Adjustment of State and Municipal Debt Under the Bankruptcy Code

I. Introduction

States and local governments across the United States are experiencing serious financial distress. With falling revenues and reductions in state and federal aid, they are facing massive budget shortfalls[1] and are trying to cope with troublesome obligations, including underfunded pensions,[2] public-employee contracts and benefits, health care obligations, and bond debt. Many are predicting that the state and local government fiscal crisis will be the next economic disaster, right on the heels of the subprime mortgage crisis.

This outline discusses how title 11 of the United States Code (the "Bankruptcy Code") can be used as a tool to address some of the problems facing state and local governments today. This outline (i) sets forth who may file under chapter 9 of the Bankruptcy Code ("Chapter 9") in its current form, (ii) reviews the recent legislative activity examining whether the Bankruptcy Code should be amended so that states can file for bankruptcy, (iii) discusses the constitutional issues that surround municipal and state bankruptcy law, (iv) provides an overview of Chapter 9, and (v) lays out the advantages and limitations of using the Bankruptcy Code as a tool for restructuring state and municipal debts and obligations.

II. Who May Be a Debtor Under Chapter 9?

A. Under §109(c) of the Code, in order to file under Chapter 9, an entity must:

1. be a municipality;

   a. **Definition of municipality**. A "municipality" is defined as either a "political subdivision," a "public agency," or an "instrumentality of a state." *See* 11 U.S.C. §101(40). The Code does not further define any of these terms and the caselaw on the topic is sparse. Thus, what actually constitutes a municipality is "far from clear." *In re Las Vegas Monorail Co.*, 429 B.R. 770, 775 (Bankr. D. Nev. 2010); *see also, In re County of Orange*, 183 B.R. 594, 601 (Bankr. C.D. Cal. 1995). That being said, cities, towns, villages, special districts, school districts, counties, public authorities, public hospitals, and publicly owned airports are generally considered "municipalities" for purposes of the Bankruptcy Code.

   b. **Political Subdivision and Public Agency.** In limited caselaw, a "political subdivision" has been defined as an entity created by a state for the local exercise of sovereign or police power, and a "public agency" has been defined as an entity "organized for the purpose of maintaining or operating a revenue producing enterprise." *See In re County of Orange*, 183 B.R. at 600-602. However, other courts have criticized these definitions as "over-precise." *See, e.g., In re Las Vegas Monorail Co.*, 429 B.R. 770, 787 (Bankr. D.Nev. 2010)("County of Orange has been criticized for being overly-precise in creating these definitions.").

[1] California is facing a $25.4 billion budget shortfall; Illinois is facing a $15 billion budget deficit; and New York is facing a $10 billion budget deficit.

[2] Estimates of states' unfunded liabilities to pay for retiree benefits range from $750 billion to more than $3 trillion.

c. **Instrumentality of a state**. While there is no "no unique or canonical meaning" of the term "instrumentality of a state," at least one court has identified a set of relevant factors including whether or not the entity is (1) "created by an enabling statute that prescribes the powers and duties of the instrumentality"; (2) "to be managed by a board selected by the government"; (3) "a separate juridical entity, with the powers to hold and sell property and to sue and be sued"; (4) "primarily responsible for its own finances"; (5) "run as a distinct economic enterprise" and not "subject to the same budgetary and personnel requirements with which government agencies must comply." *In re Las Vegas Monorail Co.*, 429 B.R. 770, 776 (Bankr. D. Nev. 2010) (holding that nonprofit corporation franchised by county government did not qualify as municipality in that it did not carry on typical governmental functions and was financed only by fares collected from its customers).

2. be specifically authorized by state law to file under Chapter 9, in its capacity as a municipality or by name;

   a. **Pre-1994 General Authorization**. Prior to the Bankruptcy Reform Act of 1994, under section 109(c)(2), municipalities were required only to be "***generally*** authorized to be a debtor under [Chapter 9] by State law." *See* 11 U.S.C. § 109(c)(2), HISTORICAL AND STATUTORY NOTES (emphasis added). As such, courts were split as to whether the state authorization needed to include specific words such as "bankruptcy," "debt adjustment," or "reorganization" or if merely giving the entity at issue "authority over such matters as finances, property, borrowing, and public services and the corresponding rights and powers necessary to achieve the purpose of such [authority]" was sufficient. *In re City of Bridgeport*, 128 B.R. 688 (Bankr. D.Conn. 1991). According to the majority view at the time, so long as a state gave "some indication" that the municipality had the necessary power, such as by granting it "the ability to sue and be sued, to make and enter into contracts" and other similar rights, the municipality then also had the right to file under Chapter 9. *In re Pleasant View Utility Dist. of Cheatham County, Tenn.*, 24 B.R. 632, 638-39 (Bankr. Tenn. 1982); *In re Villages at Castle Rock Metropolitan Dist. No. 4*, 145 B.R. 76, 82 (Bankr. D. Colo. 1990). Other courts, however, disagreed holding that the state authorization needed to be more explicit. *See, e.g., In re Carroll Tp. Authority*, 119 B.R. 61, 63 (Bankr. W.D.Pa. 1990)(holding that statute that authorized a municipality to "sue, be sued, implead, be impleaded, complain and/or defend in all courts" could not be liberally construed to allow for a Chapter 9 filing).

   b. **Post-1994 Specific Authorization**. In 1994, Congress amended section 109(c)(2), replacing the requirement that a municipality be merely "generally authorized" to file under Chapter 9, with a requirement that the entity be "***specifically authorized***, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter." *See* 11 U.S.C. §109(c)(2) (emphasis added). *See In re New York City Off-Track Betting Corp.*, 427 B.R. 256, 267 (Bankr. S.D.N.Y. 2010) (finding that executive order issued by Governor of New York authorizing municipal debtor to file bankruptcy petition satisfied specific

authorization requirement). Congress amended this language in order to overturn those courts which found "the requisite authorization for the filing [under Chapter 9] by implication." *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995). As such, the authority to file, must now be "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication." *Id.*

c. **State Authorizing Statutes**. Currently, only fourteen states specifically, and unconditionally, authorize municipal bankruptcies: (1) Alabama, (2) Arizona, (3) Arkansas, (4) Florida, (5) Idaho, (6) Kentucky, (7) Minnesota, (8) Missouri, (9) Montana, (10) Nebraska, (11) Oklahoma, (12) South Carolina, (13) Texas, and (14) Washington. Eleven states provide conditional or limited authorization, one state (Georgia) prohibits filing in all circumstances, and the remaining states do not have any specific authorization for municipal bankruptcies.

   i. **Recent State Legislative Activity**. As the threat of municipal bankruptcies looms, several states are reportedly considering passing legislation that would have the effect of preventing their cities and towns from filing for bankruptcy, or would make it more difficult to do so. For example, California passed legislation earlier this year that requires a municipality to demonstrate a fiscal emergency before seeking Chapter 9 protection (where as before, pre-*Vallejo*, there was unconditional authorization). Pennsylvania's legislative body passed legislation last year that prevented its capitol, Harrisburg, from filing Chapter 9 until at least July 2012.

   ii. **State Insolvency Statutes**. Some states, including Pennsylvania, Michigan, New York, New Jersey, Illinois, and Nevada, have legislation designed to assist formally municipalities in distress. These statutes generally provide for the appointment of a receiver or a financial management team to review the municipality's finances and then develop and implement a plan of action. The appointee may also authorize or recommend a Chapter 9 filing by the municipality.

3. be insolvent;

   a. **Insolvency**. A municipality must be insolvent in order to file under Chapter 9. *See* 11 U.S.C. § 109(c)(3). A municipality is considered "insolvent" when it is "generally not paying its debts as they become due" or "unable to pay its debts as they become due." *See* 11 U.S.C. § 101(32)(C)(i-ii). The former provision requires a straightforward retrospective analysis as to whether the municipality is in fact paying its debts on time,[3] while the latter provision requires a prospective analysis. *In re City of Bridgeport*, 129 B.R. 332, 334-36 (Bankr. D.Conn. 1991) (noting that former provision was not at issue in

[3] That being said, in the Chapter 11 context, at least one court has held that an entity was "not paying its debts as they became due" even though that entity was in fact paying its debt, finding that such payments were being made only "by a process of liquidation inconsistent with its continuation as a going business, by failing to replace hazardous equipment, and by failing to meet the obligation of its bond indentures to replace worn-out rolling stock or accumulate funds for that purpose." *In re Hudson & Manhattan R.R. Co.*, 138 F. Supp. 195, 200 (S.D.N.Y. 1955).

that city was paying debts as they became due as of the petition date, and latter provision required prospective analysis). In that municipal assets are never liquidated under Chapter 9, a solvency test instead requires a comprehensive cash-flow analysis that considers factors such as reasonable tax increases, available reserves, ability to reduce expenditures, ability to borrow, and legal opportunities to postpone debt payments. *See* McGrath, Nicholas and Ji Hun Kim, *The Next Chapter for Municipal Bankruptcy*, 29-JUN AM. BANKR. INST. J. 14 (2010).

b. **Measurement Period for Insolvency**. Furthermore, there is a limit as to how far into the future a municipality may look for insolvency purposes. The *Bridgeport* court for instance strictly circumscribed the look-forward period under section 101(32)(C)(ii), dismissing the debtor's case after finding that it could not prove that it was "unable to pay its debts as they become due ***in its current fiscal year or, based on an adopted budget, in its next fiscal year***." *In re City of Bridgeport*, 129 B.R. at 338 (emphasis added). The court described any projections beyond this limited period as too speculative noting the myriad of factors that could affect the city's fiscal condition including "the health of the regional, state, and national economies; the level of state and federal aid to [the city]; potential concessions by labor unions; potential voluntary suspension of tax abatements; potential savings through efficiency; increased tax collection rates; and the success of any efforts to borrow funds to offset any budget gap." *Id.*

c. **Comparison with other chapters**. The insolvency requirement is particular to Chapter 9, as there is no such requirement for debtors filing under chapter 7 or chapter 11. The requirement that a municipality be insolvent in order to file under Chapter 9 may discourage or stand in the way of many municipalities seeking relief. *See In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn. 1991) (petition dismissed after finding that Bridgeport was not insolvent).

