from making the adjustments it would like. However, in situations where the debtor cannot fully repay all creditors without some sort of debt relief, the plan of adjustment can provide a fresh start and enable the municipality to achieve long-term financial stability.

## Disadvantages of a Chapter 9 Filing

There are many misconceptions about the usefulness of a bankruptcy filing in addressing municipalities' extreme financial problems. While bankruptcy clearly provides certain benefits for municipalities that cannot otherwise solve their fiscal problems, it comes with some significant downsides.

### Reaction of Credit Markets

A municipality contemplating bankruptcy relief should expect the immediate suspension or severe downgrade of its credit ratings on filing. If bondholders are not fully repaid, this credit stigma may last for many years. However, it also is possible for a municipality to have its credit standing restored to robust levels within only a few years of emerging from bankruptcy.

Municipalities should expect intense scrutiny from their capital markets creditors and rating agencies. The best way for a municipality to restore its credit rating is for it to provide timely and transparent information about its financial condition to parties in interest and to the public. Establishing a track record of providing trustworthy information, even unfavorable information, is necessary if a municipality expects to emerge from bankruptcy and reestablish an acceptable credit rating. However, this takes time and resources when the municipality's staff is under tremendous stress. Municipalities must take this strain into account when weighing the pros and cons of a filing.

### Cost and Distraction

Filing and prosecuting a Chapter 9 case is very expensive. Legal and financial consulting fees can easily climb into seven figures or even more for large municipalities with complex capital structures, such as the City of Detroit and the City of Stockton. Every dollar spent on these costs is a dollar that cannot go toward resolving the municipality's underlying financial problems or compensating creditors. Unless stakeholders can come to a negotiated settlement that avoids bankruptcy, these costs ultimately will consume funds that otherwise could be more productively used. If the municipality pursues a Chapter 9 case, reaching settlements with creditors before filing a plan greatly reduces the cost of the case, as does avoiding a contested plan confirmation trial. Therefore, an effective court-appointed mediator can be critical to a successful Chapter 9 case.

Another component of the high cost of a Chapter 9 is the opportunity cost expended by taking valuable senior staff time away from solving core problems and directing them to managing and responding to the demands of the case itself. Most municipalities that enter Chapter 9 already are working with a lean staff that was reduced to avoid insolvency. The demands of dealing with a bankruptcy case can be a major distraction from the core work the staff must do to keep the organization functioning. The bankruptcy generated tasks include:

- Preparing for and attending hearings and depositions.
- Working with counsel on motions and other pleadings, including a plan of adjustment.
- Working with counsel and financial professionals on data and projections necessary to formulate and confirm a plan.

- Responding to requests for information and documents from:
  - the municipality's counsel;
  - creditors;
  - rating agencies;
  - collective bargaining units;
  - elected officials;
  - the media; and
  - the public.

A municipality contemplating a bankruptcy filing should have a clear plan for how to address these issues going in so that the demands of the case do not overwhelm the organization as it tries to function.

### Stigma on the Community

A Chapter 9 bankruptcy often is viewed with disdain by residents, employees, the media, trade creditors, and the capital markets and that perception can affect the self-esteem of residents and have an adverse impact on the overall business climate in the community. For example:

- New businesses may be reluctant to locate there.
- Real estate sales may be affected.
- General economic conditions may be depressed.

This stigma could linger for a period after the municipality emerges from the bankruptcy with a confirmed plan of adjustment. The bankruptcy filing is not the cause of the municipality's problems, but rather a symptom of its having been unable to solve them in any other way. In the end it is the underlying financial health of the municipality, including its ability to deliver services and promote a strong community, that really matters. However, a municipality that cannot pay its current obligations even after reducing the number of employees and the services it provides residents may have no alternative to seeking Chapter 9 protection because new borrowing or refinancing is unavailable and a new tax has little or no chance of voter approval.

## Preparing for Chapter 9

Once bankruptcy is inevitable, the municipality should spend as much time as possible preparing for the bankruptcy filing and the likely opposition, including litigation, from those creditors and parties in interest who may oppose bankruptcy relief. The better prepared the municipality is going into the case, the sooner it will emerge with a confirmed plan.

