Chapter 9: Municipal Bankruptcy

MSU Extension White Paper

By:
Amanda Wright

Notice/Disclaimer

The following information is provided as a public service and is intended for research and educational purposes only. The following is not intended as legal advice or counsel, and it should not be construed as such to any of its readers. If you are in need of legal advice, you should contact a licensed attorney. In addition, this information is introductory and written to familiarize the reader with the issues surrounding municipal bankruptcy. Therefore, this information does not address all the issues or aspects of municipal bankruptcy. Where clarification is needed, it may be useful to consult the original sources cited in this text.

Chapter 9: Municipal Bankruptcy

MSU Extension White Paper

Table of Contents

5/9/2012

An Introduction: What Is Chapter 9 Bankruptcy?

Chapter 9 bankruptcy is a section of the federal bankruptcy code that allows municipalities to file for bankruptcy. People often refer to Chapter 9 as a "municipal bankruptcy" because an entity must be a municipality to file under it.[1] Chapter 9 bankruptcy gives a debtor a breathing spell from debt collection so that it can work out a repayment plan with its creditors, preventing it from collapsing and allowing it to continue to provide public services.[2] Although regulated by the federal bankruptcy code, Chapter 9 is a structured negotiation process in which a municipality proposes a plan of adjustment that its creditors vote on. If the plan meets the requirements of the bankruptcy code, the bankruptcy judge approves it. The plan of adjustment is essentially nothing more than a new contract between the debtor and its creditors.

Municipalities throughout the United States contend with extreme fiscal stress. Many local governments face declining tax bases, decreasing revenues and increasing retirement plan liabilities as more public workers retire and the cost of health care increases. While not a cure for fiscal stress, Chapter 9 may serve as a tool to reset the city's financial course when all other methods fail.

In the current financial climate, discussions about Chapter 9 frequently occur. However, many misunderstandings still exist about this little-used chapter of the bankruptcy code. Much must still be learned by financial and legal experts. Since Chapter 9 emerged as a means for municipalities to obtain relief in bankruptcy court, there have only been about 600 filings. Many of these filings were initiated by special districts such as toll roads or sewer districts rather than by large cities or towns. The lack of controlling case law makes Chapter 9 a little-known and unpredictable area of law, presenting a major challenge to discussing and interpreting it. This paper will introduce the reader to some common misunderstandings surrounding Chapter 9 and some of the complex legal issues experts still need to flush out.

