

TESTIMONY BEFORE THE
PENNSYLVANIA SENATE COMMUNITY, ECONOMIC AND RECREATIONAL DEVELOPMENT
COMMITTEE,
PENNSYLVANIA SENATE LOCAL GOVERNMENT COMMITTEE
PENNSYLVANIA HOUSE URBAN AFFAIRS COMMITTEE
PENNSYLVANIA HOUSE LOCAL GOVERNMENT COMMITTEE

FIRST JOINT PUBLIC HEARING ON ACT 47 (MUNICIPALITIES FINANCIAL RECOVERY
ACT)

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OVERVIEW OF CHAPTER 9 BANKRUPTCY

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I. General Bankruptcy Overview

A. Bankruptcy is a process that enables a debtor to resolve its financial distress. It is governed by federal law (the Bankruptcy Code) When a person or entity files for bankruptcy, it is usually because many creditors are trying to get payment or property from that person. Debtors tend to file because they cannot make all of their payments to all of their creditors and they need protection from their creditors while they figure out how to repay their creditors.

B. Chapter 7 and Chapter 11 – these chapters are available to business entities.

1. Chapter 7 is a liquidation. A trustee takes control of all the debtor's assets and sells them to satisfy the outstanding claims against the debtor.

2. Chapter 11 is a reorganization. The debtor remains in control of the business and comes up with a plan to pay its creditors. The creditors vote on the plan and once the court approves the plan, it is binding on all creditors. It is as though the debtor renegotiated its contracts with everyone to which it owes money.

C. These two chapters are not available to municipalities. They must file under Chapter 9, the only chapter of the Bankruptcy Code available to municipalities. The purpose of Chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts.

II. Overview of Chapter 9 Bankruptcy

A. Eligibility Requirements: To file under Chapter 9, an entity must be:

1. A municipality

a) Bankruptcy Code defines municipality as a “political subdivision or public agency or instrumentality of a state.”

(1) This definition encompasses water districts, sewer districts, hospital districts and similar entities.

(2) Only a very small number of Chapter 9 filings are by towns, cities and counties.

b) A municipality can file *only* for Chapter 9. It does not have the ability to file under any other Chapter of the Bankruptcy Code.

2. Specifically authorized to file for bankruptcy under state law

a) Under the 10th Amendment of the U.S. Constitution, powers not granted to the federal government nor prohibited to the states

by the Constitution are reserved to the states. This is an important restatement of federalism and it limits the power that the federal government can exercise over cities.

b) Pennsylvania law generally allows a municipality to file for bankruptcy. In June 2011, the state revoked that authorization for one year for third class cities.

c) About half of the states have statutes authorizing their municipalities to file for bankruptcy. These statutes vary widely in their requirements.

(1) California: a municipality must submit to mediation before filing for bankruptcy.

(2) Rhode Island: a municipality must go into receivership before filing; the decision to file for bankruptcy is made by the receiver.

3. Insolvent

a) The municipality must be:

(1) Unable to pay its debts as they become due; or

(2) Generally not paying its debts as they become due.

b) This is a unique feature of Chapter 9 – no individual or business entity must be insolvent before filing for bankruptcy.

4. Willing to implement a plan to adjust its debts.

5. In addition, the municipality must have either:

a) Obtained the agreement of creditors holding the majority in amount of claims against it to a plan; or

b) Must have negotiated in good faith with its creditors; or

c) Must show that such negotiation would be impracticable

6. The municipality must also show that it filed the petition in good faith.

7. If all of these requirements are not met, the bankruptcy case will be dismissed.

B. What benefits does bankruptcy give to a municipality?

1. Under the Bankruptcy Code, an automatic stay arises immediately upon the filing of a bankruptcy petition. The automatic stay prohibits all actions to collect a debt from the municipality.

- a) Creditors cannot try and collect any claims against the municipality or officers of the municipality. If a creditor has commenced a lawsuit against the municipality to collect a debt, that lawsuit will be stopped by the bankruptcy filing.
- b) The automatic stay does not apply to special revenue bonds.
- c) The automatic stay is unique to bankruptcy law. One purpose of the stay is to give the debtor breathing room to sort out its affairs so that all of its debts can be dealt with in a repayment plan (plan of adjustment under Chapter 9).
- d) The automatic stay reflects the bankruptcy policy of providing a collective proceeding in which all monetary claims against the debtor are resolved under the plan of adjustment. The stay prohibits individual creditors from acting on their own after a bankruptcy petition is filed.