### Importance of Negotiations

Once the municipality's finances are in crisis, the municipality must begin negotiations with creditors and stakeholders to avoid insolvency and a bankruptcy filing. In fact, good faith negotiations are a legal prerequisite to filing a Chapter 9 case. Even if the municipality already has determined that it likely will be forced to file for bankruptcy protection, it should continue to try to negotiate with key creditors to avoid that result, and carefully document the steps taken to reach agreement (§ 109(c)(5), Bankruptcy Code). Robust, good faith, prepetition negotiations likely will set the stage for more efficient and successful negotiations over a plan of adjustment following the filing.

A municipality need not accept a short-term fix that only defers an inevitable bankruptcy. However, if a creditor proposes one, the municipality must analyze it carefully and make sure it can demonstrate that the proposal would not solve the municipality's problems sufficiently to avoid short-term and long-term insolvency. For example:

- Renegotiating a long-term debt obligation by deferring interest or other payments for a year is of limited value if, on the first anniversary of the deferral, the municipality would be unable to satisfy the revised obligation.
- Accepting one-time concessions from a labor union to avoid insolvency in the short term is unworkable if that would merely extend an unsustainable labor agreement, making insolvency inevitable and deepening the municipality's deficit.
- Taking out deficit financing, which provides funds for a limited time to plug a budget hole, without a clear path for repayment from reasonably foreseeable budgetary resources in the future will only make matters worse.

### Authorization to File

A municipality is eligible for Chapter 9 only if its governing body specifically authorizes it (§ 109(c)(2), Bankruptcy Code). Local law determines what form this authorization must take, but the typical approach would be by resolution adopted by the governing board in an open meeting. In many states:

- Usually, discussions with counsel leading up to and after a Chapter 9 filing usually are conducted in closed or executive sessions (under the litigation exception to most open meeting laws) to preserve privilege.

- The actual vote on whether to file typically must take place in an open meeting, or at least be reported out immediately after the vote in a closed meeting.

Authorization to file can take the form either of:

- A direction to file for bankruptcy relief immediately or within a specified time.
- A delegation to the executive officer of the municipality to file if certain conditions are not satisfied, such as approval by creditors or bargaining units of offers made by the municipality under authorizations from the governing body.

Taking a vote to file a bankruptcy petition is a momentous step. The municipality should expect significant public and media attention and should be prepared to respond to all inquiries by providing information regarding the process. Municipalities should have a clear media strategy that includes a protocol for providing timely responses to media inquiries and identifying a spokesperson. Legal counsel should be consulted about all public statements and press releases to avoid inadvertently waiving important privileges concerning confidential negotiations and strategy.

For a comparison of the eligibility requirements to file a bankruptcy case under Chapter 9 and Chapter 11, see Chapter 9 v. Chapter 11 Comparison Chart: Eligibility Requirements.

## Federal Securities Law Considerations

If the municipality has outstanding debt securities, it should consult counsel regarding its obligations under federal securities laws. Securities issued after July 1995 are generally covered by Securities Exchange Commission (SEC) Rule 15c2-12, subject to certain exceptions. As a result, municipalities that issue such securities, often will have entered into continuing disclosure undertakings, which require the issuing municipality to make both annual and certain other event-based disclosures. Filing for bankruptcy protection is a listed event that triggers disclosure. Leading up to the bankruptcy filing, deteriorating finances and public discussion of the potential for insolvency can trigger rating agency actions, or reserves may be drawn upon, or payment deadlines missed, any one or more of which also may constitute a listed event.

Any statement to the market by an issuer, such as a material event notice, must comply with applicable securities laws. For example, the SEC's Office of Municipal Securities has stated that information provided to the public by municipalities that is reasonably expected to reach investors and the trading markets must comply with applicable antifraud provisions of the Securities and Exchange Act of 1934, including Rule 10b-5. Therefore, such statements may not make an untrue statement of material fact nor omit to state a material fact that may cause the statement to be misleading in the light of the circumstances under which they were made.

The omission portion of the Rule is often the most difficult with which to comply in the context of municipal bankruptcy. While saying that a credit rating has been downgraded or that a bankruptcy petition has been filed may not violate the Rule, experienced counsel should be consulted to assist in crafting a public statement that provides the relevant facts and materials in order to satisfy the broader standard of Rule 10b-5.

Special consideration should be given if the municipality's financial condition or potential bankruptcy is discussed in public by members of the municipality's governing board, its officers, or staff, in the absence of continuing disclosure regarding the topic. Establishing a pattern of complete and accurate information dissemination to the market not only facilitates compliance with federal securities law, but also is important in helping a municipality maintain credibility with the market and reestablish a good credit rating after it emerges from bankruptcy. Bad news is made worse by late discovery, much more so if it appears that suppression or obfuscation was involved.

