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*Chapter 9 Bankruptcy:
What it Means for Pennsylvania's
Municipalities*

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Key Findings

- Chapter 9 of the U.S. Bankruptcy Code outlines the procedures under which municipalities may adjust their debts—in other words, declare bankruptcy
- Though bankruptcy laws have been around since the 1930s, municipal bankruptcies are quite rare and are seen as a “last resort”
- As a result of amendments in 1994, municipalities must be specifically authorized by their state to pursue a Chapter 9 filing. Pennsylvania is one of nineteen states with such an authorization. In addition, states are free to place as many restrictions on filing as they wish. In Pennsylvania Chapter 9 procedures flow through the financial distress law, Act 47
- Pittsburgh has the extra requirement of seeking the permission of the Governor to commence a Chapter 9 filing under terms of Act 11 of 2004, the law that created the oversight board
- Pennsylvania has seen only three Chapter 9 filings since the early 1980s: two cases were dismissed and the third involved a municipality that was not in Act 47, thus making it unclear if it could have been in court in the first place
- A recent Chapter 9 case in Vallejo (CA) involved the labor contracts the City had negotiated with its unions. The City and the unions used the filing as a chance to renegotiate the contracts
- While the Pennsylvania Constitution prohibits impairment of contracts and the revocation of pension benefits by statute or ordinance, this does not appear to prohibit an action by a Judge in a Chapter 9 proceeding. The bankruptcy court in the Vallejo case ruled that a state permitting its municipalities to enter into Chapter 9 has decided that the benefits of the filing supersede the state’s laws on contracts
- This could have implications for Pittsburgh if the Act 47 team, the oversight board, and the Governor deem that the best remedy for the City’s financial difficulties is to enter Chapter 9

Introduction

“The notion that the second largest city of this Commonwealth would record the unprecedented status of bankruptcy is simply an unacceptable alternative”.

This quote was taken from a report of the Intergovernmental Cooperation Authority—the oversight board—written in April of 2004. At that time there had to be a lot of people thinking that the City of Pittsburgh (the second largest city referred to in the quote) could very well find itself in front of a bankruptcy judge.¹

The City was characterized as being saddled with an outmoded tax structure and out of budgetary gimmicks to meet its spending needs. Per capita debt was far out of line with other U.S. cities.

To forestall a worsening situation, the state had approved the City’s petition for Act 47 status, created a new, separate oversight board, and enacted a tax reform package for the City. Though common opinion—both then and more recently—might have been and may be that the City is “bankrupt”, it never found itself in court.²

But could it happen? Do cities and towns go bankrupt? When they do, what are the procedures for lifting the community out of its condition?

This report attempts to answer these and other questions.

Municipal Bankruptcy: The National Experience

The U.S. Constitution grants Congress the power to write uniform bankruptcy laws, and is the source authority for the statutory framework for municipal bankruptcy.

The Legal Background

Chapter 9 of the U.S. Bankruptcy Code outlines Municipal Debt Adjustment. The Code defines a municipality as a “public agency or instrumentality of a state”, language broad enough to include cities, counties, school districts, and special purpose governments (authorities).³ States cannot declare bankruptcy under Chapter 9.

¹ Intergovernmental Cooperation Authority for Cities of the Second Class, April 12, 2004.

² To wit, at the time the reform package was coalescing in 2003 and 2004, some of the following quotes appeared in news and opinion pieces. “[Mayor] Murphy has directed city budget and law officials to study layoffs and possible city bankruptcy if the merger and state aid don’t materialize”; “There is no stomach for bankruptcy or receivership and the loss of control that implies, but City Council, the mayor and the residents of Pittsburgh have had their chance and events now have moved beyond them. At the same time, “Pittsburgh’s bankruptcy” in fact if not in law has had the laudable effect of finally focusing the public’s attention”; “If Murphy’s gamble doesn’t pay off in Harrisburg, the city’s bankruptcy becomes a better than even bet”; “at an event outside the city, some in the audience asked why people in other counties should care about the city’s bankruptcy”; “The city’s oversight board gave the state Legislature its preferred blueprint for avoiding Pittsburgh bankruptcy yesterday”

³ James E. Spiotto “Chapter 9: The Last Resort for Financially Distressed Municipalities” February 2009 (<http://www.chapman.com/attorneys.php?&AttorneyID=24>); Ryan Preston Dahl “Collective Bargaining

Besides meeting the definition of a municipality under the Code, there are additional requirements that must be met in a Chapter 9 filing:

- Must be *specifically* authorized by state law a result of 1994 amendments to the Code (see insert on page 6)
- Must be insolvent as defined by the Code—meaning that the municipality is unable to pay debts as they come due
- Must desire to have a plan to adjust debts
- And must obtain agreement of a majority of creditors, negotiate in good faith⁴

Incidence

Given the restrictions—state approval, the need to prove insolvency, etc.—and given the fact that bankruptcy is seen as a “last resort” for local governments, it is understandable that there have been relatively few municipal bankruptcies in the U.S. This is true even though the law has been around since 1937. There have been 566 debt adjustment cases in 72 years, an average of 8 per year, an amazing statistic in light of the fact that there are over 55,000 municipal entities in the U.S.⁵

Since 1980 there have been 195 municipal bankruptcy filings—representing about 34 percent of all filings since 1937. Of those 195 filings:

- The highest number of filings came in the years 1987, 1991, 1992, and 1994 with 18, 15, 13, and 13 filings respectively
- Over 60 percent of the filings occurred in four states—California, Colorado, Nebraska, and Texas
- 21 percent of the filings were from a general purpose government—a city, village, or county. The rest were tied to special purpose governments, such as municipal utilities (38%), hospitals or health care agencies (13%), schools (3%), special municipal districts (19%) and transportation or other (6%).⁶

That’s not to say that large cities and counties have not gone down the road of municipal bankruptcy. Orange County (CA), Bridgeport (CT), and the recent case of Vallejo (CA) are examples of larger governing bodies that have filed for Chapter 9 bankruptcy.

Agreements and Chapter 9 Bankruptcy” (http://works.bepress.com/ryan_dahl/1/); U.S. Bankruptcy Court “Municipality Bankruptcy” (www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter9.html)

⁴ Ibid

⁵ Spiotto “Chapter 9 Cases Filed Since the Passage of the Bankruptcy Code”. Data reflects cases as of August 2009. As stated by MuniNetGuide “In comparison [to the number of municipal filings], for the twelve month period ending June 30, 2007 alone, the U.S. Courts Administrative Office reported Chapter 7 filings of 450,332, Chapter 11 filings of 5,586, and total business filings of 23,889”.

⁶ Ibid

The Role of the Court

Section 903 and 904 of Chapter 9 define the role of the court in a municipal bankruptcy proceeding. It is not the all-powerful, Draconian dispenser of swift punishment on a troubled municipality that one might think.

It is limited in that it cannot interfere with the political or governmental powers of the debtor or any property or revenues of the debtor. The function of the Court is generally limited to approving a petition, confirming a plan of debt adjustment, and ensuring implementation of the plan. As one report points out

Federal bankruptcy law is...not an unconstitutional intrusion on state sovereignty insofar as it requires the municipal-debtor to obtain state consent, the filing is voluntary and not forced upon the municipality by the Federal courts and judicial control over state property and revenues is limited.⁷

The court can dismiss a petition if it can be proven that the petition was not filed in good faith or not in requirements with Chapter 9.⁸

A March 13, 2009 memorandum of the Eastern District of California's Bankruptcy Court addressed the issue of "whether Chapter 9 of the Bankruptcy Code permits a municipality to reject collective bargaining agreements with its public employee unions". The City of Vallejo filed a motion for approval of rejection of its collective bargaining agreements with its police, fire, blue- and white collar employees. The police and white-collar unions made supplemental agreements with the City and the motions against them were voluntarily dismissed by the time of the memorandum.⁹

The memorandum noted that the U.S. Constitution gives Congress the power to establish uniform bankruptcy laws, and reserves powers not delegated to the Federal government to the states and the people. States are free to permit or forbid their municipalities from filing for Chapter 9, and those that do permit a filing can attach as many pre-conditions as they wish. But once in Chapter 9, the state law and, presumably, state constitutional provisions, would yield to the Federal law. "When a state authorizes its municipalities to file a Chapter 9 petition it declares that the benefits of Chapter 9 are more important than state control over its municipalities".¹⁰

⁷ Public Law Research Institute "Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code" (www.uchastings.edu/plri/fal95tex/muniban.html).