4. desire to effect a plan to adjust its debts; and

   a. **Desire to Effect a Plan**. The fourth requirement for an entity to be able to file under Chapter 9 is that it "desires to effect a plan to adjust [its] debts." *See* 11 U.S.C. 109(c)(4). Few cases directly address this requirement, and those that do, do not establish any bright-line rule for when it is satisfied. *In re City of Vallejo*, 408 B.R. 280, 295 (9th Cir. BAP 2009). Instead, a municipality can demonstrate that it desires to effect a plan of adjustment by, among other things, attempting to resolve claims, submitting a draft plan of adjustment, "or by other evidence customarily submitted to show intent." *Id.* (internal citations omitted). The evidence need merely show that the "purpose of the filing of the Chapter 9 petition [was] not simply ... to buy time or evade creditors." *Id.* citing COLLIER ON BANKRUPTCY (Alan Resnick & Henry J. Sommer, eds., 15th ed. rev. 2010) ¶ 109.04[3][d], at 109-32

5. (i) have obtained the agreement of a majority of claims of each class the entity intends to impair; or (ii) have negotiated in good faith with creditors and failed to obtain such a majority; or (iii) have been unable to negotiate with creditors

because such negations would be impracticable; or (iv) must reasonably believe that a creditor may attempt to obtain a preferential transfer under § 547 of the Code.

a. **Good faith negotiations with creditors**. The final subsection of § 109(c) requires a municipality to either obtain the support of a majority of its creditors prior to filing under Chapter 9, or to provide some justification as to why it was unable to do so. *See* 11 U.S.C. § 109(c)(5). This requirement grew out of previous versions of Chapter 9 which compelled municipalities to achieve certain minimum levels of creditor support prior to filing and provided no alternative mechanisms such as a demonstration of good faith efforts. *See, e.g.,* Malito, Nicholas B., *Municipal Bankruptcy: An Overview of Chapter 9*, 17 J. BANKR. L. & PRAC. 4 ART. 2 (2008) citing Act of May 24, 1934, ch. 345, 48 Stat. 798 (the "1934 Act") and Act of Aug. 16, 1937, ch. 657, 50 Stat. 653 (the "1937 Act"). Under the 1934 and 1937 Acts, for instance, a municipality had to have the preapproval of between 30% and 51% of its creditors prior to filing under Chapter 9. *Id.* This requirement was particularly difficult to meet in light of the fact that a municipality could have thousands of bondholders, many of whom could not even be specifically identified. As such, as part of the 1976 amendments to Chapter 9, Congress relaxed these requirements so as not to make "the accessibility requirement so stringent as to preclude relief in a situation in which the petitioner is confronted with stubborn or overly hasty creditors, or creditors whose identities are unknown because of the existence of bonds in bearer form" while at the same time limiting "accessibility to the bankruptcy court somewhat." *See.* H.R. Conf. Report No. 938, 94th Cong., 2d Sess. 17 (1976) *reprinted in* 1976 U.S.C.C.A.N. 539, 583. As such, in the absence of a pre-petition, negotiated agreement with the requisite number of creditors, in order to file under Chapter 9, a municipality must at the very least "be prepared to demonstrate that it engaged in good faith negotiations with its creditors concerning the possible terms of a plan to be effected pursuant to section 941 of the Bankruptcy Code." *In re Cottonwood Sanitation District*, 138 B.R. 973, 979 (Bankr. D.Colo. 1992).

B. Involuntary Cases Not Permitted. Involuntary cases are not permitted under Chapter 9. *See* 11 U.S.C. § 303(a)("An involuntary case may be commenced ***only*** under chapter 7 or chapter 11 of this title...") (emphasis added). The Supreme Court has held that such cases are unconstitutional in that "there would be in such conditions a dislocation of that balance between the powers of the states and the powers of the central government which is essential to our federal system." *Ashton v. Cameron County Water Imp. Dist. No. 1*, 298 U.S. 513, 537 (1936); *see also In re Mount Carbon Metropolitan Dist.*, 242 B.R. 18, 32 (Bankr. D. Colo. 1999)("Initial legislation, which provided for involuntary reorganizations, was declared unconstitutional because it materially restricted states in control of their governmental and fiscal affairs.").

C. Entities Excluded from Chapter 9 Filing. Only a "municipality" is allowed to file under Chapter 9, which term does not include "the District of Columbia or any territories of the United States." 1 NORTON BANKR. L. & PRAC. 3d § 17:8 (2011). Most importantly, states are not allowed to file under Chapter 9.

III. Chapter 9 Legislative History

A. The 1934 Act. Congress did not pass a municipal bankruptcy law until the Great Depression, when many local governments were in default of their debt obligations and there were no adequate remedies available to address such defaults *See* COLLIER ON BANKRUPTCY, ¶ 900.LH[1]. States were unable to effectively deal with the problem because the Constitution forbade them from impairing contractual obligations. U.S. CONST. ART. I, § 10. The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934, which added a new Chapter IX to the Bankruptcy Act, were largely a response to the Great Depression and were intended as temporary emergency measures, with expiration dates that were repeatedly extended.

   1. **Chapter IX Under 1934 Act Found Unconstitutional: *Ashton*.** The 1934 Act provided procedures whereby a local governmental unit could have a plan of adjustment enforced by the federal courts if it could obtain acceptance from two-thirds of its creditors. In addition, under the 1934 Act, the court had certain control over the municipality's revenues and governmental affairs. In 1936, the Supreme Court found the 1934 Act unconstitutional in *Ashton v. Cameron County Water Improvement District, No. 1*, 298 U.S. 513 (1936), as an improper infringement on the sovereign powers of the states. COLLIER ON BANKRUPTCY, ¶ 900.LH[2]

B. The 1937 Act. A year after the *Ashton* decision, Congress enacted new municipal bankruptcy provisions in 1937, as Chapter X of the Bankruptcy Act, in response to the Supreme Court's decision in *Ashton*. The primary differences between the 1937 Act and the 1934 Act were that the 1937 Act (i) did not allow bankruptcy courts to interfere with the fiscal and/or governmental affairs of filing political subdivisions; (ii) did not allow for involuntary proceedings; (iii) did not allow for judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and (iv) did not allow for impairment of contractual obligations by states.

   1. **Supreme Court upholds revised Act: *Bekins*.** The Supreme Court upheld the 1937 Act in *United States v. Bekins*, 304 U.S. 27 (1938), noting that the statute was carefully drawn so as not to impinge upon the sovereignty of the states. After *Bekins*, Congress repeatedly extended the expiration dates of the jurisdiction conferred on the District Courts until 1946, when the expiration date was removed and the municipal bankruptcy legislation became a permanent part of the Bankruptcy Act, as Chapter IX. COLLIER ON BANKRUPTCY, ¶ 900.LH[3].

C. The 1976 Act. In 1975, the financial crisis of New York City provided the impetus for major changes to Chapter IX to make it a more viable solution for major cities. *See* COLLIER ON BANKRUPTCY, ¶ 900.LH[4]. Some of the major changes included: (i) eliminating the requirement that municipalities obtain the consent of 51% of creditors on a plan before filing a petition; (ii) permitting municipalities to borrow on certificates of indebtedness; and (iii) allowing municipalities to reject executory contracts. *Id.*

D. The 1978 Act. When the Bankruptcy Reform Act was passed in 1978, resulting in the enactment of the Bankruptcy Code, the 1976 revisions were fully incorporated into the new Bankruptcy Code and re-designated as Chapter 9. Applicable provisions from general bankruptcy law contained in chapters 3, 5, and 11 of the Bankruptcy Code were also were incorporated into Chapter 9 and made applicable to municipal bankruptcy cases. *Id.*

E. The 1988 Amendments. In 1988, significant amendments to Chapter 9 were enacted, which sought to harmonize municipal bankruptcy law with generally municipal law and financing practices. The changes included new provisions providing that (i) liens on "special revenue" would not be terminated post-petition, (ii) prepetition payments on bonds and notes would be free from preference attack, and (iii) revenue bonds would not be converted into unsecured general obligation bonds. COLLIER ON BANKRUPTCY, ¶ 900.LH[5].

F. The 1994 Amendments. As noted above, the Bankruptcy Reform Act of 1994 amended section 109(c)(2) of the Bankruptcy Code, which deals with eligibility, by replacing the "generally authorized" to file language with a requirement that a municipality be "specifically authorized" to file under Chapter 9 by the state, or by a governmental officer or organization with power under state law. COLLIER ON BANKRUPTCY, ¶ 900.LH[6]. This was in response to the split and confusion among courts as to whether and to what extent state authorization needed to be specific.

G. The 2005 Amendments. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended sections 301 and 921(d) to clarify prior statutory language, and established that the commencement of a contested Chapter 9 case dates from the entry by the bankruptcy court of the order for relief, and not the date of the commencement of the case. COLLIER ON BANKRUPTCY, ¶ 900.LH[7]. The 2005 Act also made the newly amended sections 555, 556, 559, and 560 (the special contract provisions) applicable in Chapter 9 cases.

