

Local Government & Public Finance Law

Municipal Bankruptcy: Is It Really an Option for Local Government?

By Michael Viscount

Municipal governments in New Jersey and throughout the United States are in a state of financial crisis. Economic pressures persist due to unfunded mandates, reduced funding by state and federal sources, long-term legacy obligations and collective bargaining agreements for public employees. At the same time, over-taxed residents and businesses demand a stop to ever-increasing taxes imposed either directly as assessments against property values or disguised as fees for the privilege of doing business with government at every level. Sound familiar?

When economic times were good, governments had easy access to cash and free-flowing capital, among other options, to pay bills. Now those options are few, and the impact is frustrating.

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As reported by the Associated Press on Sept. 5, economic uncertainty has chilled the municipal bond market and all but dried up access to capital for public works projects and the devices used to fund operations of government, with the value of municipal bonds nationwide down about 40 percent from the prior year.

Across the country, talk of municipal bankruptcy — or Chapter 9 of the U.S. Bankruptcy Code — permeates the news and has become a familiar term as a result of the problems facing such locales as the California city of Vallejo (about to exit bankruptcy with renegotiated public worker contracts, after years in court and millions of dollars spent on administrative costs that will never be recovered); the Rhode Island town of Central Falls (recently filed for bankruptcy to effectuate a restructuring of public employee union contracts and outstanding obligations to public retirees); the Pennsylvania City of Harrisburg (not in Chapter 9, but may be on its way because of questionable

decisions in connection with bonding for an incinerator project); and Jefferson County in Alabama (in the news recently for using the threat of bankruptcy to force the final negotiations with holders of sewer project bonds that have left many scratching their heads and sent some to jail).

But is bankruptcy the answer for these or any other government entity? An understanding of what can and cannot be accomplished through a municipal bankruptcy, and an understanding of what is unknown and problematic, is critical to the policy maker contemplating such a move.

What is Chapter 9?

Chapter 9 is a long-available but seldom-used provision of federal bankruptcy law that allows municipalities to reorganize their financial affairs through an “adjustment of debts.” While similar to the Chapter 11 bankruptcy provisions more commonly utilized for private sector businesses, municipal bankruptcy under Chapter 9 has some major differences that cannot be ignored. Among the issues that confront a municipality considering bankruptcy, but not a business in the same situation, are the following:

- Enforceability of state law limits defining which municipalities can utilize Chapter 9;
- Whether and to what extent preliminary state law restructuring efforts must take place first; and
- Severe restrictions on what the

presiding bankruptcy judge can and cannot order in the event the municipality and its creditors and contractors cannot reach agreement on the primary terms for the fiscal restructuring to be implemented.

Another significant aspect of municipal bankruptcy under Chapter 9 is the requirement that, unless the filing is necessary to avoid action by a creditor that will harm the interests of other stakeholders, preliminary efforts must be made by the municipality to obtain the agreement of creditors and contract counter parties to adjustment of financial obligations before bankruptcy can be utilized.

It is also important to note that Chapter 9 has no provisions that enable a liquidation of a municipal debtor and contains many provisions that seek to affect the balance of power among debtors and creditors that are much different from the provisions found in Chapter 11, and the Tenth Amendment of the U.S. Constitution places limitations on the involvement of bankruptcy courts that oversee the debt adjustment process in Chapter 9.

Not a Panacea

It is clear from recent experience that municipal bankruptcy under Chapter 9 is not the remedy for all economic woes facing municipal government. There is much that is unknown about the process, the results are uncertain at best, and the costs in and of themselves can be as devastating to the financial well-being of the governmental unit as would be the alternative of doing nothing. The stark reality is the case of Vallejo, Calif., which filed bankruptcy in 2008 to deal with public employee labor contracts, pension obligations and other long-term commitments undertaken in a different economic environment. It took the city three years

to exit from bankruptcy, and according to published reports, the cost in legal fees alone was a staggering \$9.5 million. On paper now, the financial future of the city is much better than when the process was started, but at what cost? The questions raised by this and other experiences have to be: *Is there a better way? Could that money have been better spent? In hindsight, were there better alternatives?*

No Substitute for Political Will

Municipal bankruptcy will not eliminate any of the hard choices that will have to be made to successfully restructure governmental obligations. Once in Chapter 9, a municipality most likely will need to do “unpopular” things such as raise taxes, cut services and renegotiate labor agreements in order to restructure its finances. Such undertakings can be done outside of bankruptcy and without the administrative costs of a bankruptcy filing. Bankruptcy only provides the forum and a judge — a federal judge constrained by the U.S. Constitution and with little power to compel action by local government officials — to serve as arbiter over the process. So, while bankruptcy is a useful tool for a municipality to restructure its finances in an orderly fashion, it is not a substitute for political will.

Political will is required to tackle difficult fiscal problems, because no restructuring will take place without a politician recognizing the need and proposing a solution in an environment where no solution is going to please everyone with a stake in the outcome. Everyone wants to pay less for government, but no one wants their services, benefits or entitlements cut. Everyone wants to pay less for outstanding bond debt, but no one wants to cut the debt if it means future borrowing will be more

expensive. It is the vogue to believe that public employees are paid too much for too little effort and have benefit packages that far exceed those available in the private sector at much lower costs to the recipient, but who among us wants to be the one who suggests that years of promises be broken to those employees? To be certain, there is little or no prospect for accomplishing a municipal debt restructuring that will please all of a politician’s constituents. So, no matter how it is cut, the successful adjustment of municipal debt in or out of Chapter 9 hinges on the political will of those making the municipality’s decisions. Strong political will is required for a municipality to even take a step toward filing a Chapter 9 proceeding. Yet, ironically, if the decision makers have the political will to file Chapter 9, they also have the political will to make the hard decisions to address a municipality’s distress without the need to file Chapter 9.

In conclusion, municipal officials need to muster the political strength to address the financial problems facing government today. The political class must make politically unpopular decisions and take the necessary steps to “fix” the problem. Until this is done, Chapter 9 will not and cannot be the answer that everyone is looking for. It is not the easy way out. Initially, a municipality in financial trouble does not need Chapter 9, except to be used as a potential threat. As a threat, Chapter 9 can be useful to force the tough political decisions on all sides. But the problems need to be acknowledged and understood, and solutions need to be proposed first. Only after this occurs should debate be had as to whether Chapter 9 is the right tool to effectuate real and sustainable solutions to the current financial problems facing local government. ■