

Municipal Bankruptcy:



Avoiding and Using Chapter 9 in Times of Fiscal Stress

JOHN KNOX and MARC LEVINSON



DISCLAIMER: Nothing in this booklet should be construed or relied upon as legal or financial advice. Instead, this booklet is intended to serve as an introduction to the general subject of municipal bankruptcy under chapter 9 of the Bankruptcy Code and related matters, from which better informed requests for advice, legal and financial, can be formulated.

Published by Orrick, Herrington & Sutcliffe LLP

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O R R I C K

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

- Introduction 1

- Chapter 1. **Avoiding Chapter 9** 3
 - Assessing the Problem(s) 3
 - Cash Position and Special Funds 5
 - Acknowledgement by Stakeholders 7

- Chapter 2. **Advantages and Disadvantages of a Chapter 9 Filing** 9
 - Advantages 9
 - Disadvantages 11

- Chapter 3. **Preparing for Chapter 9** 13
 - The Importance of Negotiations 13
 - Authorization to File 13
 - Federal Securities Law Considerations 14
 - Timing 15
 - Dealing With Vendors and Trade Creditors 16

- Chapter 4. **Seeking Bankruptcy Protection** 17
 - Pre-Filing Requirements 17
 - Assignment of the Bankruptcy Judge 18

- Chapter 5. **The Tenth Amendment and Limitations on the Role of the Court** 21
 - Tenth Amendment Limitations 21
 - Role of the Bankruptcy Judge 22

Chapter 6. The Chapter 9 Case	23
Initiating the Chapter 9 Case	23
Official Committees	24
Effect on Litigation	24
Assumption and Rejection of Contracts and Leases	25
Special Revenues	26
Financing Leases	27
Chapter 7. Emerging From Bankruptcy	29
Dismissal of the Case	29
The Plan of Adjustment	29
Chapter 8. Yes, There Is Life After Bankruptcy	33
Capital Markets Issues	33
Avoiding a “chapter 18”	33
Chapter 9. Conclusion	35
About the Authors	36

Introduction

Municipalities¹ have been increasingly squeezed between the cost of providing basic services (which in general has been increasing at a rate significantly higher than inflation) and flat or declining revenues (due to the economic slowdown and in particular the difficulties in the housing market affecting property tax revenues and spending patterns). In the face of these pressures, the possibility that some may want or need to seek protection under chapter² 9 of the United States Bankruptcy Code has become more real. In May 2008, the City of Vallejo, California filed a chapter 9 petition, and several other California municipalities have been reported in the media to be considering a filing. Jefferson County, Alabama, also has been reported to be on the edge of filing for several months due to financial problems with its sewer system, among other things. Whether this is the start of a larger trend remains to be seen, but it is clear that the stresses that can produce the drastic step of filing for bankruptcy protection currently are affecting many municipalities.

We intend this pamphlet to provide an overview of chapter 9 for those who manage and govern municipalities. We offer some thoughts on how to avoid filing as well as how to successfully navigate a bankruptcy case and emerge in stronger financial health. This pamphlet does not provide an exhaustive technical exposition of the law. Due to its size and format, this pamphlet only briefly summarizes, and in some cases omits entirely, areas that in particular cases might be very significant, but which we feel would not be of interest to the majority of our audience.

¹ Throughout, we use the term “municipality” to refer to a local government entity that may file a chapter 9 case. The term covers a wide variety of local governments that may or may not be considered “municipalities” under state law.

² The observant reader will note that “chapter” is not capitalized when referring to the chapters of the Bankruptcy Code. This is the standard convention.

Accordingly, this pamphlet does not purport to provide legal advice or serve as a template for a practitioner seeking to advise a client considering a chapter 9 filing or to prosecute the case once there. Rather, what we hope to achieve in this effort is to provide a basic framework to consider the chapter 9 alternative and enough background to enable decision makers and managers to ask informed questions of their advisors and appropriately consider the alternatives. Bankruptcy is a complex area of the law, and the adage “don’t try this at home” should be heeded. Any municipality seriously considering a chapter 9 filing should obtain expert legal counsel as well as financial advisory help.

CHAPTER ONE

Avoiding Chapter 9

If the reader takes away only one thing from this pamphlet, it should be that filing for bankruptcy protection under chapter 9 should be considered a last resort, to be effected only after every effort has been made to avoid it. As we discuss below, there are several significant downsides to such a filing, and in the end, the problems that brought the municipality to the point of filing will have to be solved anyway, so it is far better to resolve them, if possible, outside of bankruptcy.

Assessing the Problem(s)

The initial step in trying to avoid bankruptcy is to clearly and dispassionately assess the underlying problem(s) that are pushing the municipality in that direction. The degree of self awareness and transparency among municipalities can vary widely, and for some, one of the main problems may be just getting a good handle on the real drivers of financial stability and solvency. Not being financial managers, we will leave it to those more qualified to get into the technical details, but suffice it to say that if a municipality cannot identify in clear terms the specific factors that are driving revenues down and/or expenses up, it has some serious homework to do before venturing into bankruptcy court.

Municipalities that have been forced to the brink of, or into, bankruptcy, generally experience one or both of two types of fiscal problems. The first is a large and extraordinary one-time financial hit that cannot be absorbed by the budget or covered out of reserves. This could be a sudden and catastrophic investment loss (such as that experienced by Orange County, California, leading to its chapter 9 filing in 1994) or a large judgment rendered against the municipality (such as that experienced by Desert Hot Springs, California, leading to its chapter 9 filing in

“... filing for bankruptcy protection under chapter 9 should be considered a last resort, to be effected only after every effort has been made to avoid it.”