IV. Constitutional Challenges

A. Overall Constitutionality of Chapter 9. Although the Constitution provides Congress with the "power ... to establish ... uniform laws on the subject of bankruptcies throughout the United States..." U.S. CONST. ART. I, § 8, CL. 4., the Tenth Amendment, which states that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people," U.S. CONST. AMEND. X, limits Congress's ability to govern the affairs of state-created entities like municipalities. Tenth Amendment concerns come into play whenever federal laws potentially interfere with states' rights to manage affairs within their own borders. These concerns have informed much of the historical development of municipal bankruptcy law, and a "fundamental issue regarding municipal bankruptcy law is whether the scope of such a law interferes with state sovereignty over the affairs of its municipalities." Dubrow, David L., *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW 539, 549 (1992). The interest of protecting state sovereignty under the Tenth Amendment limits the degree of federal intrusion into municipal and state governance. As discussed below, these constitutional issues have been

adequately addressed in Chapter 9, and Chapter 9's constitutionality is no longer in question.

B. Constitutional Tensions Are Already Recognized and Addressed in Chapter 9. As noted above, from municipal bankruptcy law's earliest inception, Congress has recognized the constitutional tension of federal courts possibly interfering with states' right to govern and manage its localities. It has attempted to address this concern by including provisions in Chapter 9 that make clear that the intention of Chapter 9 is not to interfere in state governance, but to allow municipalities a form to adjust its debts. Taken together, the following sections preserve the constitutionality of Chapter 9 by severely curtailing the power of the federal court's interference into municipal affairs.

1. **§ 109(c)(2)**. Section 109(c)(2) provides that only a municipality that "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter" may be a debtor under Chapter 9. 11 U.S.C. § 109(c)(2). This requirement for municipal bankruptcy filings—that the state authorize the debtor to file—has roots in the constitutional principal of state sovereignty, that the federal government may not interfere with the internal governance of a state or its political subdivisions. Section 109(c)(2) preserves the power of the states to determine the extent to which their political subdivisions have access to the powers of the bankruptcy court, as required by the *Ashton* and *Bekins* decisions.

2. **§ 303**. Section 303 of the Bankruptcy Code provides that involuntary cases are not permitted in municipal bankruptcy cases, because to do so "may constitute an invasion of State sovereignty contrary to the tenth amendment." House Report No. 95-595, 95th Cong., 1st Sess. 321 (1977); Senate Report No. 95-989, 95th Cong., 2d Sess. 33 (1978).

3. **§ 903**. Section 903 of the Bankruptcy Code preserves the state's power to control a municipality. It provides that Chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of political or governmental powers of such municipality, including expenditures for such exercise." 11 U.S.C. § 903. The purpose of protecting state sovereignty in Section 903 is "to remove any inference that the legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness ... [since] [t]he potential for interference with State power when a federal court is involved in the financial affairs of a municipality has been the basis for opposition and challenges to municipal bankruptcy legislation since the earliest days." COLLIER ON BANKRUPTCY, ¶ 903.02[1]. The Supreme Court in *Bekins*, in upholding the constitutionality of the 1937 Act, relied in part on the language protecting states' powers. 304 U.S. 27 (1938).

4. **§ 904**. Section 904 sets forth limitations on the bankruptcy court's power in the administration of a case commenced under Chapter 9, providing that "[n]otwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not ... interfere with "(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the

debtor; or (3) the debtor's use or enjoyment of any income-producing property." *See* 11 U.S.C. § 904. Various forms of this have been contained in every municipal bankruptcy law since 1934, with the obvious purpose to obviate any possible constitutional objection to municipal bankruptcy legislation based on the Tenth Amendment. *In re County of Orange*, 179 B.R. 195 (Bankr. C.D. Cal. 1995)

5. **§ 941**. Under Section 941, the Debtor has the exclusive right to propose a plan for adjustment of debts. This provision is dictated by the Tenth Amendment, so that the municipality can be left in complete control of its political and governmental affairs during the bankruptcy.

C. Constitutionality of Specific Actions Taken in Chapter 9. While the overall constitutionality of Chapter 9 is not in question, bankruptcy courts overseeing a municipal bankruptcy case have been cautious with their power over Chapter 9 cases, as they seek to balance federal interests in making bankruptcy relief available to municipalities, with state interests in sovereignty. Otherwise, they expose themselves to Tenth Amendment challenges. However, although Section 903 reserves states' power to control municipalities, they do not limit the application of the substantive provisions of Chapter 9, and bankruptcy courts have held that federal bankruptcy law pre-empts state law and policies that "undercut the efficacy of Chapter 9." *Alliance Capital Management L.P. v. County of Orange*, 179 Bankr. 185, 189 (Bankr. C.D. Cal. 1995) (refusing to lift stay so creditor could pursue state remedy, because main benefit of Chapter 9 would be lost). As discussed below, federal bankruptcy appears to pre-empt state law that prevents the municipality from exercising its opportunity to readjust its debts and obligations.

1. **Obligations Imposed By State Statute**. In *In re City of Columbia Falls, Montana, Special Improvement District No. 25*, 143 B.R. 750, 759 (Bankr. D. Mont. 1992), the municipality's plan of adjustment provided for the restructuring of its obligations to bondholders. Under state law, the municipality was required to fund a revolving fund until all bonds and interests were fully paid and discharged. The state objected, arguing that Section 903 of the Bankruptcy Code limited the ability of the debtor to modify its obligations under the plan, and that if Chapter 9 would relieve the municipality from the revolving fund obligations imposed by state statute, it would constitute an unconstitutional interference with state powers under the Tenth Amendment. 143 B.R. at 759. The bankruptcy court rejected this argument, reasoning that by authorizing the Chapter 9 filing, the state had "affirmed that its municipalities may avail themselves of the benefits of the federal bankruptcy process, including the modification and termination of these sorts of debts, and such does not interfere with the power of the State of Montana to control a municipality or in the exercise of the political or governmental powers of such municipality." *Id.*

2. **Rejection of Contractual Obligations—Collective Bargaining Agreements**.

   a. **Debtor's ability to assume or reject executory contracts**. Section 365 of the Bankruptcy Code, which, among other things, allows a debtor to "assume or reject any executory contract or unexpired lease" is expressly incorporated into Chapter 9 by section 901(a). The Bankruptcy Code authorizes a debtor to

reject executory contracts, and this federal law provision overrides any state constitutional protection of certain contracts. The key issue to arise under this provision in the Chapter 9 context, is with regard to the rejection of collective bargaining agreements ("CBAs"), and specifically the degree to which state laws or state constitutional provisions which govern those agreements apply under Chapter 9.

b. ***Bildisco* Standard**. Prior to 1984, the rejection of CBAs under section 365 in all applicable cases was governed by the Supreme Court's decision in *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984), a Chapter 11 case. That decision, which resolved a split at the circuit court level, held that CBAs were in fact executory contracts subject to rejection under section 365, effectively preempting any federal labor laws to the contrary. The court found that a debtor could reject a CBA if it could show that (1) the agreement in question burdened the estate; (2) the equities balanced in favor of rejection; and (3) before attempting to reject, the debtor had made reasonable efforts to negotiate a voluntary modification and that such negations were unlikely to produce "a prompt and satisfactory solution." *Bildisco*, 465 U.S. at 526.

c. **Enactment of Section 1113**. Congress reacted swiftly to the *Bildisco* opinion, by enacting section 1113 of the Bankruptcy Code five months after it was decided, which provided a comprehensive scheme for the rejection of CBAs in Chapter 11 bankruptcies. Section 1113 did not incorporate state or federal labor laws, but instead

> created an expedited form of collective bargaining with several safeguards designed to insure that employers did not use Chapter 11 as medicine to rid themselves of corporate indigestion. Employers may only propose modifications in an existing labor contract that are necessary to permit an effective reorganization of the debtor. Further, the debtor must propose these modifications to the union before seeking approval to reject its collective bargaining agreement. 11 U.S.C. § 1113(b)(1)(A). Only if the expedited bargaining fails does § 1113 permit a debtor to apply for rejection of the labor agreement.

See In re Century Brass Products, Inc., 795 F.2d 265, 272 (2nd Cir. 1986).

d. **Section 1113 and Chapter 9**. Section 901 does not expressly incorporate section 1113 and thus, that provision does not appear to apply in Chapter 9 bankruptcies. *See* 11 U.S.C. § 901(a). That being said, some commentators have argued that the legislative history of the 1976 amendments to Chapter 9, which, for the first time allowed municipal debtors to reject executory contracts, indicates that Congress did not intend to give such entities the power to unilaterally reject CBAs without being subject to the requirements of state labor law. *See, e.g.,* Winograd, Barry. *San Jose Revisited: A Proposal for Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of the Bankruptcy Code*, 37 Hastings L.J. 231, 277-278 (1985)("The 1976 reforms evidence congressional solicitude for state interests. Particularly with respect to the contract rejection issue, the House

Report required that rejection of a collective bargaining agreement in a bankruptcy proceeding comply with applicable state labor laws.").

e. **Legislative history regarding state law and CBA rejection**. The legislative history makes clear that Chapter 9 should be used to reject collective bargaining agreements if such action will aid the municipality's reorganization:

> Within the definition of executory contracts are collective bargaining agreements between the city and its employees. Such contracts may be rejected despite contrary State laws. Courts should readily allow the rejection of such contracts where they are burdensome, the rejection will aid in the municipality's reorganization and in consideration of the equities of each case ... "Onerous employment obligations may prevent a city from balancing its budget for some time. The prospect of an unbalanced budget may preclude judicial confirmation of the plan. Unless a city can reject its labor contracts, lack of funds may force cutbacks in police, fire, sanitation, and welfare services, imposing hardships on many citizens. In addition, because cities in the past have often seemed immune to the constraint of 'profitability' faced by private businesses, their wage contracts may be relatively more onerous than those in the private sector." (citations omitted). Rejection of the contracts may require the municipalities to renegotiate such contracts by state collective bargaining laws. It is intended that the power to reject collective bargaining agreements will pre-empt state termination provisions, but not state collective bargaining laws. Thus, a city would not be required to maintain existing employment terms during the renegotiation period.