## Timing

The municipality must monitor its cash position during the period leading up to a potential bankruptcy filing to avoid inadvertently violating the law. These violations can occur, for example, when:

- Employees are permitted to work when the municipality lacks the ability to pay them.
- The municipality disregards legal restrictions on the use of restricted funds.
- The municipality enters into agreements knowing that it will lack the funds to meet the contract terms.

Having an idea of when this crossover point occurs is crucial to protecting the municipality and its officers. While there is always tremendous pressure to delay the ultimate step of filing a Chapter 9 petition until the last possible moment, it is prudent to leave some room, preferably 60 to 90 days, between the date management would be compelled to shut the doors of the municipality and the date the petition is filed. That time gives the court the opportunity to conduct an orderly consideration of the petition and any objections to eligibility before drastic actions that can potentially affect public health and safety must be taken.

### Dealing with Vendors and Trade Creditors

Most local government agencies have significant commercial relationships with vendors and trade creditors of various types, such as specialized service providers and suppliers. Vendors and similarly situated unsecured creditors may stop extending credit to the municipality (for example, in the form of delayed billing arrangements) once news of a bankruptcy filing becomes public. This is primarily because, unlike in Chapter 11 cases, the services of these vendors may not be considered administrative expenses of the estate, and so vendors begin to require cash on delivery (COD) or prepayment terms for future transactions. However, unlike a Chapter 11 debtor, a municipality may pay prepetition creditors on account of prepetition obligations and should be prepared to implement these arrangements for critical services and supplies if it cannot convince creditors not to impose these terms.

Payments made within the 90 days prior to the filing of the bankruptcy case on account of prior unpaid invoices may be recoverable as preferences. To protect favored vendors that have not put payments on COD terms, the municipality should pay them during the normal payment cycle rather than to fall behind and then make catch-up payments. Unlike in Chapter 11, however, payments on account of a note or bond are not avoidable as preferences (§ 928(b), Bankruptcy Code). Regardless of whether payments to vendors would be considered preferences, the municipality may choose not to pursue preference actions against its vendors and suppliers.

For a comparison of the treatment of payments made in the 90 days prior to filing a Chapter 9 or Chapter 11 case, see Chapter 9 v. Chapter 11 Comparison Chart: Preference Actions and Other Avoidable Transfers.

## Seeking Bankruptcy Protection

### Pre-Filing Requirements

To be eligible for relief under Chapter 9, an entity must meet certain threshold Bankruptcy Code requirements:

- **The entity must be a municipality within the meaning of the Bankruptcy Code.** Under section 109(c)(1) of the Bankruptcy Code, only a municipality may file a petition for relief under Chapter 9. The definition of "municipality" under section 101(40) of the Bankruptcy Code is quite broad. It includes cities, counties, and other instrumentalities of states, but not the states themselves. A municipality is defined as "a political subdivision or public municipality or instrumentality of a state." See, *In re Las Vegas Monorail Co*., 429 B.R. 770 (Bankr. D. Nev. 2010); *Kentucky Employees Retirement System v. Seven Counties Services, Inc.*, 901 F.3d 718 (6th Cir. 2018).
- **Applicable state law must authorize its municipalities or any named municipality, to seek Chapter 9 protection.** Some states have enacted legislation containing blanket filing authority to all municipalities. However, many states limit which entities can file and under what circumstances, or require special approval of state authorities to permit a filing. For example, in California, unless it is facing a fiscal emergency, a municipality must complete a mediation process with its key creditors that takes at least 60-90 days. In Connecticut, the governor must approve all chapter 9 filings. Approximately half of the states have no law concerning Chapter 9 filings. A municipality in need of relief in one of those states must seek enactment of a specific statute authorizing the filing, presenting a floundering municipality with an additional and possibly uphill and time-consuming battle. (§ 109(c)(2), Bankruptcy Code.)
- **The municipality must be insolvent as defined by section 101(32)(C) of the Bankruptcy Code.** To be insolvent within the definition in the Bankruptcy Code, the municipality either must not be paying its undisputed debts as they come due at the time of filing or be unable to pay these debts when they become due in the near future. The latter test is prospective but must be based on a projection of the current or immediately ensuing fiscal year. A projection that the municipality will be unable to meet its obligations in later years is insufficient to prove insolvency. (§ 109(c)(3), Bankruptcy Code; *In re City of Stockton, Cal., 493 B.R. 772* (Bankr. E.D. Ca. 2013).)
- **The municipality must desire to effect a plan of adjustment.** The plan of adjustment does not have to be drafted as a condition to filing, but there must be evidence that the municipality intends to implement a plan via the bankruptcy case. (§ 109(c)(4), Bankruptcy Code.)
- **The municipality must demonstrate that it has attempted to negotiate a plan or that achieving a plan outside of bankruptcy is impracticable.** This is demonstrated by proving that:

- it has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that the municipality intends to impair under a plan of adjustment (§ 109(c)(5)(A), Bankruptcy Code);
- it has negotiated in good faith and is unable to reach an agreement (§ 109(c)(5)(B), Bankruptcy Code);
- negotiations are impracticable because, for example, there are many claimants and no practical way to negotiate with all of them individually or to identify a representative with authority to negotiate (§ 109(c)(5)(C), Bankruptcy Code); or
- a creditor is attempting to gain a preference (§ 109(c)(5)(D), Bankruptcy Code).

## Assignment of the Bankruptcy Judge

Due to the importance and rarity of municipal bankruptcies and the political issues that they present, section 921(b) of the Bankruptcy Code provides that the chief judge of the circuit in which the case is filed chooses the judge to whom the case is assigned. This is unlike cases filed under other chapters of the Bankruptcy Code in which judges are assigned at random to newly filed cases. While a judge from the district in which the case is filed will likely be assigned, the chief judge may assign any bankruptcy judge in the circuit to hear the case. This is an important feature because it is likely that a Chapter 9 case will be assigned to a highly competent and experienced judge, which benefits all parties. See Access to an Expert Arbiter.

Bankruptcy judges, unlike judges who sit on the US Supreme Court, the circuit courts of appeals, and the district courts, serve pursuant to Article I of the US Constitution for terms of 14 years. Any party to a Chapter 9 case has the right to petition the district court to withdraw the reference to the district court so that it can be heard by a district court judge, who serves under Article III of the Constitution and is appointed for a lifetime term. It is up to the district court to decide whether to take the case away from the bankruptcy court. In either case, should any party to an appeal elect, all rulings by the bankruptcy court are appealable to the Article III court system, even in those circuits in which there is a bankruptcy appellate panel – unless all parties to the appeal do not opt out from the bankruptcy appellate panel deciding the appeal.

## Tenth Amendment Limitations

The Tenth Amendment to the US Constitution limits the powers of the federal government regarding the states. Chapter 9 of the Bankruptcy Code, which adjusts the debts of instrumentalities of the state, restricts the powers of the bankruptcy court (see U.S. Const. amend. X).

For this reason, the bankruptcy court plays a significantly more limited role in a Chapter 9 case than in a Chapter 11 case, and state law restrictions on the activities of municipalities and their uses of funds must continue to be observed. Under section 904 of the Bankruptcy Code, without the debtor's consent, a Chapter 9 court cannot interfere with:

- Any of the political or governmental powers of the municipality debtor.
- Any of the debtor's property or revenues.
- The debtor's use or enjoyment of income-producing property.

In other words, the court may not:

- Take over the operation of the municipality.
- Remove, replace, or add members of the governing board.
- Direct the actions of the governing board.
- Appoint a receiver, trustee, examiner, fiscal manager, or similar entity to run the affairs of the municipality.
- Approve a plan of adjustment that enables the municipality to override state laws, such as those requiring voter approval for new taxes, or limits the use of restricted funds for particular purposes (§ 943(b)(4), (6), Bankruptcy Code).
- Require the sale or lease of municipal assets to satisfy the municipality's obligations to creditors.
- Force a liquidation of the municipality by converting it to one under Chapter 7. If the Chapter 9 case fails to produce a plan of adjustment that enables the municipality to exit bankruptcy, the judge may dismiss the case, leaving the municipality with all the issues, problems, and claims it faced before bankruptcy, with whatever remedies are available under state law (§ 930, Bankruptcy Code).

For a comparison of tenth amendment limitations in Chapter 9 and Chapter 11, see Chapter 9 v. Chapter 11 Comparison Chart: Limitations on the Power of the Court.