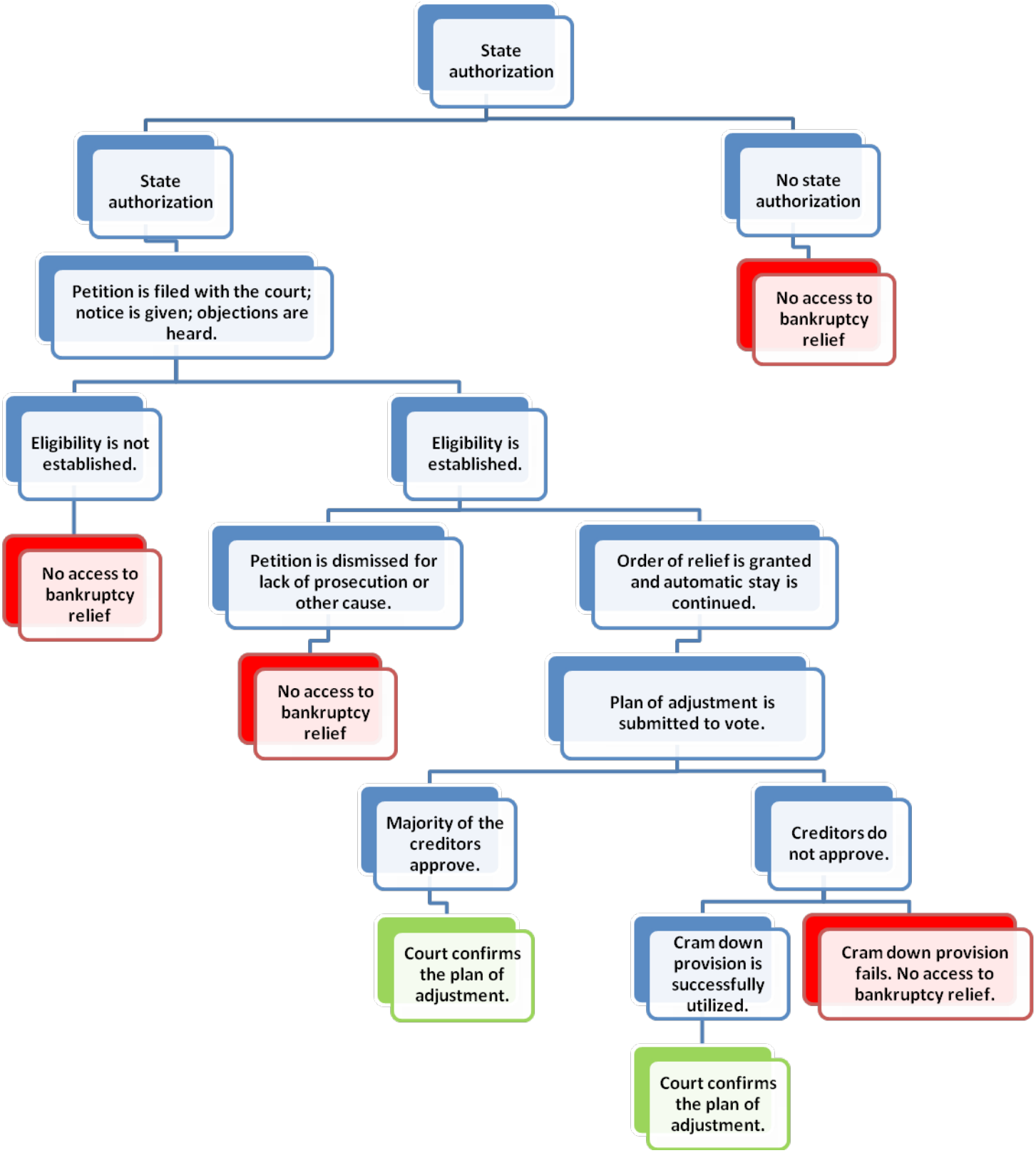
The paper begins with a rudimentary road map of a Chapter 9 filing. The road map serves as a place marker to return to at any time during the discussion to help the reader understand the process more thoroughly. Next, the paper will explain the road map with broad brush strokes by outlining and explaining the basic parts of a bankruptcy case. An explanation of the eligibility requirements for filing a Chapter 9 bankruptcy occurs within the discussion because litigation over eligibility has historically been a large part of a bankruptcy proceeding.

Next, the author will explain the basic differences between Chapter 9 and Chapter 11. While not exhaustive, this section addresses some of the common misconceptions about Chapter 9. Finally, the paper concludes by explaining some commonly cited advantages and disadvantages to filing a Chapter 9 bankruptcy.

[1] 11 U.S.C.A. § 109(c)(1).

[2] See *In re Addison Community Hosp. Auth.*, 175 B.R. 646, 648-49 (Bankr. E.D. Mich. 1994) (explaining that the "general policy considerations underlying the municipal debt adjustment plan of chapter 9 are the same as that of chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors.").

A Chapter 9 Road Map



State Authorization

The road map begins with state authorization because a municipality must be specifically authorized by state law to file for Chapter 9 bankruptcy relief.[3] If there is no state authorization, a municipality may not file for Chapter 9 bankruptcy relief. The authorizing statute must be explicit, written and exact, plain, and "direct with well-defined limits, so that nothing is left to inference or implication."[4] Courts will no longer find "general authorization" to file for Chapter 9 bankruptcy by inference from the general powers that a municipality possesses.[5] For example, authorization will not be found for states that generally allow municipalities to sue or be sued, to control finances or to be debtors.[6]

Currently, twenty-one states are not authorized by state law to file for bankruptcy.[7] Therefore, at this time, for municipalities in those states, Chapter 9 bankruptcy is not an option. If a municipality in one of those twenty-one states wanted to file for bankruptcy, the municipality would have to ask the legislature to pass a law specifically authorizing it to do so – a potentially time-consuming process.[8] Georgia is the only state to expressly prohibit a municipality from filing for bankruptcy, bringing the number of states not authorized to file to twenty-two.[9] Some experts believe that the number of states expressly prohibiting municipal bankruptcy filings will increase or that states will pass legislation making it considerably more difficult for municipalities to obtain bankruptcy relief.[10]

In the states that allow municipalities to file for bankruptcy, the kind of state authorization varies considerably. Seventeen states set conditions that municipalities must meet before filing a Chapter 9.[11] For example, with approval from the governor, Michigan municipalities are authorized to file for a Chapter 9 bankruptcy according to the procedures in Public Act 4.[12] Although Public Act 4 has currently been suspended through the process of referendum, the act currently in place, Public Act 72, also explicitly authorizes Michigan municipalities to file for Chapter 9 bankruptcy.[13] Eleven states provide "blanket authorization" for municipalities to file for bankruptcy, which means that municipalities in those states can file for bankruptcy without approval from authorities or without meeting certain preconditions.[14]

---

[3] 11 U.S.C.A. § 109(c)(2).

