

Chapter 9

Bankruptcies on the Rise as Municipalities Grapple with Recession



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During an economic downturn, it's not uncommon to see private-sector businesses opt to file for bankruptcy or even close their doors for good. But the most recent recession, the worst since the Great Depression, has also raised the specter of municipalities defaulting on debt obligations or even being taken over by the state.



While permanent closure isn't an option for local governments, Chapter 9 bankruptcy filings — available only to municipalities and other public entities — are on the rise. In the 77 years since Chapter 9 bankruptcy was first authorized by Congress, only two other calendar years have seen as many Chapter 9 filings as 2011. In 2011 alone, Birmingham, Alabama; Harrisburg, Pennsylvania; and several smaller cities have filed bankruptcy. Some believe that Detroit may also file in the near future. With reduced revenue and an estimated 35 percent increase of outstanding debt owed by state and local governments since 2005, Chapter 9 bankruptcy filings could continue to climb.

While many are likely familiar with bankruptcies under Chapter 7 (liquida-

tion), Chapter 13 (consumer repayment plans) and Chapter 11 (business or higher income individual bankruptcies), Chapter 9 bankruptcies have historically been much less common and bear some distinct differences.

History and Application of Chapter 9

Under Chapter 9, a municipality may seek to reorganize its debts and adjust its contractual relationships. Congress first codified provisions for municipal bankruptcy in 1934, primarily to provide state subdivisions an avenue for relief from unwieldy bond obligations that had exceeded an estimated 7 percent default rate nationally during the Great Depression. Fewer than 650 Chapter 9 bankruptcies have been filed in the 77 years since Congress first enacted a municipal bankruptcy statute.

Chapter 9 bankruptcy is available only to a municipality — a political subdivision or public agency or instrumentality of a state. Courts have construed this term to include not just cities or counties but also an array of other public special-purpose entities or agencies, such as sanitary, water and improvement districts; public improvement projects, such as toll roads or bridges; publicly operated hospitals; school districts; public libraries; and public transportation authorities. These smaller special-purpose municipal entities have more commonly sought bankruptcy relief than have entire cities or counties. (See illustration on page 16.)

The common thread among entities found to be municipalities under Chapter 9 is the exercise of some sovereign power or function typically reserved for state instrumentalities.

Eligibility Requirements for a Chapter 9 Debtor

To be eligible as a Chapter 9 debtor, the federal Bankruptcy Code requires that any eligible municipal debtor (i) be specifically authorized to file bankruptcy; (ii) be insolvent, (iii) have a desire to adjust its debts and (iv) have made some attempt to resolve its disputes and develop a consensual plan with its creditors before filing.

Specific Authorization to File Under State Law
Chapter 9 bankruptcy invokes unique issues of federalism and state sovereignty that are not as prominent under other chapters of the Bankruptcy Code, juxtaposing the federal legislature’s constitu-

local debt officer (positions currently held by the same person).

A municipality’s authorization to file bankruptcy is often the biggest hurdle for showing eligibility. Since 1980, a significant number of municipal bankruptcy filings have been dismissed upon a finding that the putative debtor was not specifically authorized to file bankruptcy.

The bankruptcy case filed by Harrisburg, Pennsylvania, was dismissed in November 2011 for this reason. Although Pennsylvania has a general statutory authorization for municipal bankruptcy under certain circumstances, the Pennsylvania legislature enacted a separate statute in June 2010 that

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tional authority to enact laws pertaining to bankruptcy with the states’ rights to make fiscal decisions without federal intervention. (Indeed, Congress’ original 1934 municipal bankruptcy statute was declared unconstitutional two years after its enactment because it potentially interfered with state sovereignty in violation of the 10th Amendment of the U.S. Constitution. Congress enacted a more restricted municipal bankruptcy statute in 1937 that has withstood a similar constitutional challenge.)

To protect sovereign rights, the Bankruptcy Code only permits a municipal entity to file a Chapter 9 bankruptcy if it is specifically authorized to do so by state statute or by a public official or body that is empowered by state statute to grant such authorization. Kentucky has a statute — KRS 66.400 — that authorizes a “taxing agency or instrumentality” to seek bankruptcy protection, although that statute further restricts a bankruptcy filing by a county (rather than any other municipal entity) by requiring that it first obtain approval of its proposed bankruptcy plan by the state local finance officer and the state

expressly prohibited municipalities of a certain size from seeking bankruptcy relief until July 1, 2012 — specifically with Harrisburg in mind, according to some commentators.

Principles of federalism also limit a bankruptcy court’s authority over a Chapter 9 debtor in other material ways. Bankruptcy courts cannot order the liquidation of a municipal debtor’s property or adjust any related property rights and exercise little, if any, control over a Chapter 9 debtor’s finances and expenditures during bankruptcy. Chapter 9 does give municipal debtors relief from creditor collections provided by the automatic stay and permits them to shed or rework burdensome contractual relationships. Chapter 9 can also provide a debtor easier access to post-bankruptcy financing by giving a post-petition lender a higher priority claim that will more likely be repaid.

