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# A Primer on Municipal Bankruptcy

*By Hugh M. McDonald, Francis J. Lawall, and Gary Marsh\**

*Due to the economic fallout of the COVID-19 pandemic, absent aid from the federal government, states will be left with limited resources to assist municipalities facing budgetary shortfalls. With large budget deficits likely, municipal bankruptcies may increase. This article answers frequently asked questions about municipal Chapter 9 bankruptcies.*

The current economic stress caused by the COVID-19 pandemic is likely to continue for the foreseeable future. The loss of revenue and income by companies and individuals has already severely reduced tax revenue for state and local governments while at the same time many of these same governmental entities are expending vast sums fighting the pandemic. These increased expenditures are not likely to be offset by tax revenue. Quite the opposite appears true—increased costs with decreasing revenue will lead to large budget deficits. Absent aid from the federal government, states will be left with limited resources to assist municipalities facing budgetary shortfalls.

## BACKGROUND

While states are not eligible for bankruptcy protection, municipal entities in certain states can commence proceedings under Chapter 9 of the U.S. Bankruptcy Code. A municipality must be authorized by state law to commence a Chapter 9 case. Some states, such as Georgia, explicitly prohibit such filings. While other states restrict the types of entities that can file, differentiating between water districts, school districts, healthcare districts, counties, municipal corporations and other public agencies. Some states require advance notice and approval of any filing and may even withhold permission to file. Thus, applicable state law must be reviewed carefully by both creditors and municipalities when assessing whether a municipal entity can seek Chapter 9 protection.

If a municipality is not able to file for Chapter 9, an out of court restructuring may have to be pursued, such as a refinancing or extension of debt

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obligations, tender offers or exchanges or other negotiated resolutions. In certain states, financial boards or administrators may be appointed to oversee the finances of the municipality. States have a complex tangle of laws and regulations relating to municipalities and must be thoroughly reviewed when considering the possible outcomes of a municipal distress situation.

Below are frequently asked questions about municipal Chapter 9 bankruptcies.

### **WHAT IS CHAPTER 9 OF THE BANKRUPTCY CODE?**

Chapter 9 is part of the Bankruptcy Code that applies only to municipal entities. Chapter 9 also incorporates some, but not all other provisions of the Bankruptcy Code.

### **WHAT IS CONSIDERED A MUNICIPALITY FOR THE BANKRUPTCY CODE?**

The Bankruptcy Code defines the term “municipality” as a “political subdivision or public agency or instrumentality of a State.” Entities as large as major cities (i.e., Detroit, Vallejo, and Harrisburg) along with major counties (i.e., Orange County and Jefferson County) and small public healthcare districts and entities (i.e., West Contra Costa Healthcare District and Suffolk County OTB) have commenced cases under Chapter 9.

### **CAN A MUNICIPALITY BE PUT INTO CHAPTER 9 INVOLUNTARILY?**

No. Only a municipality can initiate a Chapter 9 case.

### **HOW IS A CHAPTER 9 CASE COMMENCED?**

Assuming that applicable state law permits the commencement of a case, the municipality must vote to authorize the filing in accordance with its local charter or law. The municipality must file a petition initiating the case and must provide notice of the commencement of the case. Sometimes eligibility to file a case is hotly contested by creditors. However, unlike Chapter 11 debtors, Chapter 9 debtors are not required to file schedules or a statement of financial affairs. Rather, a Chapter 9 debtor is only required to file a list of creditors.

### **MUST A MUNICIPALITY BE INSOLVENT TO COMMENCE A CHAPTER 9 CASE?**

Yes. Unlike Chapter 11 debtors, a municipality must demonstrate that it is insolvent as of the petition date. A municipality is insolvent if it is (i) generally

not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or (ii) unable to pay its debts as they become due. The “generally not paying its debts as they become due” test requires a factual analysis of what payments have been missed and their relation to the municipality’s overall financial position. In determining whether the municipality is unable to pay its debts as they become due, courts look at the cash flow of the municipality rather than using a balance sheet test. The court also will look to the municipality’s expected projected near term fiscal condition.