[4] *In Re Timberon Water and Sanitation Dist*., 2008 WL 5170581 (Bankr. D. N.M. 2008); *County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995);

See also, Glassman, Paul R., A Practical Guide to Chapter 9 Municipal Bankruptcy. 2011 WL 5053642 (ASPATORE) (Explaining the holdings in these two cases); Foster, Seena. Eligibility for Chapter 9 Bankruptcy Relief, Applicable to Municipalities, Pursuant to 11 U.S.C.A. § 109(c). 57 A.L.R. Fed. 2d 121 (Originally published in 2011).

[5] *County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995) (Finding that the municipalities' authorization to be a debtor is not sufficient to meet the authorization requirement for chapter 9); See also, Foster, Seena (2011) (Quoting *Alleghany-Highlands Economic Development Authority, In re,* 270 B.R. 647 (Bankr. W.D. Va. 2001), (Explaining that a court will not find general authorization to be a debtor); See also, Benvenuttia, Peter J.. State Law Authorization For A Chapter 9 Filing, 2011 WL 5053632 (ASPATORE), 3 (Explaining the difference between generally authorized and specifically authorized).

[6] Id.

[7] Those states are Alaska, Delaware, Hawaii, Indiana, Kansas, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Mexico, North Dakota, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming.

[8] Jones Day. United States: An Overview of Chapter 9 of the Bankruptcy Code: Municipal Debt Adjustments 23 August 2010. Accessed online: http://www.mondaq.com/unitedstates/article.asp?articleid=108258. Last accessed Sept. 5, 2012.

[9] GA Code 36—80-5.

[10] CA GOVT § 53760.3. See California State Assembly Bill 155 (Requiring CA municipalities to obtain approval from the CA Debt and Investment Advisory Commission prior to filing a Chapter 9); "California Adopts Bill to Slow Municipal Bankruptcies, a Credit Positive." October 17, 2011. ("Lawmakers adopted a bill that prohibits the state's municipalities from filing for federal bankruptcy protection unless the local entity has either participated in a neutral evaluation process or declared a fiscal emergency.") Original Source: moodys.com; also available online at: http://7economy.com/california-adopts-bill-to-slow-municipal-bankruptcies-a-credit-positive/ (Last accessed September 7, 2012).

[11] Those states are California, Connecticut, Idaho, Illinois, Iowa, Kentucky, Louisiana, Michigan, Montana, New Jersey, New York, North Carolina, Ohio, Oregon*, Pennsylvania, Rhode Island and Washington. *Note: Oregon only allows irrigation and drainage districts to file chapter 9 bankruptcy.

[12] Section 23 of Public Act 4, The Local Government and School District Fiscal Accountability Act. (An emergency manager may request authorization to file a petition for bankruptcy subject to the governor's approval. Upon receipt of written approval, the EM is authorized to proceed in a bankruptcy filing.)

[13] Public Act 72 of 1990, Local Government Fiscal Responsibility Act, and the Appointment of Emergency Financial Managers.

[14] Those states are Alabama, Arizona, Arkansas, Colorado, Florida, Minnesota, Missouri, Nebraska, Oklahoma, South Carolina and Texas.

Commencing the Case

If a municipality has state authorization to file a Chapter 9 bankruptcy and meets all the requirements of state law, then the municipality would file a petition for relief with the bankruptcy court. Upon the filing of a petition, the automatic stay will take effect. The automatic stay stops all collection actions against the municipality. No creditor can bring a claim or file suit against the municipality for debts that become due. During the automatic stay, the municipality must choose the creditors it can afford to continue to pay. The process will likely force municipal officials to make difficult decisions involving keeping or eliminating services.

Before the judge will grant access to the court, the bankruptcy code requires that the court direct the clerk of the court, the municipality or other person to give notice of the commencement of a bankruptcy case and the order for relief.[15] An order of relief continues the automatic stay and allows access to the bankruptcy courts. This means that the municipality will have an opportunity to submit a plan of adjustment for the court to approve. Notice provides all those affected by the filing with the opportunity to guard their interests because the bankruptcy code also permits objections to the petition.[16] Typically, creditors claim that the municipality does not meet the eligibility requirements to enter bankruptcy and file objections. The next section of the Chapter 9 road map indicates a roadblock where bankruptcy eligibility must be established.[17]

If creditors file objections, the court must hold a hearing on those objections. The court will not grant relief until there has been an opportunity to object to the petition.[18] Typically, creditors want to keep a municipality out of bankruptcy because after a municipality gains access to a bankruptcy proceeding and the order of relief is granted, the creditors lose significant control over their claims.