2001). In each case, these significant one-time liabilities forced the municipality into seeking bankruptcy protection.

The second kind of problem is a structural operating deficit that continues long enough to burn through reserves and is not resolved by revenue increases or spending cuts quickly enough for the municipality to avoid running out of cash as it attempts to meet necessary and fixed expenses such as debt service and payroll. A municipality with this type of problem could be pushed over the edge 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. For example, the City of Vallejo,

which had spent down its reserves in order to meet its obligations over a period of several years, became insolvent as a result of California’s economic slowdown and the concomitant drop in real estate and sales tax revenues, combined with significant employee salary and benefit cost increases dictated by collective bargaining agreements.

In general, fiscal stress related to one-time problems can be resolved by financing the cure costs over a long enough period so that those costs can be absorbed in the budget over time. And while bankruptcy protection may be necessary to buy time to get such a financing done and delay disruptive collections efforts or the forced liquidation of collateral, all efforts should be made to convince creditors to be patient and not to cause the municipality to incur the significant costs associated with a bankruptcy filing.

Fiscal stress related to ongoing structural deficits and lack of reserves is much more difficult to tackle because a financing will have little impact on solving the underlying structural problem: in fact this tactic will likely make things worse by “kicking the can down the road” and increasing the overall costs to the municipality. In these circumstances, painful cuts in service levels, employee compensation and other expenses may be required, as well as increased revenues through higher taxes or fees. Bankruptcy protection may be needed to avoid

immediate sanctions for breaching contracts, including labor agreements, missing debt service payments or failing to provide required levels of service.

Cash Position and Special Funds

Most municipalities (particularly general purpose entities such as cities and counties) maintain scores of separate funds within their treasuries, each having a particular function and source of revenues, and each burdened by legal or grantor restrictions as to the use of the funds. For example, in California, revenues from municipal utilities such as water and sewer systems may be used only to pay the costs of operating and maintaining those systems or for capital improvements (including debt service) to those systems. Many states require that special funds be held in trust and not diverted for unrelated uses. Similarly, moneys received in grants and state subventions may be restricted for particular uses by the terms of the grants, or by statutes or regulations. Careful analysis must be made of the various funds held by the municipality to determine what diversions can legally be made and, more importantly, how limitations on the uses of funds will affect the true available cash position of the municipality. While it is not uncommon for all of these funds to be commingled for investment purposes into a pooled cash account, a significant positive balance in pooled cash can mask a serious problem in the municipality's underlying financial condition.

Typically, the only fund completely unrestricted as to its use is the municipality's general fund. It is common and accepted practice for municipalities to 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; *provided*, that the budget and reserves are sufficient³ to ensure that at the end of the fiscal year, restricted funds are not in a position of having funded items not permitted within their restrictions. For example, the general fund may receive large infusions from property tax revenues twice a year, but have a monthly cash outflow that is relatively even. Generally, it is not improper for the cash outflow deficits to be covered from pooled cash during the year so long as the general fund makes up the difference from cash inflows by the end of the fiscal year.

³ The Government Finance Officers Association (GFOA) recommends that agencies maintain general fund unrestricted reserves of at least five to fifteen percent of the annual general fund budget.

The trouble arises when the budgeted revenues for a general fund will not meet budgeted expenditures, and there are insufficient reserves to cover the shortfall. Often these imbalances are not apparent until the fiscal year is well under way and it becomes clear that projections of revenue and expense will not be met. In such a case, use of restricted funds in pooled cash could be a violation of the restrictions imposed on the special funds and therefore illegal. It is important to note that while municipal financial officers generally have immunity from personal liability for official acts, that immunity does not necessarily extend to *knowing* violations of the law. Thus, a municipal finance officer should be very careful not to permit advances from restricted funds *intra-year* if he or she knows that the amounts cannot be restored from budgeted revenues or reserves by the end of the fiscal year.

It is very important for a municipality that appears to be headed for insolvency to monitor its cash position, particularly in the funds that are

“... the municipality could be faced with the choice of either breaking the law by using restricted funds for an impermissible purpose or by failing to pay contracted for wages after work has been performed.”

projected to go negative by the end of the fiscal year, so that it can determine when it will run out of funds to keep operations going. A municipal official who requires or even permits employees to come to work if the official knows that the municipality will not be able to pay them may be violating state labor laws or committing common law fraud. In some states, this may even constitute a criminal offense. For example, if an employee is paid from a municipality's general fund (and cannot be allocated to some other special restricted fund because the employee's duties do not support the special fund's activities), and the general fund budget position is such that, taking into account any available reserves, it will be unable to achieve at least a zero year-end balance without using legally restricted funds in pooled cash, the municipality could be faced with the choice of either breaking the law by using restricted funds for an impermissible purpose or by 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, as will be seen below.

Acknowledgement by Stakeholders

Once the municipality's management has identified and quantified the underlying fiscal problems, it must recognize that a key ingredient to solving them is to clearly and transparently communicate the nature and scope of the challenges to all potentially impacted stakeholders so that they are able 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 both receive all relevant information and have an opportunity to ask questions and offer solutions. All reasonable suggestions to solve the problems should be investigated and taken seriously.