## Role of the Bankruptcy Judge

The primary responsibilities of the bankruptcy judge in a Chapter 9 case are to:

- Determine the debtor's eligibility for Chapter 9 relief.
- Approve or disapprove the assumption or rejection of executory contracts and unexpired leases.

- Rule on motions for relief from the automatic stay.
- Allow or disallow claims.
- Decide avoidable transfer actions.
- Confirm or decline to confirm a plan of adjustment.
- Dismiss the case.

Although the role of the bankruptcy judge is limited, the municipality may consent to the judge's exercise of jurisdiction. It might do so to obtain the protection of court orders or eliminate the need for multiple fora deciding issues that the bankruptcy judge is well-equipped to decide.

Despite this limited role, the judge in a Chapter 9 case exerts considerable influence over the parties and can be a very helpful neutral arbiter of difficult disputes. While the only real power the judge has is to dismiss the case and throw the municipality out of court, the judge likely will be helpful in bringing the parties to the point where a plan can be approved.

## The Chapter 9 Case

In addition to filing the Chapter 9 petition itself, the municipality must file several pleadings simultaneously with, or shortly after, the filing of the petition, including the following:

- **Creditors list.** This is a list of all persons who may assert a claim against the municipality (§ 924, Bankruptcy Code).
- **List of creditors holding the 20 largest unsecured claims.** This list contains more detail than the general list of creditors, including the names and telephone numbers of contact persons for each claim holder. The list is used by the US Trustee to solicit creditors to join the creditors' committee or other official committees, should one or more be appointed.
- **Pleadings establishing eligibility.** The section 109(c) eligibility requirements compel the municipality to prove that it satisfies each by submitting a pleading and declarations. If the municipality anticipates that one or more creditors or parties in interest will object to the claim of eligibility, the pleadings and declarations need to be more extensive than in a case where eligibility is not likely to be challenged.
- **Notice by publication.** The municipality must publish a notice of the bankruptcy once a week for three weeks in a local newspaper and in a national publication read by bondholders (§ 923, Bankruptcy Code). The notice must provide details about the filing of the Chapter 9 case and provide the date by which objections to eligibility must be filed. The bankruptcy court must approve the form of notice and the eligibility objection date before publication. The notice also must be mailed to all creditors and parties in interest. There is no comparable publication obligation for a debtor when filing a Chapter 11 case (see Chapter 9 v. Chapter 11 Comparison Chart: Commencement of the Case).

### Official Committees

Following the entry of the order for relief, the US Trustee may appoint a committee or committees to represent the interests of creditors holding similar classes of claims (§§ 901(a) and 1103, Bankruptcy Code). Unlike in Chapter 11, the debtor in a Chapter 9 case does not have to fund the costs of the committee's professionals, but it may be prudent for the municipality to pay reasonable costs because an informed and organized creditor body expedites the resolution of the case.

For more information on committees in Chapter 9 cases, see Practice Note, Representing Creditors in Chapter 9 Bankruptcy Cases: Early Case Considerations for Creditors. For a comparison of committees in Chapter 9 and Chapter 11 cases, see Chapter 9 v. Chapter 11 Comparison Chart: Case Administration.

### Effect on Litigation

The automatic stay serves to enjoin litigation against the debtor, its officers, and its inhabitants (§ 922(a), Bankruptcy Code). It also prevents all other forms of creditor enforcement remedies such as seeking the appointment of a receiver seeking a judgment lien**,** seeking a writ of mandamus or foreclosing on an asset (other than special revenues). The stay continues throughout the Chapter 9 case, although a claimant may seek an order terminating or modifying the stay by demonstrating that cause exists for the litigation to proceed in a non-bankruptcy court, or for an enforcement action to resume.

### Assumption and Rejection of Contracts and Leases

Section 365(d)(2) of the Bankruptcy Code provides a Chapter 9 debtor the ability to assume favorable contracts and unexpired leases of real or personal property, and to reject burdensome ones. However, neither is automatic. To assume a contract or lease without the nondebtor party's consent, the municipality must cure all monetary defaults and provide adequate assurance that it can perform under the agreement in the future. Ipso facto clauses in contracts or leases (which provide that the contract or lease terminates when one of the parties files for bankruptcy) are not enforceable in a Chapter 9 case. If a lease or contract is rejected, the nondebtor party will have a general unsecured claim against the municipality for the damages it has suffered because of the rejection of the agreement. The damage claim must be addressed in the plan of adjustment along with the other general unsecured claims against the municipality.