Insolvency

A debtor must be insolvent to be eligible for Chapter 9 bankruptcy — a more restrictive standard for eligibility than under other chapters. Insolvency in this

Chapter 9 Filings by State Since 1981*

State	# Ch 9 Cases Filed
Nebraska	43
California	38
Texas	29
Alabama	11
Missouri	10
Oklahoma	10
Arkansas	7
Illinois	6
Tennessee	5

Six states had four Chapter 9 filings^{FN1}

Six states had three Chapter 9 filings^{FN2}

One state had two Chapter 9 filings^{FN3}

Nine states had one Chapter 9 filing^{FN4}

^{FN1} AZ, ID, MT, PA, WA, WV

^{FN2} CO, CT, FL, MS, NY, SC

^{FN3} NH

^{FN4} IN, KY, LA, NJ, NM, NC, RI, UT, VA

* This data was collected from the U.S. Courts PACER website as of December 5, 2011.

The chart above shows the different types of municipal entities that have filed Chapter 9 bankruptcy cases since 1981.

context generally requires some actual default rather than mere budgetary insolvency or anticipated shortfall. In contrast, debtors under Chapters 7, 11 and 13 may be eligible for bankruptcy protection as a result of balance-sheet insolvency or liquidity problems. Under Chapter 9, any obligation that renders a municipality insolvent must be unconditionally owing and presently enforceable.

For example, Boise County, Idaho (population 7,000), filed for bankruptcy relief in 2011 as a result of a \$4 million judgment granted against it, with additional interest and attorney’s fees, for violations of the Fair Housing Act. That bankruptcy was dismissed because Boise County was found not to be insolvent because it had not actually failed to pay any debts that had come due and, further, had sufficient funds allocated for other public uses that could have been redirected to pay the judgment.

Attempt to Reach Consensual Plan with Majority of Creditors

Finally, a Chapter 9 debtor must obtain or attempt to obtain agreement of a majority of its creditors whose rights would be impaired by the bankruptcy before it files a Chapter 9 bankruptcy petition. Some commentators suggest, however, that a Chapter 9 debtor may be permitted to file before it engages in these negotiations when necessary for protection from creditor collection efforts while it attempts to negotiate. The only known Chapter 9 bankruptcy case filed in a bankruptcy court in

Kentucky since 1981, *In re Whitley County Water District*, was dismissed because the debtor had not attempted to negotiate with its bondholder creditors before filing its bankruptcy petition.

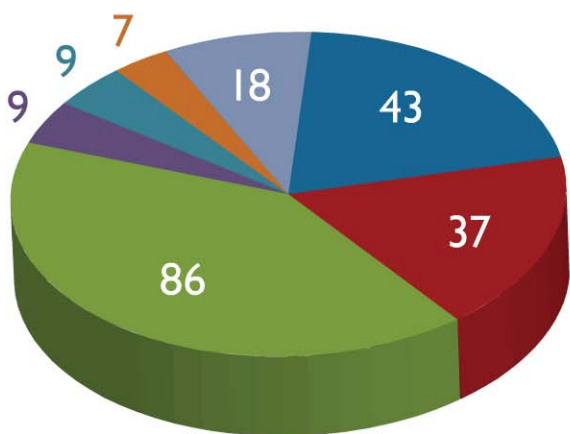
Chapter 9 Bankruptcy Today

Chapter 9 bankruptcies are most often brought on by municipal defaults — often bond defaults — and a desire by municipal entities to adjust their debt and/or contractual relationships so that they can repay the highest percentage of obligations possible in order to preserve the security and accessibility of bond markets. As a result, municipalities typically repay a higher percentage of their bond obligations than other debtors repay of their unsecured debts under other chapters of the bankruptcy code. This is true even for general obligation bonds that are treated as unsecured claims that could, theoretically, be avoided to a greater extent than other secured claims, including revenue bonds.

The circumstances that drive municipalities to insolvency are varied. Many are caused by unanticipated costs of bond-funded infrastructure improvements that outstrip the revenues available to repay them when bond obligations come due — Harrisburg and an expensive incinerator project, for instance. Some are caused by large tort judgments against the municipal entity, as with the Boise County case. Others are caused by more egregious financial mismanagement or high-risk investment schemes gone awry, such as the recently filed Birmingham (Jefferson County, Alabama) bankruptcy or the famed Orange County,

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Number of Chapter 9 Bankruptcies Filed



Types of Entities

- Towns/cities/villages/townships
- Health care entities
- Utilities (water/sewer/sanitation/waste management districts)
- Levee/irrigation/drainage/reclamation districts
- General improvement districts
- Economic development/public financing entities/investment
- Miscellaneous^{FNI}

^{FNI} Includes:	
Off Track Betting Entities	3
Housing Authorities	1
Public Park Authorities	1
Public Libraries	1
Road and Bridge Projects	3
State Fair Boards	1
School Districts	1
Transit Systems/Districts/Authorities	3
Port Districts	1
General Municipal Authorities	3

*This data was collected from the U.S. Courts PACER website as of December 5, 2011.

California, bankruptcy of the mid-1990s. Indeed, corruption, bribery and fraud charges have led to 22 convictions of individuals involved in promoting and structuring the bond financing that led to the massive bond default of Birmingham.

With increasing burdens on municipal entities in the form of vested retirement, pension and health benefits for public employees, reduced tax revenue due to high unemployment, funding cuts by the state and federal government and myriad other factors that have put the squeeze on city and local government budgets, Chapter 9 bankruptcies are predicted to become more frequent and more prominent. **KYC**

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