[15] 11 USC 923. (The clerk, or such other person as the court may direct, is to give notice. Fed. R. Bankr. 2002(f). The notice must be published "at least once a week for three successive weeks in at least one newspaper of general circulation published within the district in which the case is commenced, and in such other newspaper having a general circulation among bond dealers and bondholders as the court designates.")

[16] 11 USC 921(c).

[17] 11 USC 109(c)(1)-(5) (Section of bankruptcy code governing eligibility to be a debtor); Klein, Christopher. U.S. Bankruptcy Judge, Eastern District of California. Eligibility Litigation in Chapter 9 Municipality Cases Under U.S. Bankruptcy Code. Published in The Ugly Truth: Municipal Restructuring and Bankruptcy. Presented by: The American Bar Association. (2012)("As the court orders relief only after there has been an opportunity to object to the petition, all of the eligibility requirements are fair game for litigation on objection to the petition.")

[18] Id.

Bankruptcy Eligibility

The municipality bears the burden of proving that it meets each of the four eligibility requirements listed under 11 USC 109(c)(1)-(4) and at least one of the four requirements listed under 11 USC 109(c)(5). For simplicity, we'll categorize the first four requirements as the "Gatekeeper Requirements" because creditors who are trying to keep the municipality out of bankruptcy vehemently contest these requirements. We'll categorize the second four requirements as the "Creditor Negotiation Tests" because nearly all of these requirements have to do with negotiation and only one of them must be met.

The Gatekeeper Requirements

As previous stated, the municipality must meet each of the four eligibility, or Gatekeeper Requirements. The four Gatekeeper Requirements are listed under 11 USC 109(c)(1)-(4) of the bankruptcy code. Under these requirements an entity must (1) be a municipality to be eligible for relief under Chapter 9, (2) be authorized by state law to file for Chapter 9 bankruptcy relief, (3) be insolvent, and (4) desire to effect a plan of adjustment. The following section further explains each of these requirements.

Must Be a Municipality

An entity must be a municipality to be eligible for relief under Chapter 9. The bankruptcy code defines a "municipality" as a "political subdivision or public agency or instrumentality of a State."[19] To decide if an entity is a municipality, one court used a three-part test looking at (1) whether the entity has traditional government attributes or engages in traditional government functions, (2) if so, whether there is state control, and (3) whether or not the state categorizes the entity as a municipality.[20] Generally, a political subdivision typically includes such entities as cities, counties, townships or towns, while public agencies are "state-sponsored or controlled" authorities or entities that raise revenues through taxes.[21]

Must Be Specifically Authorized

A municipality must be authorized by state law to file for Chapter 9 bankruptcy relief. The authorizing statute must be explicit, written and exact, plain and "direct with well-defined limits, so that nothing is left to inference or implication."[22] Courts will no longer find "general authorization" to file for Chapter 9 bankruptcy by inference from the general powers that a municipality possesses.[23] For example, authorization will not be found in states that generally allow municipalities to sue or be sued, to control finances or to be debtors.[24]

Must Be Insolvent

The municipality must be insolvent.[25] The legal test for insolvency under Chapter 9 is not a traditional balance sheet test. Some municipalities may find this problematic including those that may not run out of money immediately but face extreme financial hardship and high legacy costs not yet realized.[26]

[19] A municipality means "a political subdivision or public agency or instrumentality of the state." 11 U.S.C.A. § 101(40).

[20] *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Bankr. D. Nev. 2010) (Requirement of municipality not established).

[21] *In re County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995); Glassman, Paul R., A Practical Guide To Chapter 9 Municipal Bankruptcy. 2011 WL 5053642 (ASPATORE), 4; Foster, Seena. Eligibility for Chapter 9 Bankruptcy Relief, Applicable to Municipalities, Pursuant to 11 U.S.C.A. § 109(c). 57 A.L.R. Fed. 2d 121 (Originally published in 2011).

[22] *In Re Timberon Water and Sanitation Dist.*, 2008 WL 5170581 (Bankr. D. N.M. 2008); *County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995); See also, Glassman, Paul R. A Practical Guide To Chapter 9 Municipal Bankruptcy. 2011 WL 5053642 (ASPATORE) (Explaining the holdings in these two cases); Foster, Seena. Eligibility for Chapter 9 Bankruptcy Relief, Applicable to Municipalities, Pursuant to 11 U.S.C.A. § 109(c). 57 A.L.R. Fed. 2d 121 (Originally published in 2011).