For more information on executory contracts and leases in bankruptcy, see Practice Note: Executory Contracts and Leases: Overview.

Collective bargaining agreements (CBAs) are subject to assumption and rejection as well (see *In re City of Vallejo*, 432 B.R. 262 (E.D. Cal. 2010)). However, due to the importance and the widespread impact the rejection of a CBA could have, there are extra burdens on debtors seeking to reject these agreements. These include:

- Mandating that the bankruptcy court balance the hardships employees would suffer because of rejection of the agreements against the need of the municipality to reject those agreements.
- Finding that the municipality employed reasonable efforts to resolve contract issues short of rejection, and that a prompt resolution would not be forthcoming.

Rejecting CBAs in Chapter 9 cases is not as difficult as in Chapter 11 because section 1113 of the Bankruptcy Code (which imposes significant additional procedural and substantive requirements) does not apply in Chapter 9.

## Special Revenues

Many municipalities have separate governmental enterprises that are owned and operated by the municipality but are not separate legal entities. For example, a city may own and operate a system that provides potable water to its inhabitants and businesses. Typically, these systems are treated as separate accounting units and are paid for from revenues received from users of the system in the form of fees and charges for service. Often, new users that desire to connect to the system and receive service must pay a capital charge or assessment to contribute their share of the capital cost of the system.

These systems often are financed through debt obligations secured by a pledge of a lien on the system revenues, and the capital, operations, and maintenance costs of the system are similarly supported only by the system revenues. In most cases, this is the sole source of security and payment for the obligations of the system, but in some cases, the municipality also is obligated to pay these amounts from the general fund if revenues are insufficient.

Section 928 of the Bankruptcy Code treats the revenues of this system that are pledged to the payment of debt obligations as special revenues (§ 902(d), Bankruptcy Code). It also provides that those special revenues may not be diverted to pay the debts of the municipality that are unrelated to the system or enterprise that generated them. In many jurisdictions, state law restricts the use of these revenues to the enterprise itself. Once the court determines that a stream of payments constitutes special revenues, such funds may not be diverted to pay the debts of the municipality that are unrelated to the system or enterprise that generated them. In many jurisdictions, this also is the result under state law, which restricts the use of these revenues to the enterprise itself.

Notwithstanding the automatic stay, Chapter 9 permits the holder of a lien on special revenues to apply these revenues to the obligation secured by the lien (§ 922(d), Bankruptcy Code). Obligations payable from special revenues have historically been treated as secured obligations for bankruptcy purposes, and a plan of adjustment would not impair those obligations, nor would the automatic stay apply to the continued use of special revenues to pay bondholders. *In re Jefferson Cnty., Ala.*, 474 B.R. 228, 262-74 (Bankr. N.D. Ala. 2012). Under recent rulings, however, a municipal debtor may not be compelled to make special revenue payments to bondholders (such payments would only be permissive not mandatory). See *Assured Guar. Corp. v. Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 919 F.3d 121, 127-32 (1st Cir. 2019). This ruling was decided under The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), with the judge interpreting certain Chapter 9 provisions that have been incorporated into that statute (48 U.S.C. § 2161(a)).

For an in-depth analysis of the treatment of special bond revenues in Chapter 9, see Practice Note, Special Revenue Bonds in Municipal Restructuring.

### Special Tax Financing

Another class of special revenues obligations is special assessment or special tax financing, which is commonly used to construct infrastructure to serve new development or to improve infrastructure of special benefit to the assessed property. The special assessments or taxes levied and pledged to support the bonds issued to provide this financing are treated as special revenues and cannot be invaded to pay the municipality's other obligations in bankruptcy. This is also generally consistent with most state laws restricting the use of these types of revenues solely to the purposes for which the assessment or tax was levied.

Tax increment financing and certain other types of financing that involve a pledge of specific restricted tax revenues to pay debt service also may qualify as special revenues obligations.

The automatic stay in Chapter 9 permits the holder of a lien on special revenues to apply such revenues to the obligation secured by the lien. However, according to the First Circuit in *Assured Guar. Corp.*, that provision does not require the debtor to make payments during the case. That court also ruled that a lender seeking to compel the payment of special revenues during the case must obtain relief from the automatic stay from the federal trial court and then seek to enforce the payment obligation in state court (*In re Fin. Oversight & Mgmt. Bd. for Puerto Rico* (1st Cir. 2019), cert. denied sub nom. *Ambac Assurance Corp. v. Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 140 S. Ct. 856, 205 L. Ed. 2d 459 (2020)).