Senate Report No. 95-989, 95th Cong., 2d Sess. 111 (1978).

f. **Caselaw regarding state law and CBA rejection**. Outside of the legislative history, the role of state law in the rejection of CBAs has also been an issue in several recent major municipal bankruptcies. In the *Orange County* bankruptcy, for instance, the court issued a temporary restraining order preventing the municipal-debtor from unilaterally modifying a labor contract under section 365, finding that the *Bildisco* standard had not been met based on the Debtor's failure to satisfy state law requirements for modification. *In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal. 1995). In particular, the court noted that the debtor was required to comply with state law regarding CBA rejection "if not as a legal matter, [then] certainly from an equitable standpoint" in that *Bildisco* did not "excuse attempts by the County to comply with the requirements of California law." *Id.* at 184. In *In re Vallejo* on the other hand, the court emphatically rejected the *Orange County* decision holding that state labor law could not provide "the applicable standard controlling the rejection of the City's collective bargaining agreements." *In re City of Vallejo*, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009) Focusing on the fact that, in 1991, Congress considered, but chose not to enact a provision which would have required a debtor to exhaust all "state law procedures for the bargaining, implementation, and amendment of a collective bargaining agreement" prior to the rejection of such agreements, the court refused to

"presume to do what Congress has not done, whether by incorporating section 1113-like provisions into Chapter 9, or by requiring compliance with state labor law." *Id.* at 78. As such, the city of Vallejo was allowed to proceed with the rejection of certain of its union contracts, and did in fact successfully reject at least one such contract. *See In re City of Vallejo, CA*, 432 B.R. 262 (E.D. Cal. 2010) (affirming bankruptcy court decision rejection CBA).

V. Proposed Federal Legislation to Allow State Bankruptcies

A. Necessary Statutory Changes to Enable State Eligibility. As discussed above, states are not currently permitted to file for bankruptcy under Chapter 9 or any other chapter of the Bankruptcy Code. In order to allow states to file, the Bankruptcy Code would need to be amended by Congress.

B. Recent National Discussion. U.S. lawmakers, scholars, and the press have recently taken an interest in whether states should be allowed to file for bankruptcy and whether such an option would prove beneficial.

1. **Gingrich Support**. The debate over whether states should be allowed to file for bankruptcy was arguably sparked by former House speaker Mr. Gingrich in November 2010, who spoke about the challenges states were facing and urged House Republicans to introduce a bill that would allow states to file for bankruptcy. Mr. Gingrich's speeches were followed by an op-ed piece co-written by Mr. Gingrich and Mr. Jeb Bush, the former governor of Florida, arguing that Congress "has the opportunity to prepare a fair, orderly, predictable and lawful approach to help struggling state governments address their financial challenges without resorting to wasteful bailouts." *See* Bush, Jeb and Newt Gingrich, *Better off Bankrupt: States Should Have the Option of Bankruptcy Protection to Deal With Their Budget Crisis*, L.A. TIMES (Jan. 27, 2011).

2. **Skeel Article**. In late November 2010, David Skeel, a law professor at the University of Pennsylvania, published a controversial piece in The Weekly Standard, "Give States a Way to Go Bankrupt" (Nov. 29, 2010), which argued that allowing states to file for bankruptcy is the best way to avoid a massive federal bailout of the states, and would give states an ordered way to restructure their debts. Skeel contended that any constitutional concerns could be easily addressed. The piece brought the issue to public attention and elicited a national debate on both sides, including from the National Governors Association, which strongly opposed the idea of state bankruptcies.

C. Review of Recent Legislative Efforts

1. **Congressional Hearings**. Partly in response to the issues raised by Mr. Gingrich and Mr. Skeel, Congress held hearings regarding various state bankruptcy proposals, as U.S. lawmakers examined whether congressional intervention was needed to ease difficulties faced by states and municipalities.

2. Currently, however, the discussion regarding allowing states to file bankruptcy has died down, as has Congressional activity investigating the same.

D. Constitutional Challenges To State Bankruptcies

1. **Tenth Amendment Concerns**. The main constitutional objection to allowing states to file for bankruptcy is that it interferes with the Tenth Amendment's principle of state sovereignty—that federal courts cannot interfere with the state's management of its own affairs.

2. **Addressing Constitutional Concerns**. This constitutional concern is identical to the one concerning municipal bankruptcies. As discussed above, however, Congress has arguably already addressed this concern by including certain provisions in the Bankruptcy Code protecting state sovereignty, and there is no reason why such protections could not be imported into a state bankruptcy chapter were such legislation to be passed. The following protections for state sovereignty should alleviate any concerns that allowing states to file for bankruptcy is unconstitutional: (a) specific state consent; (b) the filing is voluntary; (c) states have the exclusive right to file a plan of adjustment of debts; (d) powers reserved to states are specifically reserved; and (e) judicial control over management and property of the state is limited.

VI. Overview of Chapter 9

A. Notice of Case and Objections

1. **Filing of petition and appointment of judge**. A Chapter 9 case is commenced by the voluntary filing of a petition by a municipality. *See* 11 U.S.C. §§ 303, 901(a). The body that has the authority under state law to act for the municipality at issue, also has the authority to file the Chapter 9 petition (assuming, as discussed *supra*, that state law otherwise specifically authorizes the entity to file). COLLIER ON BANKRUPTCY ¶ 921.02. As opposed to filings under other chapters of the Bankruptcy Code, in which the court clerk automatically assigns the case to a particular judge, the "chief judge of the court of appeals for the circuit embracing the district in which the case is commenced [designates] the bankruptcy judge to conduct the case." *See* 11 U.S.C. § 921(b). "This provision was designed to remove politics from the issue of which judge will preside over the Chapter 9 case of a major municipality and to ensure that a municipal case will be handled by a judge who has the time and capability of doing so." 6A WEST'S FED. FORMS, BANKRUPTCY COURTS § 10251 (4th ed. 2010)

2. **Notice**. Notice must be given under Chapter 9 at the commencement of the case, as well as at the time of the entry of the order for relief or for dismissal of the case. *See* 11 U.S.C. § 923.

3. **Objections**. Section 921(c) of the Bankruptcy Code permits objections to a municipal-debtor's Chapter 9 petition. *See* 11 U.S.C. § 921(c). Pursuant to that section, the court may dismiss the petition, after notice and a hearing, if the debtor did not file the petition in good faith or if the debtor failed to otherwise meet the requirements of Chapter 9 including the eligibility provisions of section 109(c). *Id.*

4. **Order for Relief**. Under section 301(b) of the Bankruptcy Code, which is applicable in Chapter 9 cases based on section 901(a), "the commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter." Initially, this section led to some confusion in Chapter 9 cases, in

that section 921(d) of the Code provided that "[i]f the petition is not dismissed under subsection (c) of this subsection, the court shall order relief under this chapter." Based on these conflicting provisions, "the statute was unclear as to the operative date of the order for relief where a Chapter 9 petition was contested; *i.e.*, the date the case was commenced as provided in section 301, or the date the Bankruptcy Court entered relief pursuant to section 921(d) in such a contested case." COLLIER ON BANKRUPTCY ¶ 921.04[5]. Because of this ambiguity, through BAPCPA, Congress added in the clause "notwithstanding section 301(b)" at the end of section 921(d), to clarify that the date of the order for relief under Chapter 9 is the date on which the court chooses not to dismiss the case. *Id.*

B. Bankruptcy Court's Limited Role. A major difference between Chapter 9 and chapter 11 is the degree of control exercised by the court over the debtor during the proceeding. In chapter 11 cases, a bankruptcy court has significant control and oversight as to what the debtor may and may not do during the course of the case. However, Tenth Amendment concerns severely limit the court's role in a Chapter 9 case, as federal courts cannot meddle in a state's management of its internal affairs. As discussed above, section 903 preserves the state's power to control a municipality "in the exercise of political or governmental powers." 11 U.S.C. § 903. Section 904 expressly prohibits the bankruptcy court from interfering with the "political or governmental powers of the debtor," the "properties or revenues of a debtor" or the "debtor's use of or enjoyment of any income-producing property." Taken together, these sections severely limit the powers of the bankruptcy court in order to avoid any Tenth Amendment issues.

C. Automatic Stay. Section 362 which, among other things, stays the commencement or continuation of all prepetition actions or proceedings against the debtor, is incorporated into Chapter 9 by section 901(a). However, the automatic stay in Chapter 9 proceedings is further expanded to protect not only the debtor itself, but also any "officer or inhabitant of the debtor", *see* 11. U.S.C. § 922(a)(1), as well as to preclude the "enforcement of a lien on or arising out of taxes or assessments owed to the debtor." *See* 11 U.S.C. § 922(a)(2). As such, creditors are prohibited from bringing mandamus actions against municipal officials on account of prepetition obligations, and actions against citizens who owe taxes to the debtor.