[23] *County of Orange*, 183 B.R. 594 (Bankr. C.D. Cal. 1995) (Finding that the municipalities authorization to be a debtor is not sufficient to meet the authorization requirement for chapter 9); See also, Foster, Seena (2011) (Quoting *Alleghany-Highlands Economic Development Authority, In re*, 270 B.R. 647 (Bankr. W.D. Va. 2001), explaining that a court will not find general authorization to be a debtor); See also, Benvenuttia, Peter J. State Law Authorization For A Chapter 9 Filing, 2011 WL 5053632 (ASPATORE), 3 (Explaining the difference between generally authorized and specifically authorized).

[24] Id.

[25] 11 U.S.C.A. § 109(c)(3).

[26] See Glassman, Paul R. (2011) (Explaining that "A municipality with burdensome long-term obligations must also make the requisite showing of cash flow insolvency in the short term.")

However, a municipality need not wait until it runs out of money to file a Chapter 9 proceeding, but must demonstrate that in the near future it will run out of money and will be unable to pay its debts as they become due.[27]

We can say a municipality is insolvent when it is (1) generally not paying debts as they become due unless such debts are the subject of a bona fide dispute or (2) unable to pay its debts as they become due.[28] The test for insolvency involves a prospective cash flow test beginning from the date the municipality files the petition. The prospective analysis will look no further than the current or upcoming fiscal year.

Must Desire to Effect a Plan of Adjustment

The municipality must desire to effect a plan of adjustment.[29] This requirement assures that the purpose of Chapter 9 is being realized. Courts have generally held that there is no bright-line rule or specific test to prove when a municipality meets this requirement.[30]

Usually, a filed statement or oath indicating intent to effect a plan of adjustment, combined with evidence of efforts made toward negotiating and drafting a plan, would satisfy the court that the municipality met the requirement.[31] The municipality may use direct or circumstantial evidence to fulfill this requirement. Best practice indicates that a municipality should file a draft plan of adjustment with the petition for relief, or file one as close to the filing of the petition as possible.

Creditor Negotiation Tests

As previous stated, the municipality must meet at least one of the four Creditor Negotiation tests. The four tests are listed under 11 USC 109(c)(5) of the bankruptcy code. The tests require that the municipality show that (1) it has reached an agreement with the majority of its creditors to file for bankruptcy, (2) it has negotiated in good faith with its creditors but failed to reach an agreement, (3) negotiations are impractical, or (4) it believes a creditor may attempt to obtain an avoidable preference.[32] The following section further explains each of these tests.

Obtained an Agreement of Creditors

The municipality must show it has reached an agreement with the majority of its creditors to file for bankruptcy. Prior to filing the petition, a municipality could obtain the agreement of creditors holding at least a majority of the claims of each class that the municipality intends to impair.[33] Municipalities may find this a difficult option because, as discussed earlier, creditors usually want to keep a debtor out of bankruptcy for fear of losing control of their claims. A small municipality with few creditors may be able to obtain an agreement of the majority of its creditors to enter bankruptcy and pass the Creditor Negotiation test using this first option.

Negotiated in Good Faith With Creditors

Additionally, the municipality could attempt to negotiate in good faith but fail to reach an agreement and also meet the negotiation requirement.[34] This requirement ensures that municipalities choose bankruptcy as a last resort. Good faith negotiations alone will not meet this requirement unless they revolve around negotiating the terms of a plan the municipality could achieve under Chapter 9.[35] This requires actual negotiation of a plan that addresses all of the municipality's liabilities and the methods they would use to adjust them.[36]

During negotiations, municipalities must be transparent with creditors, making it clear that unsuccessful negotiations may result in Chapter 9 bankruptcy. In at least one case, the court has held that negotiations presented on a "take it or leave it basis," or with an unwillingness to compromise, will not meet the negotiated-in-good-faith requirement.[37]

---

[27] Foster, Seena (2011) (Explaining the court in *City of Bridgeport, In re*, 129 B.R. 332 (Bankr. D. Conn. 1991) was "in agreement with the proposition that a city should not have to wait until it runs out of money in order to qualify for bankruptcy protection.")

[28] 11 U.S.C.A 101 § (32)(C).

[29] 11 U.S.C.A. § 109(c)(4).