Obligations payable from special revenues are treated as secured obligations for bankruptcy purposes, and the plan of adjustment may not impair those obligations to the extent they can be paid from the special revenues. If the special revenues are insufficient, the municipality's obligation, if any, to backfill from general revenues, could be impaired by the plan.

## Financing Leases

In many states, municipal agencies use lease financing for capital projects and equipment. Although styled as leases (usually to avoid debt limitations under state statutory or constitutional provisions), these instruments typically bear tax-exempt interest to the investors who fund the projects or equipment (which requires that they be treated as debt for federal tax purposes). They also are generally treated as debt for accounting purposes. Parties in a Chapter 9 case can argue that these instruments must be treated in a plan of adjustment as debt obligations rather than as true leases.

Characterization as a debt may mean that the municipality would not be required to assume or reject the leases within the relatively short period of time after the date on which the debtor is deemed eligible for Chapter 9 relief (§ 356(d)(4), Bankruptcy Code). Moreover, the creditor (lessor) might be unable to evict the municipality from the leased property or to require return of the leased equipment if the municipality defaults on the debt.

# Emerging from Bankruptcy

A municipality may emerge from Chapter 9 either by confirming its plan of adjustment or having its Chapter 9 case dismissed.

For a comparison of a plan of adjustment under Chapter 9 with a plan of reorganization under Chapter 11, see Chapter 9 v. Chapter 11 Comparison Chart: Plan of Adjustment v. Plan of Reorganization.

## Plan of Adjustment

A plan of adjustment provides for the treatment of the various claims against the municipality. The bankruptcy court can approve a plan over the objection of dissenting creditors if the plan satisfies the best interest of creditors test and is feasible (§ 943(b)(7), Bankruptcy Code). The court may confirm the plan despite its rejection by a class of creditors so long as at least one other class has approved it and the treatment of the dissenting class is fair and equitable and does not discriminate unfairly (§§ 901(a), 1129(b), Bankruptcy Code) (see *In re City of Stockton*, 542 B.R. 261 (B.A.P. 9th Cir. 2015)).

The municipality is not eligible for Chapter 9 unless it has, among other things, negotiated with its creditors in advance for an agreement on debt adjustment. Once the case is filed, the negotiations should resume as soon as possible with the goal of either reaching agreement and dismissing the case or reaching agreement with the requisite majorities and confirming a plan of adjustment. If creditors mount an eligibility challenge, there is less room for negotiation during the several months that are devoted to determining whether the debtor is eligible for Chapter 9 relief.

### Role of Committees in the Plan Process

Committees serve and speak for all similarly situated creditors, and the members of and professionals employed by a committee have a fiduciary duty to the class they represent. An energetic and informed committee, particularly one that is both proactive and constructive during the process of negotiating a plan of adjustment, is beneficial for all parties to the bankruptcy case.

### Role of the Court in Approving the Plan of Adjustment

The bankruptcy court must confirm the plan of adjustment if it finds that the various Chapter 9 confirmation requirements have been satisfied. These include, among others, that:

- At least one class of impaired creditors has voted to accept the plan (§§ 901, 1129(a)(10), Bankruptcy Code).
- Administrative claims are paid in full on the plan's effective date (unless an affected creditor agrees to different treatment) (§ 943(b)(3), Bankruptcy Code).
- The municipality has obtained any necessary approval by regulators or voters (in the case of most tax increases) (§ 943(b)(6), Bankruptcy Code).
- The plan of adjustment is feasible, and the municipality will not need further reorganization or another Chapter 9 case in the relatively near future (§ 943(b)(7), Bankruptcy Code).
- The plan is in the best interests of creditors (§ 943(b)(7), Bankruptcy Code), which has been interpreted to mean that creditors will receive as much or more under the plan than they would were the case dismissed.

Broadly stated, the court should find that the debtor municipality has used all reasonable efforts to pay its creditors as much and as quickly as possible, recognizing that application of state law may dramatically limit the municipality's ability to raise revenues.

### Failure to Approve a Plan of Adjustment

If the plan of adjustment is not confirmed, the bankruptcy judge has the discretion to send the parties back to the drawing board to create a better plan or to dismiss the Chapter 9 case (§ 930, Bankruptcy Code). Due to the Tenth Amendment and section 304 of the Bankruptcy Code, the judge lacks the power to craft a plan of adjustment and compel the municipality to accept it (see Tenth Amendment Limitations).

