Municipal Bankruptcy Basics: What the Municipal Finance Officer Needs to Know

Washington State Finance Officers Association
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Overview: Bankruptcy Basics

• **Context:**
  • Just how big a problem is municipal bankruptcy? What does it really mean?

• **Legal Framework:**
  • What are the constitutional and other legal constraints?

• **Other Considerations**
  • What role does municipal bankruptcy play as just one of the tools available for managing municipal obligations?
Municipal Bankruptcy in Context

Bankruptcy Overview

• Provides opportunity for debt relief:
  • Debtor
  • Creditors
    • Secured
    • Unsecured
  • Federal Bankruptcy Code
    • Chapters 7 & 13 (individuals)
    • Chapters 7 & 11 (corporate)
    • Chapter 9 (municipal)
  • Federal Bankruptcy Court
Municipal Bankruptcies are Incredibly Rare

<table>
<thead>
<tr>
<th>Type of Bankruptcy Filing</th>
<th>2013 Filings</th>
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<tbody>
<tr>
<td>Ch 7 Liquidation (indiv/bus)</td>
<td>728,833</td>
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<tr>
<td>Ch 13 Wage earner (indiv)</td>
<td>333,626</td>
</tr>
<tr>
<td>Ch 11 Reorganization (corp)</td>
<td>8,980</td>
</tr>
<tr>
<td>Ch 12 Farmers</td>
<td>395</td>
</tr>
<tr>
<td>Ch 15 International</td>
<td>88</td>
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<td>Ch 9 Municipal</td>
<td>9</td>
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Notable Municipal Bankruptcies

How many?
1937 to 2007
approx. 600

Since 2008
approx. 40

And a Few Notable Near-Bankruptcies:

- **New York City** - (late 1970s) (federal loans)
- **Cleveland, OH** - (1978) (sale of utility)
- **Harrisburg, PA** - (2012) (petition rejected)
Why Municipalities Use Bankruptcy

• Retirement obligations
  - Detroit (MI), Stockton (CA), San Bernadino (CA), Prichard (AL), Vallejo (CA)

• Losing a lawsuit
  - Desert Hot Springs (CA), Westfall Tnshp (PA), Pierce Co. Housing Auth (WA), Boise Co. (ID), So. Tuscon (AZ), Mammoth Lakes (CA)

• Loss of key revenue source

• Utilities

• Burdensome labor contracts

• Hospital and health care districts
Chapter 9 Bankruptcy

A Brief History

- 1934 – Bankruptcy Act amended to authorize municipal filing
- 1936 – Ashton v. Cameron Co. Water Imp’t Dist. No. 1, 298 US 513
- 1937 – Congress passes Article IX of the Bankruptcy Act, including various “hands off” provisions
- 1978 – New B’cy Code enacted; Chapter 9 retained
- 1994 – Require, as a condition of eligibility, that state law “specifically authorize” a municipality to file under Ch.9.
Chapter 9 Bankruptcy

Chapter 9 Eligibility:

• “Municipality”
  • political subdivision or public agency of a State
  • States not eligible

• State law must specifically authorize

• Insolvent
  • Cash flow test, not balance sheet

• Desires to effect plan to adjust debts, **AND**
  • Consent of majority of each creditor class,
  • Has negotiated in “good faith” w/ creditors, but no agreement,
  • Unable to negotiated because impractical, **OR**
  • Reasonably believes that a creditor may attempt avoidable transfer
Washington Municipalities May File Ch. 9

- 12 States that specifically authorize municipal bankruptcies
- 12 States that conditionally authorize municipal bankruptcies
- 3 States with limited authorization
- 2 States prohibit filing, but one has an exception (Iowa)
- Remaining 21 States are either unclear or do not have specific authorization so there is no specific authorization
The overarching policy justification for Chapter 9 is to enable a municipality to restructure its debts without liquidating its assets, in order to continue to provide public services.

- "Special Revenue" obligations are paid in full, perhaps on restructured terms.
- "General obligation" bonds and other unsecured debt are restructured, and may or may not be paid in full.
- Voted general obligation bonds are treated as "special revenue" obligations?
- Other types of special revenues?
Similarities to Ch. 11 Corporate Re-Organization

- Automatic stay applies
- Debtor can recover preferences and fraudulent transfers
- Debtor can assume or reject executory contracts (including union contracts and long-term leases)
- “Plan of reorganization” = “Plan of adjustment”
- Secured creditors (incl. “special revenue” obligations) paid in full
- Unsecured creditors restructured and may or may not be paid
Differences from Ch. 11 Corporate Re-Organization

- Eligibility to file paramount in Ch 9 (nonexistent in Ch11)
- Bankruptcy court has much less control, and takes a much more hands-off approach, in Ch 9

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<th>Chapter 9</th>
<th>Chapter 11</th>
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<tr>
<td>Can the court replace the debtor's management?</td>
<td>No, local officials cannot be replaced by the court or a trustee.</td>
<td>Yes, court can convert the case to chapter 7 and appoint a trustee.</td>
</tr>
<tr>
<td>Labor contracts - rejection standards</td>
<td>Easier</td>
<td>Harder</td>
</tr>
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<td>Court approval required for litigation or other disputes?</td>
<td>No.</td>
<td>Yes.</td>
</tr>
<tr>
<td>Court approval required for sales or transactions outside the ordinary course of business?</td>
<td>No. The court has no power to oversee the debtor’s activities.</td>
<td>Yes. Debtor may do things outside the ordinary course only with court approval.</td>
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Restrictions on Bankruptcy Court’s Authority

- 11 USC § 904 provides:

  Notwithstanding any power of the court, unless the debtor consent or the plan so provides, the court may not, by any stay, order or decree, in the case or otherwise, interfere with:
  - any of the political or governmental powers of the debtor;
  - any of the property or revenues of the debtor, or
  - the debtor’s use or enjoyment of any income-producing property.

- So what if municipal debtor is unable to confirm a plan of adjustment?
  - No plan confirmed? case dismissed?
Questions?
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