[30] Foster, Seena (2001) (Explaining the holdings in *New York City Off-Track Betting Corp., In re*, 427 B.R. 256 (Bankr. S.D. N.Y. 2010) and *City of Vallejo*, 408 B.R. 280, 57 A.L.R. Fed. 2d 637 (B.A.P. 9th Cir. 2009)).

[31] Foster, Seena (2011) ("A filed statement indicating an intent to effect a plan of reorganization, said the court, combined with efforts made towards negotiating the drafting plan, is sufficient to fulfill this requirement.")

[32] 11 USC 109(c)(5).

[33] 11 U.S.C.A § 109(c)(5)(a).

[34] 11 U.S.C.A § 109(c)(5)(b).

[35] Foster, Seena (2011) (Explaining the holding in *Sullivan County Regional Refuse Disposal Dist., In re*, 165 B.R. 60 (Bankr. D. N.H. 1994)).

[36] Id.

[37] *In re Ellicott School Bldg. Authority*, 150 B.R. 261, 266 (Bankr. D. Colo. 1992) (Holding that "the Authority presented the plan as a "take it or leave it" proposal, and expressed unwillingness to compromise. For these reasons, it appears to the Court that no true good faith negotiations took place.").

Showed Negotiations Are Impractical

Alternatively, a municipality may argue that negotiation with its creditors is impracticable. The court defined impracticable negotiations as those causing extreme and unreasonable difficulty. For example, a debtor may have a large number of creditors. Municipalities might also apply this test when taking time to negotiate before filing for Chapter 9 would put its assets at risk or cause it to be unable to provide services. The municipality's need to act quickly to avoid public harm may make negotiations impracticable.[38] This is a "fact sensitive inquiry and will depend on each debtor's unique circumstances."[39]

Believes a Creditor May Attempt to Obtain an Avoidable Preference

The municipality may believe a creditor may attempt to obtain an avoidable preference. Rarely used to prove Chapter 9 eligibility, this final alternative has never been successfully utilized. At least one bankruptcy judge has questioned the requirement's wording.[40] Some believe the wording may be flawed. The code does not make it clear that a transfer by a municipality is actually avoidable under Section 547 because a Chapter 7 liquidation procedure is unavailable in a Chapter 9 proceeding.

[38] *In re Valley Health System*, 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008)3 ("Negotiations may also be impracticable when a municipality must act to preserve its assets and a delay in filing to negotiate with creditors risks a significant loss of those assets."); See, Foster, Seena (2011) (*Explaining the holding in New York City Off-Track Betting Corp., In re*, 427 B.R. 256 (Bankr. S.D. N.Y. 2010)).

[39] Id.

[40] Klein, Christopher. U.S. Bankruptcy Judge, Eastern District of California. Eligibility Litigation in Chapter 9 Municipality Cases Under U.S. Bankruptcy Code. Published in The Ugly Truth: Municipal Restructuring and Bankruptcy. Presented by: The American Bar Association. (2012).

Plan of Adjustment

After a municipality has proven eligibility and gained access to the courts, the road map indicates that the court will grant the order of relief and thus, the automatic stay would continue. At this point, the road map indicates that the petition could still be dismissed for lack of prosecution or other cause. For example, lack of prosecution would mean that the municipality failed to submit a plan of adjustment in accordance with the court's scheduling order. If it is not dismissed for another reason, the municipality would submit a plan of adjustment to the court for approval as indicated on the road map. The plan of adjustment is essentially nothing more than a contract between the debtor and its creditors, which defines how the debt is to be adjusted and how the debtor will be structured post-bankruptcy. In fact, one can think of the entire Chapter 9 proceeding as a structured negotiation that leads to a new agreement between all the parties, voted on by the creditors and confirmed by the court.

General Obligation Bonds Versus Special Revenue Bonds

Generally, a municipality has two types of bonds under a Chapter 9 bankruptcy: general obligation bonds and special revenue bonds. The municipality issues general obligation bonds secured by its full faith and credit. On the other hand, the municipality issues special revenue bonds secured by some specific pledge of revenue, usually the profit retained from the operation of a special project such as a toll road. Under Chapter 9, this kind of debt is not subject to the automatic stay and is not able to be impaired. However, nothing in the bankruptcy code compels a municipality to continue running a special project, and creditors (i.e., special revenue bondholders) are only entitled to payments from profit less the operating expenses of the special project. Therefore, sometimes this secured debt becomes unsecured, and special revenue bondholders have an incentive to compromise and voluntarily agree to adjustment of their debts.