D. Special Protections to Bondholders. Many municipalities finance their operations by issuing bonds. General obligation bonds, which are comparable to unsecured general debt obligations, are backed by the full faith and credit of a municipality. Revenue bonds, which are comparable to secured debt, are secured by a lien on a revenue source such as a particular tax, fee, or income stream. In the event of a default, revenue bondholders have no legal right to payment from any other assets of the municipality. Chapter 9 was amended considerably in 1988 to address these unique features of municipal finance, to assure bondholders that payments to them would not be subject to preferential attack and that general revenues would not be used to pay revenue bondholders, and to afford special protections to holders of revenue bonds, including payment of debt service during the case from pledged revenues and the continuation of their lien on revenues.

1. **Protection from Preference Attack**. Section 926(b) of the Bankruptcy Code provides that a "transfer of property of the debtor to or for the benefit of any

holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title." 11 U.S.C. § 926(b). "This section is intended to allow municipalities and their holders of notes and bonds to have the same rights under state law and constitutional provisions as to transfers and benefits conferred prior to the institution of a Chapter 9 case." Senate Report No. 100-506, 100th Cong., 2d Sess. 22 (1988).

2. **Special Revenue Doctrine**

   a. **Definition.** Under section 902(2), "special revenues" are defined as (i) receipts derived from the ownership, operation, or disposition of projects of the debtor that are primarily used to provide transportation, utilities, or other services, *see* 11 U.S.C. § 902(2)(A); (ii) special excise taxes imposed on particular activities or transactions, *see* 11 U.S.C. § 902(2)(B); (iii) incremental tax receipts from tax-increment financing areas, *see* 11 U.S.C. § 902(2)(C); (iv) other revenues derived from particular functions of the debtor, *see* 11 U.S.C. § 902(2)(D); or (v) taxes specifically levied to finance one or more specific projects of the debtor, *see* 11 U.S.C. § 902(2)(E). Essentially, the definition is meant to capture "revenue derived from a project or from a specific tax levy, where such revenues are meant to serve as security to the bondholders." H.R. REP. NO. 1011, 100TH CONG., 2ND SESS. 1988, *reprinted in* 1988 U.S.C.C.A.N. 4115 (1988). Pursuant to section 927, the holder of a claim payable solely from special revenues does not have recourse to the debtor's general funds on account of such obligations. *See, e.g.,* 9C AM. JUR. 2D BANKRUPTCY § 2540 (noting that section 927 prevents a creditor from "convert[ing] nonrecourse revenue bonds into recourse or general obligation debt.")

   b. **Survival of special revenue lien post-petition.** Under section 552(a) of the Code, which is applicable in Chapter 9 pursuant to section 901(a), "property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any [prepetition] security agreement." As per this provision, prior to 1988, it appeared that special revenues collected by the debtor post-petition were *not* subject to liens in favor of the special revenue bondholders. In order to ameliorate this situation, as part of the 1988 amendments to the Bankruptcy Code, Congress enacted section 928 which provided that "notwithstanding section 552(a) ... special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any [prepetition] security agreement," *see* 11 U.S.C. § 928(a), subject to any such lien generally being subordinate to the "necessary operating expenses" of the project or system in question. *See* 11 U.S.C. § 928(b). As the legislative history to the 1988 amendments noted, "under section 552(a) ... [because] property acquired by a debtor after filing bankruptcy is not subject to any lien created prior to bankruptcy ... the lien created by a revenue bond issued prior to bankruptcy is extinguished" by a Chapter 9 filing. *See* H.R. REP. NO. 1011. The amendments were intended to "eliminate this problem by making special revenues still subject to a post-petition lien in a Chapter 9 bankruptcy, notwithstanding section 552(a)." *Id.*

c. **Special Revenues and the automatic stay**. Pursuant to section 922(d) of the Code, the filing of a petition under Chapter 9, "does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues." In other words, the automatic stay does not prevent the debtor (or in many cases an indenture trustee) from transferring pledged special revenues to special revenue bondholders. Some debate has arisen among commentators regarding the broadness of this exception to the automatic stay. On the one hand, some believe that section 922(d) is to be read narrowly and does not authorize the debtor to make special revenue payments during the Chapter 9 case. *See* COLLIER ¶ 922.05[2]. Instead, a creditor is permitted only to "apply funds which are already in the creditor's possession [*i.e.*, an indenture trustee distributing funds that it acquired prepetition to bondholders] but not to obtain possession ... of funds that are subject to a nonpossessory lien." *Id.* Other commentators disagree and claim that section 922(d) should be read broadly relying primarily on language from that section's legislative history. *See, e.g.* Amdursky, Robert S., *The 1988 Municipal Bankruptcy Amendments: History, Purposes, and Effects*, 22 URB. LAW. 1, 13 (1990); Dubrow, David L., *Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?*, 24 URB. LAW. 539, 572-73 (1992). In particular, the Report of the Senate Judiciary Committee expressly states that in the context of section 922, "pledged revenues includes funds in the possession of the bond trustee ***as well as other pledged revenues***." *See* S. Rep. No. 506, 100th Cong., 2d Sess. 4 (1988)(emphasis added). Furthermore, these commentators argue that a narrow interpretation would be inconsistent with the entire rationale behind section 922(d) that was meant to prevent needless disruption of financial markets with regard to the payment of special revenues to bondholders. *See* Dubrow, 24 URB. LAW. 539 at 573.

E. Powers of the Debtor

1. **Ordinary course power to use property, raise taxes, and make expenditures**. Due to the restrictions placed on bankruptcy courts by sections 903 and 904, municipalities are given broad powers to operate as usual while functioning under Chapter 9. More specifically, "[t]he municipal debtor has broad powers to use its property, raise taxes, and make expenditures as it sees fit." *See* 6A WEST'S FED. FORMS, BANKRUPTCY COURTS § 10251 (4th ed. 2010).

2. **Postpetition Financing**. Pursuant to sections 364(c)-(f), which are incorporated into Chapter 9 by section 901(a), municipal debtors are authorized to obtain post-petition financing, the repayment of which may, in some cases, obtain priority over the debtor's other obligations. Sections 364(a) and (b), which give the court authority to allow the debtor to obtain unsecured credit through the ordinary course of business, or out of the ordinary course of business as an unsecured administrative claim, are inapplicable in a Chapter 9, in that "[t]o do so would give the court authority to supervise the amount of debt the debtor incurred in the operation of its municipal affairs" contrary to sections 903 and 904. COLLIER ¶ 901.04[8]. Only when a municipal debtor seeks to obtain credit in manner which it would not otherwise be able to under state law is court approval appropriate. *Id.*

a. **Priority over administrative expenses**. Under section 364(c)(1), in certain circumstances, the repayment of a post-petition lender may obtain a priority status over all "administrative expenses." Under section 503, which is incorporated into Chapter 9 pursuant to section 901(a), administrative expenses generally refer to the actual, necessary costs and expenses of preserving debtor's estate. *See* 11 U.S.C. § 503(b)(1)(A). That term does not, however, incorporate general municipal operating expenses, "[s]ince the court has no authority over expenditures made by the debtor in the operation of its municipal affairs." COLLIER ¶ 901.04[8]. Thus the only administrative fees relevant in a Chapter 9 filing are those "incurred directly in connection with the Chapter 9 case itself, such as court costs, attorneys' fees, costs of distribution of the plan and solicitation of acceptances, and other costs intimately related to the case." *Id.*

b. **Liens on unencumbered property**. Pursuant to section 364(c)(2), in certain circumstances, the court may authorize a debtor to obtain postpetition credit through the granting of a lien on property not otherwise subject to a lien prepetition. On its face, this subsection appears to be inconsistent with the legislative history of section 364 in Chapter 9 which indicates that the court will become involved in postpetition financing "[o]nly when the municipality needs special authority", *see* 11 U.S.C. § 901, REVISION NOTES AND LEGISLATIVE REPORTS, in that municipalities are authorized to grant liens on property not otherwise subject to a lien outside of bankruptcy. As such some commentators have read this provision as giving bankruptcy courts the authority to permit debtor actions that are *not* otherwise permitted under state law. *See* Dubrow, 24 URB. LAW. 539 at 565. For instance, under some state laws, municipalities are not permitted to issue special revenues bonds. According to these commentators, it is possible that section 364(c)(2) overrides these state laws and permits the granting of liens in favor of special revenue bondholders. *Id.* at 566. Others disagree based on the broad reservation of rights in section 903 in which courts are not permitted to interfere with state authority over municipalities. *See, e.g.*, COLLIER ¶ 901.04[8].

F. Roles of Other Interested Parties

1. **Role of U.S. Trustee**. The role of the United States Trustee is extremely limited in a Chapter 9 case and, aside from appointing a creditor's committee, he or she does not otherwise supervise the case's administration. As opposed to cases under other chapters, under Chapter 9, the U.S. Trustee does not examine the debtor at a meeting of creditors as there is no meeting of creditors; does not have the authority to move for the appointment of a trustee or examiner; can not move for conversion of the case; does not monitor the financial operations of the debtor; and does not review the fees of professionals retained in the case. *See* 6A WEST'S FED. FORMS, BANKRUPTCY COURTS § 10251 (4th ed. 2010).

2. **Role of Creditors and Creditors' Committees**. Sections 1102 and 1103 of the Bankruptcy Code, which provide for the appointment of creditors committees, are incorporated into Chapter 9 by section 901(a), however, like the U.S. Trustee, their role, and the role of creditors generally, is limited in a Chapter 9 case.