The ins and outs of labor negotiations are far beyond the scope of this pamphlet, but if payroll costs or benefits are a key component of the municipality's fiscal stress, it will be necessary to engage labor law advisors and to assist resolving these problems. Outside a bankruptcy case, in most states labor laws applicable to public employee contracts place numerous restrictions on revising labor agreements, even if the agreements are pushing the municipality toward bankruptcy. However, if all parties realize that failure to modify extant agreements would likely land the municipality in bankruptcy court, all parties should be willing to work very hard to achieve consensual modification of burdensome agreements. Although bankruptcy may provide more flexibility in dealing with labor agreements, bankruptcy is not necessarily a "silver bullet" with respect to such matters, so every effort should be made to reach an agreement that provides a workable arrangement for the municipality prior to the decision to file.

Similarly, creditors such as banks, bondholders and credit enhancers may be willing to restructure long term debt in order to avoid forcing a municipality into bankruptcy. Attempts should be made to approach these stakeholders with clear and transparent information in order to reach some accommodation.

Often an intermediate step in such a restructuring is a forbearance agreement under which the creditors agree not to declare a default and/or take remedial action against the municipality for a specified period of time while the parties attempt to reach a negotiated settlement.

Finally, the officers and governing body of the ailing municipality must make the hard decisions about ongoing projects and programs that may have to be postponed, scaled back or cancelled in order to free up cash. These are often painful political choices, but the looming possibility of a bankruptcy filing can serve as a catalyst to reach consensus on these difficult issues.

CHAPTER TWO

Advantages and Disadvantages of a Chapter 9 Filing

There are many misconceptions about the utility of a bankruptcy filing in addressing extreme financial problems for municipalities. While bankruptcy clearly provides certain benefits for municipalities that cannot otherwise solve their fiscal problems, it is no panacea and comes with some significant downsides.

Advantages

Protection. One of the most important and immediate advantages of a bankruptcy filing is the protection against actions that might be taken by creditors or others against the municipality, its officers, elected officials, employees and even its inhabitants. Filing a bankruptcy petition invokes an automatic stay—basically a federal court injunction—against any action that could otherwise be taken against the municipality (which becomes the debtor upon the filing of the bankruptcy case) or its officers or employees. Unlike a bankruptcy involving a private entity, in chapter 9, the automatic stay extends to elected officials and to all inhabitants of the jurisdiction of the debtor municipality. This means that even if the municipality or other protected persons take or omit to take actions related to claims against the municipality that would otherwise subject them to sanctions or liability in state or federal court, or to actions by regulatory bodies, those actions may not proceed without the claimants first obtaining the permission of the bankruptcy court. The

“... the automatic stay extends to elected officials and to all inhabitants of the jurisdiction of the debtor municipality.”

stay lasts during the pendency of the chapter 9 case, but the bankruptcy judge retains the right to modify or terminate the stay for cause shown.

Breathing Space. Bankruptcy gives the debtor breathing space in which to function while it tries to work out its creditor and cash flow problems. Raising new revenues, renegotiating contracts and restructuring debt obligations takes time. 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 collateral, or be forced into regulatory or other state fora to answer for such actions and redress grievances before it is able to fashion a workable solution for the benefit of all creditors and residents. The bankruptcy case allows all of 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 multiple brushfires.

Access to an Expert Arbiter. An often underestimated advantage of a bankruptcy filing is found behind the bench of the bankruptcy courts. Bankruptcy judges are experts in financial restructuring, negotiations and arbitrating complex debtor/creditor and intercreditor disputes. While chapter 9 filings may be rare, bankruptcy judges see similar issues in the private sector day in and day out, and generally are very well equipped by dint of knowledge and temperament to help the parties arrive at workable compromises. Furthermore, because of the unique system of assigning bankruptcy judges to chapter 9 cases, it is very likely that a chapter 9 case will 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.

Ability to Adjust Obligations. Most people see the ability to adjust debts and other obligations as the prime benefit of a bankruptcy filing. If a plan of adjustment can be confirmed in a chapter 9 case, it may provide that unpaid claims of creditors be either reduced (paid in “tiny bankruptcy dollars”) and/or extended and restructured. There are limitations on how these adjustments can be made, and it may be possible for creditors to block a debtor from making

the adjustments they would like (or feel that it needs) to make. Nevertheless, in situations where it is not possible to fully repay all creditors absent some sort of debt relief, the plan of adjustment can provide a fresh start and the ability to achieve long-term financial stability for the municipality by deferring and/or reducing past obligations.

Disadvantages

Credit Markets Reaction. Municipalities that seek bankruptcy relief (and even those that seriously consider filing) should expect the immediate suspension and/or downgrade of their credit ratings. Particularly if bondholders are not fully repaid, this credit stigma may last for many years. However, it is certainly possible, as was seen with Orange County, that the municipality may emerge from bankruptcy and have its credit standing restored to robust levels within only a few years.

Municipalities contemplating bankruptcy should expect intense scrutiny from their capital markets creditors and rating agencies. One of the best things a municipality can do to position itself to get its credit ratings restored is to be able to provide timely and transparent information about its financial condition to the capital markets and rating agencies. Establishing a track record of providing trustworthy information, even if it is not favorable information, is an absolute necessity if a municipality expects to emerge from bankruptcy and get back on its feet in the credit markets. This effort takes time and resources from the municipality's finance staff at a time when the staff will be under tremendous stress. Municipalities must take this burden into account when they contemplate a filing.