2. The municipality can assume favorable contracts and reject unfavorable contracts. As a result, a municipality can modify labor contracts in Chapter 9. A municipality's rejection of labor contracts is subject to the standards set forth in the U.S. Supreme Court's opinion in *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1994)

3. All monetary claims against the municipality are dealt with under the plan of adjustment – this is analogous to the plan of reorganization under Chapter 11 of the Bankruptcy Code. The plan can:

- a) Modify contracts
- b) Modify debts (except special revenue bonds)
- c) Provide for the sale of municipal property. Keep in mind, however, that the Bankruptcy Code does not force a sale of any of the municipality's property.
- d) Once approved by the bankruptcy court, the plan of adjustment replaces the debtor's pre-bankruptcy obligations.

C. Role of the Court under Chapter 9

1. At no point does a federal judge take control of a municipality, nor does the court take control of the property of a municipality. Indeed, Chapter 9 explicitly forbids interference with governmental functions.

2. The court has the power to confirm the plan of adjustment. To do so:
 - a) The plan must comply with the Code
 - b) Every class of impaired claims must accept the plan.
 - (1) Impaired means that the plan alters contract rights (amount to be paid, interest paid, etc.).
 - (2) A class accepts by the affirmative vote of 2/3 in amount and a majority in number of claims voting.
 - c) There is a cramdown provision. That means if at least one class accepts, all creditors can be bound by the plan so long as it is “fair and equitable” and does not discriminate unfairly against any creditors.
 - (1) In Chapter 11, this means that creditors must get at least the value of their collateral.
 - (2) In Chapter 9, it means that creditors are getting all that they could reasonably expect to get in the circumstances.
 - (3) The availability of cramdown provides the debtor with important bargaining leverage.
 - d) Plan must also be in the best interest of creditors (this applies regardless of acceptance by all classes of creditors)
 - (1) Under Chapter 11, this means that creditors who have not accepted the plan must receive at least what they would have received in a Chapter 7
 - (2) Because there is no way that a city can liquidate under Chapter 7, in Chapter 9, it means that the plan is better than any other alternative.
 - e) Plan must be feasible
 - f) Any actions needed to carry out the plan must not be prohibited by applicable non-bankruptcy law. For example, if the municipality needs electoral approval to raise taxes, the required electoral approval must be a condition of the plan.

D. Power is completely in the municipality’s hands

1. Only the municipality can propose a plan; there can be no competing plans.

2. Court cannot force the municipality to liquidate.

III. Chapter 9 Bankruptcy – What it can and cannot do.

A. Bankruptcy provides some unique benefits:

1. The automatic stay stops all debt collection actions so that the municipality can resolve its obligations in one forum, the Bankruptcy Court.
2. The plan of adjustment, upon approval by the court, is binding on all creditors. So long as the plan meets all of the Bankruptcy Code's confirmation requirements, the plan can bind even creditors who do not accept the plan.
3. Bankruptcy, therefore, is a useful tool for a municipality in its negotiations with its creditors.

B. Bankruptcy itself, however, is not the answer to every municipality's money problems:

1. Bankruptcy cannot solve a municipality's budget problems. A municipality will need to solve its revenue problems going forward.
2. Bankruptcy cannot solve a municipality's governance problems.

IV. Open Questions about Chapter 9 Bankruptcy and about Municipal Financial Distress Generally

- A. How successful is Chapter 9? It depends, because filers range from small service districts to large counties, but the latter type of filing is far rarer. Therefore, it is hard to tell what impact Chapter 9 has on counties and cities.
- B. What impact does a Chapter 9 filing have on the municipal bond market? Again, hard to tell. Remember that a municipality can be insolvent without filing for bankruptcy, and it is the municipality's poor financial condition that will affect its bond rating.
- C. Will a municipality that has filed for bankruptcy be able to reenter the capital markets?
- D. What standards will the court apply if a municipality seeks to alter or terminate a collective bargaining agreement?
- E. What are the alternatives to Chapter 9? What happens if a municipality runs out of money and does not file for Chapter 9?