Creditors may not propose competing plans under any circumstances, *see* 11 U.S.C. § 941, and debtors are permitted more "freedom to operate without court-imposed restrictions." *See* 6A WEST'S FED. FORMS, BANKRUPTCY COURTS § 10251 (4th ed. 2010). That being said, creditor committees are permitted to consult with the debtor concerning administration of the case; to investigate the assets, liabilities, and general financial condition of the debtor; to participate in the formulation of a plan (however, the municipal debtor has the exclusive right to propose a plan); and to employ professionals to assist them in these duties. *Id*

G. Plan for Adjustment of Debts

1. **Debtor's right to file plan**. Under Chapter 9, a municipal debtor has the exclusive right to file a plan for the adjustment of its debts. *See* 11 U.S.C. § 941. This is in contrast to debtors operating under other chapters of the bankruptcy code who generally have an exclusive time period in which to file a plan or reorganization, the expiration of which leads to other entities becoming entitled to file a plan.

2. **Time for filing plan**. Section 941 assumes that in the ordinary case, a plan of adjustment will be filed with the petition. *See* 11 U.S.C. § 941 ("The debtor shall file a plan for the adjustment of the debtor's debts. ***If such a plan is not filed with the petition***, the debtor shall file such a plan at such later time as the court fixes.")(emphasis added); *see also* COLLIER ON BANKRUPTCY ¶ 941.03. This assumption grew out of earlier versions of Chapter 9 which required the plan to be filed at that time. *See* COLLIER ON BANKRUPTCY ¶ 941.LH. If the plan is not filed with the petition, the court is free to set the time for its filing a plan either on its own motion on the request of the petitioner, though due to the debtor's exclusive right to propose a plan, most agree that the court should not be overly demanding in fixing a short time period. *See* COLLIER ON BANKRUPTCY ¶ 941.04.

3. **Standards for plan confirmation**. Under section 943(b), a court must confirm a debtor's plan of adjustment if

   a. the plan complies with the those provisions of the Bankruptcy Code made applicable by sections 103(e) and 901;

      i. **Applicable requirements of § 1129**. The most important provisions alluded to by this first requirement of plan confirmation are those subsections incorporated into Chapter 9 from section 1129 which are made applicable to Chapter 9 by section 901(a) – §§ 1129(a)(2), (a)(3), (a)(6), (a)(8) and (a)(10) and 1129(b)(1), (b)(2)(A) and (b)(2)(B). In particular, as discussed below, §§ 1129(a)(8) and (a)(10) may be particularly relevant in the Chapter 9 context.

      ii. **§ 1129(a)(2)**. Under § 1129(a)(2), in order for a court to be able to confirm a plan, the proponent of the plain must comply with all applicable provisions of the Bankruptcy Code.

      iii. **§ 1129(a)(3)**. Under § 1129(a)(3), any plan must be "proposed in good faith and not by any means forbidden by law."

iv. **§ 1129(a)(6)**. Under § 1129(a)(6), for plan confirmation purposes, "[a]ny governmental regulatory commission with jurisdiction, after confirmation of the plan, over the rates of the debtor" must have "approved any rate change provided for in the plan" or such a rate change must be "expressly condition on such approval.

v. **§ 1129(a)(8)**. In conjunction with § 1129(a)(10) (discussed immediately below), § 1129(a)(8) is particularly relevant under Chapter 9 in that it requires that each class of claims either not be impaired by the plan or vote to accept the plan. Unlike the other subsections of § 1129(a), a plan may still be confirmed under the cram-down provisions of the Bankruptcy Code, in the absence of compliance with § 1129(a)(8), so long as the plan complies with all of the other subsections of § 1129(a) including § 1129(a)(10).

vi. **§ 1129(a)(10)**. Assuming there is at least one class of impaired claims under a plan, under § 1129(a)(10), at least one such impaired class must vote to accept the plan in order for the plan to be confirmed. This requirement may be particularly difficult to meet in the Chapter 9 context, particularly when the focus of a municipality's financial difficulties can be traced to things like legacy pension and health care obligations. By way of an example, in such a situation, a proposed plan of debt adjustment may otherwise keep all of municipalities other obligations in place, while rejecting CBA contracts relating to public employee pensions and the like. In order to get such a plan confirmed, the municipality would be forced to get at least of these rejected-contract classes to accept the plan in the face of the impairment of its claims. Furthermore, the Bankruptcy Code does not permit the "gerrymandering" of classes. *See* 11 U.S.C. § 1122 ("[A] plan may place a claim or an interest in a particular class only if such a claim or interest is substantially similar to the other claims or interests of such class.") (incorporated into Chapter 9 under § 901(a)). As such, a municipality would be hard-pressed to separate out a class of claimants who had their CBAs rejected but nonetheless agreed to a plan from a similar class of claimants who had their CBAs rejected but refused to accept a plan.

vii. **§§ 1129(b)(1), (b)(2)(A) and (b)(2)(B)**. The subsections of § 1129(b) that are incorporated into Chapter 9 address the circumstances in which a plan may be "crammed down" on otherwise disapproving. The possibility of a "cram-down" plan in Chapter 9 is discussed, *infra* at § IV(G)(4).

b. the plan complies with the other provisions of Chapter 9;

c. all amounts owed for expenses incurred during the case, or incident to the plan, have been fully disclosed and are reasonable;

d. the debtor is not prohibited by law from taking any action necessary to carry out the plan;

i. **State law contrary to plan**. As with sections 903 and 904 of the Bankruptcy Code, this fourth requirement for plan confirmation is meant to prevent municipalities from circumventing applicable state law by providing for an otherwise prohibited action through the guise of a plan of reorganization. *See* COLLIER ON BANKRUPTCY ¶ 943.03[4]. This provision is consistent with § 1129(a)(3), which requires any plan to be "proposed in good faith and not by any means forbidden by law." That being said, this provision does not impact a municipality's ability to reject executory contracts such as CBAs under section 365 of the Bankruptcy Code, regardless of whether or not such rejection is barred by state law.

e. the plan provides for payment in full of administrative claims, except to the extent that the holders of such claims agree to different treatment;

i. **Operating costs**. As opposed to Chapter 11, "administrative expenses" under Chapter 9 do not include the debtor's operating expenses. Operating expenses "are generally included in business reorganization cases, because those costs are considered 'costs and expenses of preserving the estate.'" COLLIER ON BANKRUPTCY ¶ 943.03[5][a][ii] quoting 11 U.S.C. § 503(b)(1)(A). Under Chapter 9, however, there is no "estate" and thus, "operating expenses of the debtor cannot be said to be costs of preserving the estate." *Id.* Thus in applying section 943(b)(5), the court should focus solely on those costs that are related to the administration of the Chapter 9 case and not on the operating expenses of the municipality.

f. The regulatory and/or electoral approval necessary under applicable non-bankruptcy law in order to carry out the plan has been obtained; and

g. the plan is in the best interests of creditors and is feasible.

i. **Comparison to Chapter 11**. Under section 943(b)(7), the final requirement for plan confirmation under Chapter 9, is that the plan be "in the best interests of creditors." This requirement was also part of former Chapter XI of the code where it was interpreted to mean that, for a plan to be approved, creditors would have to receive as much under a plan as they would under a liquidation of the debtor's business. COLLIER ON BANKRUPTCY ¶ 943.03[7][a]. This meaning was codified in the current version of Chapter 11 of the Bankruptcy Code which requires each impaired class to either accept the plan or to receive property under the plan "that is not less than the amount that such holder would receive ... if the debtor were liquidated under chapter 7..." *See* 11 U.S.C. § 1129(7)(A)(ii). This interpretation, however, does not work under Chapter 9, where the assets of a municipal debtor can not be liquidated for the benefit of creditors. *See, e.g., Newhouse v. Corcoran Irr. Dist.*, 114 F.2d 690 (9th Cir. 1940) (noting that the "bankruptcy of a public entity ... is very different from that of a private person or concern" in that the assets of

that entity "cannot be disposed of as in the ordinary bankruptcy proceeding for the benefit of the debtor").

ii. **"Better than dismissal" standard**. As such, courts have interpreted this requirement to mean that a municipal-debtor's plan of adjustment must be better than the alternative options available to the creditors. *See, e.g., In re Mount Carbon Metropolitan District,* 242 B.R. 18, 34 (D. Colo. 1999). That being said, "one must not be so carried away with the potentially adverse consequences of the alternative to a Chapter 9 plan that one reaches the conclusion that any plan is better than the alternative." COLLIER ON BANKRUPTCY ¶ 943.03[7][a]. For instance, a "plan that makes little or no effort to repay creditors over a reasonable period of time may not be in the best interest of creditors." *Id.* On the other hand, creditors can not force a municipality to devote all of its resources to paying off prepetition claims. A municipal debtor can only be required to make "reasonable efforts" to pay off creditors. *In re Mount Carbon Metropolitan District,* 242 B.R. at 34.

iii. **Feasibility**. A feasibility finding under Chapter 9 "requires a practical analysis of whether the debtor can accomplish what the plan proposes and provide governmental services." *In re Mount Carbon Metropolitan District,* 242 B.R. at 35. A debtor does not have to guarantee success, but "more is required than mere hopes, desires and speculation." *Id.*