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Cost and Distraction. Filing and pursuing a chapter 9 case is very expensive. Legal and financial consulting fees can easily range into seven figures (or even more for very large and complex entities). Every dollar spent on these costs is a dollar that cannot go toward solving the underlying financial problem. It is therefore in the interest of all stakeholders to realize that unless they can come to a negotiated settlement that avoids bankruptcy, these costs ultimately will consume funds that otherwise could be more productively used.

Another component of cost is the opportunity cost that will be expended by taking valuable senior staff time away from solving core problems and directing it to managing and responding to the demands of the case itself. Most municipalities that take the drastic step of filing a bankruptcy petition already will have cut staff to the bone in order to try to avoid insolvency. The distraction of dealing with a bankruptcy case - preparing for and attending hearings and depositions, responding to endless requests for information and documents from creditors, rating agencies, collective bargaining units, elected officials and the public - can be a major distraction from the core work the staff must do to keep the organization functioning. A municipality contemplating a bankruptcy filing should have a clear plan regarding how to address these issues going in, lest the demands of the case simply overwhelm the ability of the organization to function.

Stigma on the Community. Bankruptcy likely will be viewed by citizens, workers, and creditors as a stigma, and that perception can affect the self-esteem of the citizens and have an adverse impact on the overall business climate in the community. New businesses may be reluctant to locate in the community, real estate sales may be affected, and general economic conditions may be depressed. This stigma could linger for a period of time after the municipality emerges from the bankruptcy in the legal sense. Of course, the bankruptcy filing is not the cause of the municipality's problems, but rather the result of not being able to solve them any other way. It is the underlying financial health of the municipality, including its ability to deliver services and promote a strong community, that really matters.

CHAPTER THREE

Preparing for Chapter 9

The Importance of Negotiations

It is crucial that, once the magnitude of a financial crisis is established, thorough negotiations be undertaken with creditors and stakeholders to avoid insolvency. In fact, such negotiations, undertaken in good faith, 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 should carefully document what steps are taken to reach agreement. It is not necessary that a municipality accept a short term fix that only briefly defers an inevitable meltdown. But if such a fix is offered, the municipality must analyze it carefully and make sure it can prove that in fact it will not solve the municipality's problems sufficiently to avoid both short-term and long-term insolvency. For example, it makes no sense to renegotiate a long-term debt obligation by deferring interest or other payments for a year if, on the first anniversary of the deferral, the municipality will be unable to satisfy the revised obligation absent something akin to divine intervention. Similarly, a municipality should not accept one-time concessions from labor that would avoid insolvency in the short term but extend unsustainable labor agreements by one or more years such that insolvency is inevitable and the deficit facing the municipality will be even deeper as a result of the extension.

Authorization to File

A municipality may not validly file a chapter 9 petition unless the governing body of the municipality specifically authorizes the filing. 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, while

discussions with counsel leading up to and after a filing usually are conducted in closed or executive sessions under the litigation exception to most open meeting laws, the actual vote on whether or not to file typically must take place in an open meeting, or at least be reported out immediately after the vote in an open meeting.

Authorization could take the form of an immediate direction to file, or a delegation to the executive officer of the municipality to file in the event that certain conditions are not satisfied (such as approval by creditors or bargaining units of offers made by the municipality pursuant to authorizations from the governing body).

Taking a vote to file a bankruptcy petition is obviously a momentous step; the municipality should expect significant public and media attention, and should be prepared to respond fully and accurately to inquiries, providing relevant details and information regarding the process. While media strategy is beyond the scope of this pamphlet, municipalities should carefully consider how they will provide timely responses to media inquiries, and should have a clear plan in place including identification of one or more spokespersons. Also, legal counsel should be consulted about public statements and press releases so as not to inadvertently waive important privileges concerning confidential negotiations and strategy.

Federal Securities Law Considerations

If the municipality has any outstanding publicly-traded securities, counsel should be consulted regarding its obligations under the federal securities laws with respect to the bankruptcy filing and other material events. Securities issued after July of 1995 are generally covered by Securities Exchange Commission (“SEC”) Rule 15c2-12, which requires both annual and material event disclosure to be made by the issuing municipality. Filing for bankruptcy protection is a material event that triggers disclosure. It is possible (even likely) that leading up to the bankruptcy filing, deteriorating finances and public discussion of the potential for insolvency will trigger rating agency actions, which may constitute material events as well.

Any statement to the market by an issuer, such as a material event notice, must satisfy Rule 10b-5 promulgated by the SEC. Rule 10b-5 requires that information provided to the public intended to be a statement to the securities market may

not misstate a material fact nor omit to state a material fact necessary, in light of the circumstances, to make the statements made not misleading. The omission portion of the rule is most difficult with which to comply. In general, saying that a credit rating has been downgraded or that a bankruptcy petition has been filed by itself will not be enough. 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. Establishing a pattern of complete and accurate information dissemination to the market will be important in helping a municipality 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.

“Bad news is made worse by late discovery, much more so if it appears that suppression or obfuscation was involved.”