Confirmation of the Plan of Adjustment

The Creditors Vote

After the municipality submits the plan of adjustment, the road map indicates that all of the impaired creditors will vote to accept or reject the plan. If a majority of the creditors approve, the court confirms the plan of adjustment *if it meets all the other requirements in the code*. However, if the majority of the creditors do not vote to accept the plan, the "cram down provision" can force the plan on creditors who do not approve or vote in favor of the plan of adjustment. This provision is explained in more detail in the section "The Cram Down Provision" below.

The plan of adjustment must include provisions for assumption, rejection or assignment of executor contracts and unexpired leases. It should separate creditor claims into different classes, and the creditors must vote on it.

The Bankruptcy Code states the confirmation requirements as follows: "The court shall confirm the plan if — (1) the plan complies with the provisions of this title made applicable by sections 103(e) and 901 of this title; (2) the plan complies with the provisions of this chapter; (3) all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable; (4) the debtor is not prohibited by law from taking any action necessary to carry out the plan; (5) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507(a)(1) of this title will receive on account of such claim cash equal to the allowed amount of such claim; (6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and (7) the plan is in the best interests of creditors and is feasible."[41]

The Cram Down Provision

In a Chapter 9 proceeding, getting the majority of creditors in every class of creditors to vote in favor of the plan is difficult. For this reason, the court utilizes the "cram down provision." This provision allows the court to confirm the plan if at least one impaired class has accepted the plan, the plan complies with all other requirements of the code, and the plan does not discriminate unfairly and is fair and equitable with respect to each class of impaired creditors that has not accepted the plan.[42] To "not discriminate unfairly" means that creditors with the same legal rights receive equal treatment. "Fair and equitable" usually means that a plan must at a minimum satisfy all other requirements.[43]

If a municipality anticipates using the cram down provision, it should have at least one class of creditors who supports the proposed plan of adjustment pre-bankruptcy. The plan still must treat similarly situated creditors the same, and thus, an entity cannot gerrymander one class of creditors for the sole purpose of gaining their approval. If very similar classes of creditors are classified separately, an objection will likely be filed.

Advanced planning will allow a municipality to think strategically about how it treats varying classes and how it arranges its creditors into classes. Advanced planning will likely lead to more effective use of the cram down provision.

Court Approval

If either the majority of the creditors accept the plan or the majority do not approve so the court utilizes the cram down provision and the plan of adjustment meets the remaining requirements in the code, then the court will approve the plan if it meets the best interest of the creditors test and the plan is feasible.

Courts have interpreted the best interest of the creditors test to mean that the plan must be better than other alternatives available to the creditors.[44] "Generally speaking, the alternative to Chapter 9 is dismissal

[41] 11 U.S.C. § 943(b).

[42] United States Courts. Municipal Bankruptcy, Chapter 9. http://www.uscourts.govfederalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx. (Last Accessed July 3, 2012) (Citing 6 COLLIER ON BANKRUPTCY § 943.03[7] (15th ed. rev. 2005)).

[43] Id.

[44] United States Courts. Municipal Bankruptcy, Chapter 9. http://www.uscourts.gov federalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx. (Last Accessed July 3, 2012) (Citing 6 COLLIER ON BANKRUPTCY § 943.03[7] (15th ed. rev. 2005)).

of the case, allowing every creditor to fend for itself."[45] However, the municipality must not devote all its resources to the repayment of its creditors.[46] Instead, courts require an outcome that is better for the creditors than having the case dismissed.[47]

[45] Id. (Last Accessed July 3, 2012) (Again Citing 6 COLLIER ON BANKRUPTCY § 943.03[7] (15th ed. rev. 2005)).

[46] United States Courts. Municipal Bankruptcy, Chapter 9. http://www.uscourts.gov federalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx. (Last Accessed July 3, 2012) (Stating: An interpretation of the "best interests of creditors" test to require that the municipality devote all resources available to the repayment of creditors would appear to exceed the standard.)

[47] United States Courts. Municipal Bankruptcy, Chapter 9. http://www.uscourts.gov federalcourts/bankruptcy/bankruptcybasics/Chapter9.aspx. (Last Accessed July 3, 2012). (Stating: "The courts generally apply the test to require a reasonable effort by the municipal debtor that is a better alternative for its creditors than dismissal of the case.")

The debtor generally must show it can meet its obligations under the plan and still maintain its operations at a satisfactory level.[48] When referring to a city or town, the term "operations" generally means the entity's ability to provide services to its citizens. The requirements of this test generally require the court to simply review whether the evidence the debtor submitted proves that it can perform its obligations under the plan.