4. **Cram-Down**. In the event that all of the classes impaired by a Chapter 9 plan do not vote to accept the plan, the plan may still be confirmed under the "cram-down" provisions of section 1129 which are incorporated into Chapter 9 by section 901(a). In particular, "if all of the applicable requirements of [section 1129(a)] other than paragraph (8) [*i.e.*, the requirement that all impaired classes have accepted the plan] are met with respect to a plan, the court ... shall confirm the plan ... if the plan does not discriminate unfairly, and is fair and equitable with respect to each class of [impaired] claims" that has not accepted the plan. *See* 11 U.S.C. § 1129(b)(1). Pursuant to section 1129(b)(2)(A), with respect to a class of secured claims, a plan is "fair and equitable" if pursuant to the plan, (i) the holders of such claims retain their liens and receive deferred cash payments equal to the total amount of their allowed claim; (ii) the property subject to such liens is sold with the liens attaching to the proceeds of such sale; or (iii) the holders of such claims otherwise realize the "indubitable equivalent" of their claims. *See* 11 U.S.C. §1129(b)(2)(A)(i)-(iii). Pursuant to section 1129(b)(2)(b), with respect to a class of unsecured claims a plan is "fair and equitable" if pursuant to the plan, (i) the holders of such claims receive property equal to the allowed amount of such claim; or (ii) the holder of any junior claim or interest does not receive any property. *See* 11 U.S.C. §1129(b)(2)(B)(i)-(ii).

   a. **Fair and Equitable**. The requirement that a plan be "fair and equitable" was formerly an express requirement of all Chapter 9 plans. *See, e.g.*, COLLIER ON BANKRUPTCY ¶ 943.LH[2] ("The 1976 amendments deleted the "best interests of creditors" test as redundant of the "fair and equitable" requirement.") As per the legislative history with regard to that express provision, the "fair and

equitable rule in effect incorporates the best interests test" as well as the absolute priority rule "which requires that senior creditors be paid in full before any creditor junior to them may be paid at all." H.R. REP. NO. 686. As per *Fano v. Newport Heights Irr. Dist.*, 144 F.2d 563 (9th Cir. 1940), for a plan to be "fair and equitable" a municipality must be exercising "its taxing power to the fullest extent possible for the benefit of its creditors ... and [t]he court must find that the amount proposed to be paid under the plan was all that the creditors could reasonably expect under the circumstances." *Id.* At its core, in Chapter 9, the "fair and equitable" standard requires "that the plan embody a fair and equitable bargain, openly arrived at and devoid of overreaching." *Id.*

b. **Relevant factors**. Generally, in a Chapter 9 case, the only assets which will be available to satisfy creditors' obligations are future tax revenues. In considering those revenues, in the context of both the "fair and equitable" standard as well as the "best interests of creditors" standard, courts must look to analyses based on "data which will permit a reasonable, and hence an informed, estimate of the probable future revenues available for the satisfaction of creditors." H.R. REP. NO. 686. Relevant factors include (i) past revenues from each source of taxation; (ii) the present assessed value of property subject to tax; (iii) the tax rates currently prescribed; (iv) the extent of past tax delinquencies; and (v) any general economic conditions of the municipality which may reasonably be expected to affect the percentage of future delinquencies. *Kelley v. Everglades Drainage Dist.,* 319 U.S. 415, 421 (1943).

c. **Absolute Priority Rule**. While the legislative history indicates that the absolute priority rule is incorporated into Chapter 9, that rule must be at least somewhat modified in the municipal-debtor context in that there are no equity holders, and the municipal debtor can not be forced to cease operations. *See, e.g., In re Corcoran Hosp. Dist.*, 233 B.R. 449 (Bankr. E.D.Cal. 1999)(noting in a Chapter 9 proceeding that there were no equity holders and that "what is commonly referred to as the 'absolute priority rule' embodied by § 1129(b)(2)(B) does not prevent the [municipal] debtor here from continuing to operate"). As such, this rule provides much less protection to creditors in the municipal arena than it does in the corporate arena.

d. **Unfair discrimination**. The requirement that a plan not "discriminate unfairly" goes hand and hand with the requirement that the plan be fair and equitable, such that if the plan does not satisfy one of the standards, it is unlikely to meet the other as well. That being said, that a plan not discriminate unfairly is listed as a distinct confirmation requirement and generally requires that a plan not treat one of several similarly situated classes of claims more favorably than others. *See* COLLIER ON BANKRUPTCY ¶ 943.03[1][f][ii](noting that plan would not be confirmed under this rule "where one creditor was obtaining some special favor or inducement not accorded the others, whether that consideration moved from the debtor or from another").

H. Confirmation

1. **Discharge**. Pursuant to section 944(b), a municipal debtor is discharged of all of its debts as of the time when (i) the plan is confirmed; (ii) any consideration to be distributed under the plan is deposited with a court appointed disbursing agent; and (iii) the court determines that any securities to be issued by the debtor, the debtor's promises to pay, and/or the debtor's grant of security interests are all valid legal obligations of the debtor. *See* 11 U.S.C. §944(b)(1)-(3). The purpose of the latter two requirements, which are not present in chapter 11 cases, is to ensure that the court can monitor the debtor's compliance with the plan while not impinging on the state sovereignty issues implicated by sections 903 and 904. *See* COLLIER ON BANKRUPTCY ¶ 944.03[1][a]. The scope of the Chapter 9 discharge – in terms of precisely which debts it applies to – is not expressly provided for but, "[u]nder general principles, it operates as a release of all debts incurred before the date of the filing of the Chapter 9 petition." *Id.*

VII. Summary of Recent Chapter 9 Filings

A. Vallejo, California

1. A city in the San Francisco Bay area with a population of approximately 120,000, Vallejo filed for Chapter 9 bankruptcy in May 2008, primarily because of unsupportable public-employee labor and legacy costs, coupled with falling property tax revenues.

2. **Struggles with Labor**. The city languished in bankruptcy for three years while unions argued over the city's efforts to modify collective bargaining agreements. The dispute led to appeals that stretched on at enormous expense. Vallejo initially planned to use bankruptcy to cut its workers' and retirees' pensions, but it changed course when California's state pension system (CalPERS) threatened a costly and debilitating court battle. Vallejo instead wound up cutting pay, health care, and other benefits (including reducing pension benefits for new employees, cutting payments for retiree health care, and raising pension contributions for current workers), as well as reducing city services and payments to its bondholders, but left the pensions intact. It also negotiated new labor contracts with its unions. *See, e.g., IBEW v. Vallejo* (*In re City of Vallejo)*, 403 B.R. 72 (Bankr. E.D. Cal. 2009); 432 B.R. 262 (E.D. Cal. 2010) (expressly rejecting *Orange County* and upholding bankruptcy court approval of rejection of electrical union workers' CBA).

3. **Plan of Adjustment**. The city's Plan of Adjustment was confirmed by the Bankruptcy Court on August 4, 2011. Under the plan, Union Bank, holding more than $45 million in unpaid certificates of participation, will recover approximately 40% on its claims. The claims of Vallejo's public employees will be paid in full over time. Unsecured creditors will receive a 30% recovery, including the retirees with claims for health care benefits. As noted above, while the plan reduces retirement health care benefits, the city's obligations to its pension trusts remain unaltered.

B. Central Falls, Rhode Island

1. The city of Central Falls, with a population of 18,000, filed for Chapter 9 bankruptcy on August 1, 2011, after the city and its public safety unions failed to reach agreement on contract concessions. The main reason for Central Fall's bankruptcy was to revamp pension obligations; the filing came one year after the state took control of the city's finances.

2. **Pre-filing Legislation Giving Bondholders Preference Over General Creditors**. Three weeks prior to Central Falls' filing, Rhode Island's Governor Lincoln Chafee signed legislation providing that lenders to a debtor-municipality automatically receive a first-priority lien on both the municipality's general and property tax revenue in the event of a bankruptcy filing. It is unclear if that will withstand likely legal challenges.

3. Up to this point in the bankruptcy case, the Bankruptcy Court has approved a deal forged by Central Falls and many of its retired employees voluntarily to reduce the level of benefits they are receiving. Retired police and firefighters agreed to sharp pension cuts in return for a commitment from the state to seek extra money for the next five years. The court also approved a new collective bargaining agreement for current police and fire employees.

C. Harrisburg, Pennsylvania

1. The city of Harrisburg, with a population of 49,500, filed for Chapter 9 bankruptcy on October 11, 2011 with authorization from the Harrisburg City Council. The city faced a seemingly insurmountable debt burden because of an overhaul and expansion of a trash-to-energy incinerator that did not generate enough revenue to service the $310 million in debt incurred to fund the project.

2. **Eligibility Issues**. As Harrisburg's fiscal crisis mounted, Harrisburg at first looked to the Pennsylvania Municipalities Financial Recovery Act 47 for relief. Pennsylvania designated Harrisburg as "financially distressed" in October 2010, and the Commonwealth then appointed an Act 47 coordinator, who submitted a detailed fiscal recovery plan. The City Council repeatedly rejected this plan, however, arguing that it prioritized the interests of creditors over the needs of the citizenry. The City Council favored a Chapter 9 filing as an alternative to the creditor-friendly Act 47 plan, and in June of 2011, the City Council voted to prepare for a possible Chapter 9 filing. In response, on June 30, 2011, the Pennsylvania General Assembly passed "Act 26", which provides that prior to July 2, 2012, no distressed city such as Harrisburg could file for Chapter 9. However, on October 11, 2011, the City Council voted to authorize Harrisburg to file for Chapter 9, without Mayor Linda Thompson's support, and later that day the city filed a Chapter 9 petition. Both the Mayor and the state, as well as the county and various other creditors and parties in interest, sought dismissal of the filing, arguing that Act 26 mandated dismissal of Harrisburg's petition, and that the City Council lacked the authority to take legal action on Harrisburg's behalf without the Mayor's approval. On November 23, 2011, Bankruptcy Judge Mary France orally dismissed the Chapter 9 case, finding that Harrisburg was not specifically authorized to file under Chapter 9 as required by the Bankruptcy

Códe, that the state law passed in June did not violate Pennsylvania's constitution, and that the City Council did not have the authority under municipal law to commence a Chapter 9 case on Harrisburg's behalf.