Timing

As noted earlier, it is important to monitor the municipality’s cash position in the period leading up to a potential bankruptcy filing so as not to knowingly violate the law—for example by permitting employees to work when the municipality lacks the ability to pay them, disregarding legal restrictions on special funds, or entering into essential contracts knowing that there will be a lack of sufficient funds to meet the contract terms. Having an idea of when this crossover point may occur is crucial in determining when a petition must be filed in order to protect the municipality and its officers. While there will be tremendous pressure from many quarters to delay the ultimate step of filing a chapter 9 petition until the last possible moment, it is prudent to leave at least some room between the time management would be compelled to shut the doors of the municipality and the date of filing the petition. The precise amount of time will depend on the circumstances of that particular municipality, but in general, 60 to 90 days would be a prudent period. The reason for this is to allow the court time to conduct an orderly process of considering the petition and any objections to it before drastic actions that potentially affect public health and safety (such as forced furloughs of essential service personnel) 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. A municipality preparing to file a chapter 9 petition should expect that these providers will stop extending credit to the municipality in the form of delayed billing arrangements once news of the filing becomes public. It is likely that they will require COD or prepayment terms for future transactions and the municipality should be prepared to implement these arrangements for critical services and supplies. Moreover, payments made within 90 days of the filing of the bankruptcy case on account of prior unpaid invoices may be recoverable as preferences, so in order to protect favored vendors that have not put it 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, though, payments on account of a note or bond are not avoidable as preferences.

CHAPTER FOUR

Seeking Bankruptcy Protection

Pre-Filing Requirements

In order to be eligible for relief under chapter 9, an entity must meet certain threshold requirements:

1. The entity must be a municipality within the meaning of the Bankruptcy Code. The definition of municipality in the Bankruptcy Code is quite broad, and includes cities, counties and other instrumentalities of the state. It does not include states themselves. Section 109(c) defines municipality to mean *“a political subdivision or public municipality or instrumentality of a state.”*
2. Applicable state law also must authorize municipalities to seek chapter 9 protection. In some states, such as California, there is a very broad statute that grants blanket filing authority to all California 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 Connecticut, the governor must approve all chapter 9 filings. Twenty-six states prohibit chapter 9 filings. A municipality in those states in need of bankruptcy relief must seek enactment of a specific statute particular to it authorizing the filing. It goes without saying that floundering municipality faces an uphill battle in such states.

3. The municipality must be insolvent as defined in the Bankruptcy Code, which means that the municipality either must not be paying its undisputed debts as they come due at the time of filing, or be unable to pay such debts when they become due in the near future. The latter test is a prospective, but must be based on a projection of the current or immediately ensuing fiscal year. A projection that the municipality will not be able to meet its obligations in subsequent years is not sufficient to establish insolvency.
4. The municipality must “desire to effect a plan to adjust its debts.” It is important to note that the plan of adjustment does not have to be in existence as a precondition to filing, but there must be evidence that the municipality wants to effect a plan through the vehicle of the bankruptcy case.
5. The municipality must demonstrate that it has attempted to avoid the filing or that the filing was necessary by proving one of the following:
 - a. 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 of claims, or
 - b. It has negotiated in good faith and is unable to reach such an agreement, or
 - c. Negotiations are impracticable (for example, because there are a multitude of claimants and no practical way to negotiate with all of them individually or to identify a representative with authority to negotiate), or
 - d. A creditor is attempting to gain a preference (basically a payment that would unfairly disadvantage other creditors because it disproportionately favors the creditor that seeks to receive the payment).

Assignment of the Bankruptcy Judge

In all other types of bankruptcy cases (such as chapter 11 cases), the bankruptcy judge is assigned by lot to each case as it is filed. Due to the importance and rarity of municipal bankruptcies, and due to the powers reserved to the states under the Tenth Amendment to the United States Constitution, the Bankruptcy Code provides that the Chief Judge of the Circuit in which the case is filed has the task of assigning a judge to each chapter 9 case. While it is probably likely that a judge

from the District in which the case is filed will be assigned, the Chief Judge could assign any bankruptcy judge in the Circuit to hear the case. This is an important feature because it means it is very likely that a chapter 9 case will be assigned to a highly competent and very experienced judge, which is good for all parties. Moreover, the Chief Judge will consider whether a judge who resides in or near the debtor municipality ought to play a role in the case filed by that municipality.

Bankruptcy judges, unlike judges of the U.S. Supreme Court, the various Circuit Courts of Appeal and the numerous U.S. District Courts, serve pursuant to Article I of the United States Constitution, for terms of 14 years. Any party to a chapter 9 case has the right to petition the federal District Court to remove the case to the District Court so that it can be heard by a District Court judge, who serves under Article III of the United States Constitution and is appointed for a lifetime term. It is up to the District Court to decide whether or not to take the case away from the bankruptcy court or to leave it there. In either case, all rulings by the bankruptcy court are appealable to the Article III court system.

CHAPTER FIVE

The Tenth Amendment and Limitations on the Role of the Court

Tenth Amendment Limitations

The Tenth Amendment to the United States Constitution reserves certain powers to the states regarding the management of their internal affairs. In chapter 11 cases (which municipalities are ineligible to file), the bankruptcy judge wields significant power to control what the debtor may and may not do during the course of the case. For example, without court approval, any proposed action by the debtor outside the ordinary course of business must be approved by the court after creditors and other parties in interest have been provided with the time and the opportunity to object. Nor may the debtor borrow funds outside of the ordinary course of business, grant collateral for a new loan or settle a significant claim against it absent court approval. However, in light of the Tenth Amendment and provisions of the Bankruptcy Code that implement it, the court plays a significantly more limited role in a chapter 9 case, and state law restrictions on the activities of municipalities and their uses of funds must continue to be observed.