The municipality must also demonstrate a desire to affect a plan to adjust its debts, and demonstrate one of the following:

- Creditor agreement at time of filing;
- Failure of good faith negotiations;
- Negotiations were avoided as impracticable; or
- The municipality reasonably believes a creditor may seek preference.

#### **CAN A MUNICIPALITY WIND UP LIQUIDATING?**

No. A municipality cannot dissolve or be liquidated in a Chapter 9 proceeding. Applicable state law would govern any such result.

#### **WHAT PROTECTIONS CAN A MUNICIPALITY OBTAIN BY FILING?**

The automatic stay comes into effect at the commencement of the case and stays all actions against the municipality. Also, many, but not all, of the provisions of Chapter 11 apply in a Chapter 9 proceeding.

#### **MUST A MUNICIPALITY PAY ALL OF ITS DEBTS IN A CHAPTER 9 CASE?**

No. A municipality can determine which debts (both pre- and post-petition) it will pay as part of the resolution of the case.

#### **WHAT HAPPENS TO BONDS ISSUED BY A MUNICIPALITY?**

A municipality will not have to make principal and interest payments on bonds during the pendency of its case. However, bonds backed by special revenues, such as receipts from a designated project, may still be paid after the filing. Recent case law related to the Puerto Rico case found that the automatic stay only applied to the application of special revenues to payments of bonds and did not require the debtor to collect the special revenues for such application. Also, the holder of a bond that is backed by special revenues does not have recourse to the municipality.



## **WHAT IS THE ROLE OF THE BANKRUPTCY COURT?**

Unlike other bankruptcy cases, the role of the bankruptcy court is limited in a Chapter 9 case. The court may not interfere with the day to day operations (i.e., use of property or revenues) of the municipality or its political discourse. The court's main role is to approve or disapprove a debt adjustment plan and enforce the automatic stay. The court can, with the consent of the parties, facilitate compromises and resolutions of issues. However, the municipality has full discretionary authority to settle matters without court oversight according to a recent decision in the *Stockton* case.

## **WHAT HAPPENS TO RETIREMENT PLANS IN A CHAPTER 9 CASE?**

A municipality has the ability to alter the terms of retirement plans while in bankruptcy. Unlike in a Chapter 11 case, there are no specific provisions relating to retirement and health plans in a Chapter 9 case. This, however, remains a hotly contested issue both legally and politically.

## **WHAT HAPPENS TO COLLECTIVE BARGAINING AGREEMENTS IN A CHAPTER 9 CASE?**

A municipality has the ability to reject a collective bargaining agreement during its case. As with retirement and health benefits, there is no specific provision in Chapter 9 relating to collective bargaining agreements. However, U.S. Supreme Court precedent requires the municipality to engage in good faith negotiations with the union prior to seeking authority to reject the agreement.

## **CAN A MUNICIPALITY REJECT OTHER CONTRACTS IN A CHAPTER 9?**

Yes. The municipality has the ability to assume or reject executory contracts as part of its bankruptcy case. However, a lease to a municipality is not treated as an executory contract.

## **ARE THE SAFE HARBORS STILL APPLICABLE IN A CHAPTER 9 CASE?**

Yes. Counterparties to securities contracts, commodities or forward contracts, repurchase agreements, swaps and master netting agreements may still exercise their rights to liquidate, terminate or accelerate such contract after the

commencement of the Chapter 9 case. The definitional requirements for exercising such rights must still be carefully reviewed prior to the exercise of any such rights.

### **DO I NEED TO FILE A PROOF OF CLAIM IN A CHAPTER 9 CASE?**

Maybe. The municipality is required to file as list of creditors. If a claim is listed on the schedule, a proof of claim is deemed filed. However, if the claim is not listed or there is a dispute as to amount or status, a proof of claim must be filed.

### **HOW IS A CHAPTER 9 CASE CONCLUDED?**

As with a Chapter 11 case, the goal of a Chapter 9 case is the filing of a plan for the adjustment of the municipality's debts. If the plan was not filed with the petition, it must be filed by a date fixed by the court. The court will schedule a hearing to consider confirmation of the plan. Once the plan is confirmed, it is binding on the debtor and all creditors (regardless of whether a claim was filed or deemed filed) and the debtor receives a discharge of all claims as of the date the plan is confirmed.