3. **Fiscal Emergency Legislation**. Nine days after Harrisburg filed for Chapter 9, Pennsylvania Governor Tom Corbett signed into law the Municipalities Financial Recovery Act, which gave Harrisburg's mayor and the city council 30 days to come up with a recovery plan. Failing implementation of such a plan, the Act authorizes the Governor to appoint a receiver to take over the state capital's finances. On October 24, 20111, Governor Corbett declared a fiscal emergency in Harrisburg. As a result of the Governor's declaration, the Pennsylvania Department of Community and Economic Development had 10 days to develop an emergency action plan to ensure the public safety and to coordinate services that included police and firefighting, water and wastewater, trash collection, payroll, and pension and debt payments. The dismissal of the Chapter 9 filing on November 23, 2011, cleared the state to install a receiver to enact a financial recovery plan. On December 2, 2011, a Pennsylvania judge approved David Unkovic as receiver, an attorney, to spearhead the effort. On February 6, 2012, the Receiver released a recovery plan that includes the sale or lease of city assets and concessions by unions. The plan must be approved by a state judge within 60 days. If Harrisburg fails to complete the sale or lease of assets by June, the Receiver said the city may have to file for bankruptcy to maintain city services.

4. **Appeals**. After the dismissal of the Chapter 9 filing, the City Council filed a notice of appeal on December 10, 2011. On December 13, Judge France denied the appeal on the grounds that the deadline for appeal had passed, finding the City Council should have lodged the notice within 14 days after her November 23 dismissal order, even though the written opinion on the dismissal was not docketed until December 5, 2011. The City Council appealed the bankruptcy court's decision regarding the appeal to the District Court on January 24, 2012. U.S. District Court Sylvia Rambo denied the appeal, ruling that the Council missed the deadline, and calling the efforts to appeal "potentially frivolous."

D. Jefferson County, Alabama

1. Jefferson County, with a population of 660,000 and home to Birmingham, Alabama, had incurred $3.2 billion in debt to finance a new sewer system, which it was struggling to pay. In September 2011, county commissioners voted to accept a restructuring agreement that, with the approval of the state legislature prior to a June 30, 2012 restructuring deadline, would have allowed the county to shed about $1 billion in debt and lower the interest rate on roughly $2 billion of new, 40-year debt that would have been issued to replace the current debt. However, the County's governing board voted to file a Chapter 9 petition after settlement talks with JPMorgan Chase and other bondholders broke down. On November 9, 2011, Jefferson County filed the largest municipal bankruptcy on record to address the $3.2 billion in debt tied to the overhaul of its sewer system.

2. **Motion to Dismiss Based on Type of Debt**. Shortly after Jefferson County's filing, the Bank of New York Mellon ("BNYM"), the indenture trustee for county sewer warrants, filed a motion to dismiss the case, arguing that the county lacked

a particular kind of indebtedness that would make it eligible under state law to file for Chapter 9 protection. BNYM argued that, under state law, only government entities with refunding or funding bonds are eligible to file a Chapter 9 petition – Jefferson County had only outstanding warrants. The County has countered that BNYM's interpretation of Alabama law is too restrictive and that the Alabama legislature has sought to grant municipalities broad access to bankruptcy.

3. **Receivership Litigation**. The day of the Chapter 9 filing, the County demanded, based on the automatic stay, that the receiver, who had been appointed in prior litigation after the county defaulted on sewer-related debt obligations, turn over control of the sewer system and its revenues which were used to pay down the system's debt. The Receiver filed an emergency motion on November 10 to maintain the status quo, which BNYM as indenture trustee joined, asking the court to abstain from interfering with the receivership based on the Rooker – Feldman prohibition against federal court review of final state court decisions and the restrictions over federal court interference in rate-making procedures under the Johnson Act. The Alabama bankruptcy judge rejected the motion and the receivership, automatic stay, and jurisdiction issues are currently on appeal.

VIII. Benefits and Limitations of the Bankruptcy Code as a Vehicle for Fiscal Reform for States and Municipalities

A. Benefits of Filing for Bankruptcy

1. **Power to amend or terminate collective bargaining agreements and pensions**. Collective bargaining agreements and pension obligations impose substantial financial burdens on state and local governments and are often the source of a state or municipality's financial difficulties. The relative freedom to rework these obligations is one of the principal advantages to proceeding under Chapter 9.

2. **Plan of adjustment binding on all creditors; cram-down powers**. Using Chapter 9, entities can pressure creditors to agree to unfavorable debt readjustment plans, and using the cram-down mechanism, can force plans on unwilling creditors. This cram-down power gives bankruptcy a major advantage over other restructuring alternatives, which often need full creditor assent in order to be binding.

3. **Automatic Stay**. The bankruptcy stay provides breathing room for the entity to negotiate with various creditor constituencies and come up with a plan for adjusting its debts.

4. **A single, known forum and procedures**. A bankruptcy allows an entity to resolve all of its fiscal issues in one forum—the bankruptcy court—as opposed to being subject to multiple state venues and proceedings in order to restructure its debts and obligations.

5. **Familiarity and experience of bankruptcy courts in dealing with similar issues**. Bankruptcy judges deal with complex financial issues and the rejection of executory contracts, and generally are well equipped and knowledgeable to help parties reach compromises in contentious situations.

6. **Leverage in negotiations with creditor constituencies**. In that bankruptcy is always available as a last resort, municipalities retain leverage in negotiations with their creditors, such as public employee unions, with the threat that, if the municipality and creditors can not come to some sort of consensual agreement, the municipality can use Chapter 9 to force a plan of debt adjustment on unwilling creditors through the bankruptcy courts.

7. **Way to force politically unpopular decisions**. Bankruptcy could be used to force politically unpopular, but sensible, decisions upon a municipal entity. It can be used to push through politically unpopular reforms, and politicians can shift blame for unpopular decisions onto a bankruptcy court.

8. **Avoid legislative process**. Bankruptcy can be used as an alternative to the state legislative process, which can be slow, difficult, and beholden to special interest groups.

B. Limitations and Risks In Using Bankruptcy

1. **Standing**. As noted, states are not eligible to file for bankruptcy under the current version of the Bankruptcy Code and thus legislation would be needed to provide them with the requisite authority. Additionally, only fifteen states specifically, and unconditionally, authorize municipal bankruptcies. Furthermore, there is a growing counter-movement which seeks to pass state legislation barring municipality bankruptcies in additional states. *See, e.g.*, Vekshin, Alison, *Vallejo Municipal-Bankruptcy Morass Prompts U.S. States to Prevent Filings*, BLOOMBERG (April 27, 2011). In order to file for bankruptcy, these obstacles must first be overcome.

2. **Impact on credit markets**. The major concern expressed by groups opposed to municipal bankruptcies is that such bankruptcies adversely affect the municipal bond market, and lead to increased borrowing costs for the state as well as other municipalities within the state.

3. **Cost**. There are significant costs associated with a bankruptcy filing, the bulk of them being professional fees. The *Vallejo* bankruptcy cost the city nearly $10 million in legal fees. Funds spent on bankruptcy professionals could be used instead towards debt pay down out of bankruptcy.

4. **Time**. Bankruptcy can be a lengthy process. Vallejo was mired in its bankruptcy case for years, as it took time for the city to renegotiate its contracts and formulate its plan of debt adjustment.

5. **Distraction**. The various items that need to be attended to in a bankruptcy proceeding (preparing the petition, hearings, depositions, responding to document requests, formulation of the plan of adjustment, plan confirmation, etc.) can be a major impediment to the work necessary to keep the governmental entity functioning.

6. **Stigma**. Residents, workers, and businesses (all sources of revenue) may view bankruptcy as a stigma. Bankruptcy may cause them to move out, or keep new sources from entering.

7. **Lack of precedent**. Due to the shortage of cases filed under Chapter 9, there is little precedent for the issues that may arise in a Chapter 9 case.

C. Alternative Restructuring Alternatives. States and local governments have other restructuring alternatives available. However, many of them have their own sets of limitations and fail to address the underlying problems facing these entities.

1. **Raise taxes and cut spending**. Such measures may be limited by federal and state requirements, and there are also practical reasons for limits. Government services need to be maintained at a certain level, and residents can move out if taxes increase too much or if government services are cut, causing revenue sources to disappear.

2. **Issue more debt; privatize assets and services**. States can borrow, or sell their assets or services, to obtain more funds to bridge the gap. However, this requires legislation, and the amount of debt a state can issue is usually limited by state law or the state constitution.

3. **Negotiate pay cuts and higher benefit contributions from unions**. States can attempt to get concessions from public employee unions, but this will prove to be difficult outside of bankruptcy, as seen in *Vallejo*. This is particularly true in some states such as Illinois, where the state constitution protects pension benefits.

4. **Legislation to curtail public-employee bargaining rights**. States can attempt to pass legislation and/or amend their constitutions to curtain collective bargaining and pension rights. There is pending legislation in Ohio that proposes to curtail such rights. However, such legislation is typically hard to pass.

5. **Federal bailout**. As a last resort, states can attempt to seek federal assistance, in the form of grants, tax credits, loans or guarantees on debt. However, this relief is highly unlikely given the political climate, and, as with the other alternatives available, fails to address the underlying structural problems that are at the root of the distress.

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