Thus, for example, the court cannot take over the operation of the municipality, remove governing board members, direct the actions of the governing board or appoint a receiver or trustee to run the affairs of the municipality. Similarly, the court cannot permit the municipality to override state laws such as those requiring voter approval for new taxes, or limiting the use of restricted funds for particular purposes. Obviously, the court lacks the power to require the sale or lease of a park or a sewage facility in order to satisfy the municipality's obligations to creditors.

One important effect of the Tenth Amendment on municipal bankruptcies, distinguishing them from nongovernmental entity bankruptcies, is that there can be no forced liquidation of a municipality under the Bankruptcy Code. If a private firm files for bankruptcy under chapter 11 seeking to reorganize and thus continue

*“... the court cannot
‘take over’ the
operation of the
municipality ...”*

to operate, but it fails to achieve that objective, the case likely will be converted to a liquidation case under chapter 7 of the Bankruptcy Code. In chapter 7, a trustee is appointed, and is charged with liquidating all assets for the benefit of creditors, who go away with whatever share they can receive. Assets are sold or foreclosed upon, the

entity no longer operates, and it ceases to conduct business. For obvious practical reasons, and due to the Tenth Amendment’s limitations on the powers of the federal courts, there is no chapter 7 analogue for municipalities other than those that may be provided by applicable state law outside of the bankruptcy court system. Thus, if the chapter 9 case fails to produce a plan of adjustment allowing the municipality to exit bankruptcy, the case is dismissed and the municipality continues to exist with all of its problems and claims as it did before bankruptcy, with whatever remedies are available to the municipality and its creditors under state law.⁴

Role of the Bankruptcy Judge

The primary responsibilities of the bankruptcy judge are to approve or disapprove the bankruptcy petition by determining eligibility, to oversee the assumption or rejection of executory contracts and unexpired leases, to decide avoidable transfer actions (i.e., preferences and fraudulent transfers) and to confirm or decline to confirm a plan of adjustment. The municipality may consent to the judge’s exercise of jurisdiction in many of the more traditional areas of bankruptcy court oversight in bankruptcy in order to obtain the protection of court orders and eliminate the need for multiple fora to decide issues. Indeed, these latter features reflect some of the benefits of filing for bankruptcy in the first place.

Despite this limited role, the judge in a chapter 9 case does exert considerable influence over the parties and can be a very helpful neutral arbiter of difficult disputes. While, as described below, the only real “hammer” the judge ultimately has is to dismiss the case and throw the municipality out of court, the judge nevertheless is likely to be very helpful in bringing the parties to the point where a plan can be approved.

⁴ The rules governing the ability of municipalities to disincorporate or otherwise be dissolved vary greatly by jurisdiction and type of entity and are beyond the scope of this pamphlet.

CHAPTER SIX

The Chapter 9 Case

The following sections discuss specific aspects of filing and prosecuting the chapter 9 case important to municipalities.

Initiating the Chapter 9 Case

In addition to filing the chapter 9 petition itself, the municipality must file a number of pleadings in order to initiate the bankruptcy case. These include the following:

Creditors List—This is a list of all persons who may assert a claim against the municipality. The Bankruptcy Code defines the term “claim” very broadly, and the municipality should include each and every person that may assert a claim, even if the municipality believes that a given claim is specious.

List of Creditors Holding the 20 Largest Unsecured Claims—This list contains more detail than the general list of creditors, including the requirement that contact persons and phone numbers be listed. The list is used by the United States Trustee to solicit creditors to join an official committee or committees.⁵

Pleadings Establishing Eligibility—The Bankruptcy Code contains a number of eligibility requirements, and the municipality must prove that it satisfies each one. It does so by submitting a pleading and declarations. If the municipality

⁵ The Office of the United States Trustee is an arm of the United States Department of Justice, and the various regional offices assist the court system in administering bankruptcy cases. The U.S. Trustee’s role in a chapter 9 case is much more limited than it is in cases under chapters 7 or 11.

anticipates that one or more creditors or parties in interest will object to the claim of eligibility, the pleadings and declarations will need to be more extensive than in a case where eligibility is unquestioned.

Notice by Publication—The municipality must publish a notice once a week for three weeks in a local newspaper and in a national publication read by bondholders. 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 form of notice and the eligibility objection date must be approved by the bankruptcy judge in advance of publication.

Official Committees

Following the entry of the order for relief—in other words, after the court determines that the municipality is eligible to be a chapter 9 debtor—the United States Trustee for the relevant district may appoint a committee or committees to represent the interests of creditors holding similar classes of claims. In the Vallejo case, for example, there is one committee, and it represents the interests of retirees. Unlike in the case of a chapter 11 debtor, a municipality is not obligated to fund the costs of counsel to such a committee, but prudence may dictate that the municipality should pay reasonable costs because an informed and organized creditor body will expedite the resolution of the case.

Effect on Litigation

The automatic stay that becomes effective the moment the chapter 9 petition is filed serves to enjoin litigation against the debtor, its officers and its inhabitants. The stay also prevents all other forms of creditor enforcement remedies such as seeking a judgment lien or foreclosing on an asset (other than special revenues, as described below). The stay continues throughout the chapter 9 case, although a claimant may seek permission to terminate or modify the stay by filing pleadings that attempt to convince the bankruptcy judge that cause exists for the litigation to proceed in court or for an enforcement action to resume.