[48] See Glassman, Paul R. (2011) 2011 WL 5053642 (ASPATORE), 15 ("This means that there must be a reasonable prospect that the debtor will be able to perform under the plan.")

Chapter 9 Versus Chapter 11: Basic Distinctions and Common Misconceptions

Chapter 9 differs from Chapter 11 in many ways. Many of these differences stem from the requirements of the 10th Amendment and state sovereignty.[49] First, the filing of a Chapter 9 petition must be voluntary. Many people, being familiar with Chapter 11, might think that if their state authorizes municipalities to file a Chapter 9 bankruptcy, that a city's creditors will force it into bankruptcy; this is simply not allowed under Chapter 9. The voluntary requirement is unlike a Chapter 11 case in which three or more creditors may force a debtor into bankruptcy.

Next, the ability of any party, other than the debtor, to propose a plan of adjustment is nonexistent; only the debtor may propose a plan of adjustment in a Chapter 9 proceeding. While the plan of adjustment must be voted on by the creditors and approved by the court, the municipality will not lose control of its future planning because only the municipality can submit the plan of adjustment to the court for approval.

In general, the court and the judge take a "hands-off" approach and will not interfere with the municipality's use and enjoyment of its property, or otherwise become involved in the municipality's day-to-day operations without consent of the debtor. Residents and municipal personnel alike worry that the judge will order the city to increase taxes or lay off workers. While the judge can help exert influence over the parties to reach a compromise, a judge will generally not order a municipality to do something that affects the municipalities operations because this would interfere with state sovereignty.

In addition, the judge who presides over the case is not selected at random as in a Chapter 11. Rather, the chief judge of the Court of Appeals for the Circuit designates the bankruptcy judge from the judges within the circuit. A Chapter 9 bankruptcy offers the opportunity for an appointment of a qualified judge with enough time to handle the complex issues that will arise in a Chapter 9 filing.

Finally, a Chapter 9 case has no liquidation provision. A municipality cannot be forced to sell its assets and distribute the profit to its creditors. However, a municipality may choose to sell assets if it wants to. Most people are familiar with a Chapter 11 bankruptcy in which there is a liquidation provision that forces the company or business to sell off all of its assets. Residents worry that if a city or town goes bankrupt, it will be forced to sell the library, city hall or the hospital, if the municipality owns such assets. While selling assets or at least researching their value may be a fiscal strategy the municipality uses, it will not be forced to sell any of its assets.

[49] Glassman, Paul R., A Practical Guide To Chapter 9 Municipal Bankruptcy. 2011 WL 5053642 (ASPATORE) at 3.

The Advantages and Disadvantages of Filing a Chapter 9 Bankruptcy

Advantages

The major advantage of a Chapter 9 proceeding is that it forces all the creditors to come together all before one judge in the same proceeding. Though, in some cases, it may be possible to negotiate a similar plan of adjustment outside of a Chapter 9 proceeding, the process prevents creditors from holding out for more. Additionally, negotiations outside of a Chapter 9 proceeding often lead to lawsuits being filed, which diverts time, money and energy away from the real issues while the municipality is still trying to provide basic services to its citizens. Conversely, during a Chapter 9 proceeding, a debtor can take advantage of the automatic stay and still maintain substantial control over its day-to-day operations. Entities whose main form of debt lies in burdensome collective bargaining agreements may find Chapter 9 especially useful. The standard for adjusting these agreements is of a lower threshold than a Chapter 11 restructuring.

Disadvantages

A major disadvantage of a Chapter 9 proceeding is the lack of control of the outcome from a political standpoint. For example, in Michigan, outside of a Chapter 9 bankruptcy, the governor retains the authority to fire an emergency financial manager if he believes he or she is doing a poor job. However, once in bankruptcy, some political power to control at least the outcome is ceded to the bankruptcy judge.

Additionally, debtors who file a Chapter 9 worry about the credit market response, and surrounding cities worry about "contagion," or the bankruptcy affecting their ability to borrow. Entities will also likely face stigma and negative media attention. Another potential disadvantage of Chapter 9 is the unknown. In some states, no city has ever filed a Chapter 9 petition, and therefore, results in a lack of controlling case law and little predictability. Even in states such as California, which has seen many recent filings, the case law is sparse, and many questions still need to be answered. Lastly, bankruptcy can be expensive and consume human resources.

Fortunately, proper planning, pre-negotiations and transparency with a municipality's creditors can avoid at least some of these negative effects.

MICHIGAN STATE UNIVERSITY | Extension

Produced by ANR Communications. 12/6/2012.