### Cramdown

While proposing a plan of adjustment that is supported by all impaired classes is the goal of any Chapter 9 debtor, a plan can be confirmed despite the rejection by a class of impaired creditors. The cramdown process should be avoided if possible because it will mean litigation, including discovery, and it will increase the legal fees of both the debtor and the objector(s).

## Dismissal of the Case

The bankruptcy court may dismiss the Chapter 9 case for the following reasons, including:

- The petition was not filed in good faith or does not meet the requirements of Chapter 9 (§ 921(c), Bankruptcy Code).
- Lack of prosecution (§ 930(a)(1), Bankruptcy Code).
- Unreasonable delay by the debtor that is prejudicial to creditors (§ 930(a)(2), Bankruptcy Code).
- Denial of confirmation of a plan of adjustment (§ 930(a)(5), Bankruptcy Code).

Involuntary dismissal of the case will be challenging for the municipality because outside of bankruptcy it will be unable to pay its debts and will not have the protection of the automatic stay. This result benefits neither the municipality nor its residents or creditors, and should incentivize the parties to the Chapter 9 case to reach agreement on a plan of adjustment.

Conversely, the municipality may voluntarily dismiss the case, as the bankruptcy judge cannot force it to remain in bankruptcy against its will due to the Tenth Amendment. If the municipality and its key creditors (such as indenture trustees and other capital market creditors, major vendors, and unions) reach agreements during the case and these agreements are binding on the parties under applicable nonbankruptcy law, the municipality can and should dismiss the case, not only because confirming a plan of adjustment is no longer necessary, but also because there is no need to incur the significant cost and delay of drafting, confirming, and consummating a plan of adjustment.

# Post-Bankruptcy Considerations

## Capital Markets Issues

As should be expected, the capital markets will threaten to, and may, punish a municipality for becoming insolvent and seeking Chapter 9 relief. The degree and length of that punishment depends largely on:

- The strength and viability of a negotiated settlement or plan of adjustment.
- The degree to which capital market debt holders and guarantors are made whole.
- The degree of cooperation and participation among stakeholders.
- Whether voters and elected officials have contributed to the settlement or plan by approving new taxes, fees, or other revenue sources.
- Whether the municipality can demonstrate that it has stable and effective management in place.
- How well the municipality communicates with the market and the timeliness and transparency of the financial information presented.

- How well the settlement or plan of adjustment is implemented, monitored, and honored.

A plan of adjustment should assume that the municipality will be unable to access to the public capital markets immediately following its approval, excepting enterprise and other special revenue credits unimpaired by the plan, which may still suffer some level of pricing penalty for a period of time due to, among other reasons, general association or rating agency scrutiny.

While access to the capital markets after a bankruptcy is inevitably more expensive and limited than it normally would be, the municipality having sought bankruptcy relief may not be a permanent or even a very long-term problem. Focusing on the factors listed above should help a municipality mitigate the adverse effects of a bankruptcy and emerge stronger and in a better financial position than before it filed the case.

## Avoiding a Repeat Filing

Given the cost, disruption, and pain of going through a bankruptcy case, a municipality's relapse into a Chapter 9 bankruptcy (a so-called Chapter 18) is to be avoided at all costs. Particularly if the need for new bankruptcy relief occurs soon after the completion of the original case, the bankruptcy court may be very skeptical of the municipality's eligibility to file again.

Avoiding a Chapter 18 scenario is best achieved by driving the hard bargains required to achieve a settlement or plan of adjustment that not only works, but also can weather contingencies and uncertainties. The successful arrangement must:

- Provide for adequate rainy-day reserves.
- Leave the municipality with flexibility to adjust costs and service levels to account for unforeseen downturns.
- Limit exposure to undue risks in the debt markets by, for example, relying too heavily on variable rate debt without appropriate hedges or cushions against rising rates.
- Avoid reliance on uncertain future revenue streams, particularly if they require voter approval or are otherwise outside the control of the municipality.
- Be supported by a consensus of most of the affected stakeholders, as well as the community and its leaders, and be backed by a meaningful commitment to implement the plan.

The reorganized municipality's management and governing board must have the discipline to stick to its settlement or plan and make it work.