Assumption and Rejection of Contracts and Leases

The Bankruptcy Code provides a chapter 9 debtor with the ability to assume its favorable contracts and real and personal property leases and to reject its burdensome ones. Neither is automatic, though. To assume a contract or lease, absent consent by the nondebtor party, the municipality must cure all monetary defaults and provide adequate assurance that it will be able to perform under the agreement in the future. So-called *ipso facto* clauses in contracts or leases (which provide that the contract or lease terminates on account of a bankruptcy filing by one of the parties) are not enforceable in a chapter 9 case or any other bankruptcy case. In the event a lease or contract is rejected, the nondebtor party will have a general unsecured claim against

the municipality for the damages it has suffered on account of the rejection of the agreement. The damage claim will have to be addressed in the plan of adjustment along with the other general unsecured claims against the municipality.

Collective bargaining agreements are subject to assumption and rejection as well. However, due to the importance and the widespread impact rejection of a collective bargaining agreement could have, the U.S. Supreme Court has placed extra burdens on debtors seeking to reject such agreements. These include mandating that the bankruptcy court balance the hardships employees would suffer as a result of rejection of the agreements against the benefits to the municipality for rejecting those agreements. The court also must conclude that the municipality employed reasonable efforts to resolve contract issues short of rejection, and that a prompt resolution would not be forthcoming. A special Bankruptcy Code provision makes it even more difficult to reject a collective bargaining agreement in a chapter 11 case, but Congress has chosen not to extend the sweep of that provision to chapter 9 cases.

“...due to the importance and the widespread impact rejection of a collective bargaining agreement could invariably have, the U.S. Supreme Court has placed extra burdens on debtors seeking to reject such agreements.”

Special Revenues

Many agencies 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, such systems are treated as separate accounting units and are paid for from revenues received from the 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 such amounts from the general fund if revenues are insufficient.

The Bankruptcy Code treats the revenues of such a system that are pledged to the payment of debt obligations as “special revenues” and 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. As noted above, in many jurisdictions, this also is the result under state law, which restricts the use of such revenues to the enterprise itself. Notwithstanding the automatic stay, which prohibits certain post-bankruptcy actions by creditors, 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. Obligations payable from special revenues are treated as secured obligations for bankruptcy purposes, and as such the plan of adjustment may not impair those obligations at least to the extent they can be paid from the special revenues (but, for example, if the special revenues are insufficient, the municipality’s obligation to pay from general revenues, if any, could be impaired by the plan).

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. In these situations, the special assessments or taxes levied and pledged to support the bonds issued to provide such financing are treated as special

revenues and cannot be invaded to pay other obligations of the municipality 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.

Financing Leases

In many states, municipal agencies use lease financing for capital projects and equipment. Although styled as leases (usually to avoid limitations on debt 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), and are also treated as debt for accounting purposes. Although the matter is not entirely free from doubt and will depend on the facts and circumstances of each case, these instruments should in general be treated as debt obligations under the Bankruptcy Code and not as true leases. The significance of such characterization might be that the municipality would not be required to assume or reject the lease within a relatively short period of time after the court's acceptance of the chapter 9 petition, and that the creditor (lessor) might be unable to evict the municipality from the "leased" property (or to require return of the "leased" equipment) in the event of a payment default.

CHAPTER SEVEN

Emerging From Bankruptcy

Dismissal of the Case

The bankruptcy court may dismiss the chapter 9 case for cause, including unreasonable delay by the debtor or denial of confirmation of a plan of adjustment. Conversely, the case may be voluntarily dismissed by the municipality, as the bankruptcy judge cannot force it to remain in bankruptcy against its will due to Tenth Amendment considerations. Thus, if the municipality and its key creditors (such as indenture trustees, major vendors and unions) reach agreements during the case and such 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, and also because there is no need to incur the significant cost and delay of drafting, confirming and consummating a plan of adjustment.

The Plan of Adjustment

A Good Plan Is the Product of Negotiation Among All Constituencies.

A plan of adjustment, like a chapter 11 plan of reorganization, is little more than a contract among various parties that provides for the treatment of the various claims against the municipality. One of the benefits of chapters 9 and 11, other than preserving assets by way of the automatic stay during the negotiation period, is that the bankruptcy court has the power to approve a plan over the objection of dissenting creditors so long as the requisite majorities of creditors holding similar claims have approved the plan and so long as the plan does not discriminate among holders of similar claims. As described above, the municipality is not eligible for chapter 9 unless it has, among other things, negotiated with its creditors prior to filing the case in an attempt to

“One of the benefits of chapters 9 and 11, other than preserving assets by way of the automatic stay during the negotiation period, is that the bankruptcy court has the power to approve a plan over the objection of dissenting creditors...”

avoid the need for a filing. 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. Unfortunately, if a creditor (or creditors) mount an eligibility challenge, there is less room for negotiation during the several month period that will be devoted to determining whether the debtor is eligible for chapter 9 relief.

The 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, will be beneficial for all parties to the bankruptcy case.

The Role of the Court in Approval of 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; that post-bankruptcy claims will be paid in full on the plan’s effective date (unless an impacted creditor agrees to different treatment); that any necessary approval by regulators or voters (in the case of most tax increases) has been obtained; and that creditors will receive as much under the plan as 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 (such as tax limitation initiatives or other restrictions) may dramatically limit the ability of municipality to raise revenues. The court also must find that the plan is feasible, which means that the municipality will not need further reorganization or another chapter 9 case in the near future.

Failure to Approve a Plan of Adjustment. If the plan of adjustment is not confirmed either by consent or by a court order binding non-consenting creditors (often referred to in bankruptcy parlance as a “cramdown”), the bankruptcy judge has the discretion to send the parties back to the drawing board to craft a better plan, or to simply can dismiss the chapter 9 case. Due to the Tenth Amendment and the applicable Bankruptcy Code provisions, the judge has no ability to craft a plan of adjustment and compel the municipality to accept it. Dismissal of the case, of course, is a nightmare scenario because the municipality, which the judge earlier concluded (during the eligibility phase of the case) was unable to pay its debts, is now out of court, without the protection of the automatic stay, and is still unable to pay its debts. Such a result benefits neither the municipality nor its residents nor its creditors, and should provide a compelling incentive for the parties to the chapter 9 case to reach agreement on a plan of adjustment.

CHAPTER EIGHT

Yes, There Is Life After Bankruptcy

Capital Markets Issues

As should be expected, the capital markets will punish a municipality for having become insolvent. The degree and length of that punishment will depend in large part on several factors:

- The degree to which capital market debt holders and guarantors are made whole
- The strength and viability of the negotiated settlement or plan of adjustment
- The degree of cooperation and “buy in” among stakeholders
- Whether voters and/or 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 and monitored

While it is unavoidable that access to the capital markets after a bankruptcy will be more expensive and limited than it normally would be, it is not certain that the fact of a bankruptcy will be a permanent or even a very long term problem. Focus on the factors listed above will help municipalities mitigate the adverse effects of a bankruptcy and emerge stronger and in a better financial position than before they filed the case.

Avoiding a “chapter 18”

When a private company successfully navigates through a chapter 11 case with a confirmed plan of reorganization, but either cannot perform its obligations under the plan or the plan is flawed because it failed to adequately resolve all of the

company's financial problems, the company may be forced back into bankruptcy court to seek yet another reorganization. This is euphemistically referred to as seeking "chapter 22" relief; several commercial airlines have taken this route. If this were to happen to a municipality after a chapter 9 case, we assume that the second round would be deemed a "chapter 18" case. However, given the cost, disruption and pain of going through a bankruptcy case, chapter 18 is to be avoided at all costs. Also, and 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 (remember, that one of the criteria is that the municipality "desires to effect a plan of adjustment").

Avoidance of a "chapter 18" scenario will be best achieved by driving the hard bargains required to achieve a settlement or plan of adjustment that not only works, but that 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 future unforeseen downturns
- Limit exposure to undue risks in the debt markets (by for example, relying on too much 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 at least a majority of the affected stakeholders, and backed by a meaningful commitment to implement the plan

Finally, the municipality's management and governing board must have the discipline to stick to any settlement or plan and make it work. Remember that the bankruptcy court has limited oversight powers due to the Tenth Amendment. It may be tempting in light of the heartfelt and legitimate desires of the citizens and the politicians who represent them to spend more or tax less than the plan contemplates. Perhaps a review of the costs of going through the first bankruptcy—in money, time, energy and reputation—would be warranted if such temptations arise.

CHAPTER NINE

Conclusion

For the overwhelming majority of municipalities, even severe economic downturns such as the one currently being experienced will not result in the filing of a petition under chapter 9 of the Bankruptcy Code. Municipalities feeling financial stress should work as hard as possible, accepting as much pain as they and their constituents, creditors and employees can endure, to avoid that path. However, for some municipalities, the challenges will be too great, the avenues of solution too limited, and the window of opportunity for corrective action too small, to avoid using chapter 9 as a tool to help right the ship. For those entrusted to manage and govern municipalities, we hope this pamphlet provides some initial guidance and promotes a disciplined and thoughtful approach to avoiding or using chapter 9 in times of fiscal stress.

About the Authors

John H. Knox, a partner in the San Francisco office of Orrick, Herrington & Sutcliffe LLP, is a member of the firm's Public Finance Department. Mr. Knox has been involved in several municipal workout situations, representing the City of Vallejo, California, in its chapter 9 bankruptcy case, the City of Richmond, California, in a successful financial restructuring that allowed it to emerge from a near-bankruptcy situation to become a solid "A" rated credit, and the City of Half Moon Bay, California, in connection with a very large judgment that threatened to bankrupt it. His bond practice focuses on local governmental infrastructure financing, primarily for cities and counties, including general fund financings, pension bonds, special assessment and other land-secured financings, redevelopment tax increment financings, enterprise revenue bonds, municipal lease transactions and general obligation bonds. He also has been involved in creating various statewide financing programs, including financings for governmental receivables, infrastructure and development impact fees. He also assists nonprofit institutions, including colleges, universities, and private K-12 schools with tax-exempt financings.

Marc A. Levinson, a partner in the Sacramento office of Orrick, Herrington & Sutcliffe LLP, is a member of the firm's Restructuring Group. Mr. Levinson is nationally recognized for his capabilities in complex reorganizations and restructurings, out-of-court workouts and other insolvency matters. Mr. Levinson is the lead insolvency lawyer on the Orrick team that filed a chapter 9 case for the City of Vallejo—the largest California city to seek bankruptcy relief. The case has generated cutting edge legal issues, as well as litigation over a number of hotly-contested factual issues, including those relating to the City's insolvency and its eligibility to be a chapter 9 debtor. Mr. Levinson is a conferee of the National Bankruptcy Conference and a member of the Board of Directors of the American College of Bankruptcy, and he is a frequent speaker on bankruptcy topics.

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