⁸ Ibid. The U.S. Courts' explanation states "the restrictions...are necessary to ensure the constitutionality of Chapter 9 and to avoid the possibility that the court might substitute its control over the political or governmental affairs or property of the debtor for that of the state and the elected officials of the municipality"

⁹ U.S. Bankruptcy Court, Eastern District of California, Sacramento Division "In re City of Vallejo, Debtor" March 13, 2009

¹⁰ Ibid

States and Chapter 9—Gatekeepers on Bankruptcy Filings

States play a key role as gatekeepers or guardians in that, by virtue of amendments codified in 1994, they have to specifically authorize their municipalities to file for Chapter 9. Silence on the matter is taken as a prohibition on filing. Since Pennsylvania’s Act 47 contains Chapter 9 requirements for municipalities only all other types of agencies—such as municipal authorities—are prohibited from filing.

A state is free to attach as many conditions on filing as it wishes. It can require prior approval before a municipality files; it can mandate the appointment of a trustee and a plan of readjustment; it can create municipal distress statutes (like Act 47) that run in place of or concurrently to bankruptcy filings.



In addition to Pennsylvania eighteen states—Alabama, Arkansas, Arizona, California, Colorado, Florida, Idaho, Mississippi, Missouri, Montana, North Carolina, Nebraska, New Jersey, Ohio, Oklahoma, South Carolina, Texas, Washington—have specific authorizations for municipalities to be debtors under Chapter 9. Georgia prohibits filing, and the remaining thirty states are silent on the issue of filing, thus implicitly prohibiting filing under the 1994 amendments.¹¹

The memorandum pointed out that “by authorizing the use of Chapter 9 by its municipalities, California must accept Chapter 9 in its totality; it cannot cherry pick what it likes while disregarding the rest”. Going into Chapter 9 means a municipality is “entitled to fully utilize [the Bankruptcy Code] to accept or reject its executory contracts”.¹²

¹¹ Spiotto, Dahl. As noted in the DCED publication “Municipal Authorities in Pennsylvania” authorities are prohibited from filing for Chapter 9 bankruptcy (<http://www.newpa.com/get-local-gov-support/publications/index.aspx>).

¹² Ibid

So what did the judge do in the Vallejo case? At the time of the memorandum, the City was still trying to renegotiate contracts with the firefighters and the blue-collar workers as it had with police and white-collar unions, so the court agreed to give the negotiations more time. In addition, the court wanted to see a clear accounting of the City's finances since the unions had argued that the City's more than 100 special and enterprise funds could be used to solve the City's financial problems. (According to the City's Public Relations Officer, negotiations have begun with the firefighters and blue-collar employees, and the court was satisfied with the City's explanation of the special funds).¹³

The discussion now turns to Pennsylvania and its legal requirements for Chapter 9 bankruptcy. What does current law say? Have any municipalities declared bankruptcy? And what would a bankruptcy court do with a municipality like Pittsburgh which carries large long-term legacy costs?

Municipal Bankruptcy: The Pennsylvania Experience

The Legal Background

As mentioned earlier, a state has to specifically authorize its municipalities to pursue a Chapter 9 debt adjustment proceeding. Pennsylvania is one of those states and its specific authorization is contained in Act 47 of 1987, the Financially Distressed Municipalities Act.

Act 47 permits a municipality in financial distress to pursue a Chapter 9 filing. Subchapter D, Section 261 "Filing Municipal Debt Adjustment Under Federal Law" states that if one of the following conditions is present the municipality is authorized to file a debt adjustment action:

- The Act 47 coordinator recommends filing
- There is imminent action by a creditor that would threaten the ability of the municipality to provide services
- A creditor has rejected the Act 47 plan and the rejection cannot be resolved
- A condition causing financial distress could be solved by filing
- The governing body has failed to adopt an Act 47 plan or carry out the recommendations of the coordinator¹⁴

If a majority of a qualifying governing body votes to file for Chapter 9, then the municipality would be subject to a debt readjustment proceeding. The municipality is still treated as being financially distressed under the terms of Act 47 and, if there is a

¹³ Ibid. Also MuniNet Guide "Vallejo Bankruptcy Filing Garners Attention in Municipal Finance Circles" August 26, 2008 (www.muninetguide.com/print.php?id=282). In the article it is noted "Vallejo accumulated a significant amount of debt to its public employees as a result of salary increases and unfunded pension obligations".

¹⁴ Act 47 of 1987

recovery plan in place for the municipality it is used as a guide for the Federal action under Chapter 9.¹⁵

Given Pittsburgh's unique position of both being in Act 47 status and under the direction of an oversight board there is an additional layer of the state's gatekeeper function: the Governor would have to approve a Chapter 9 filing for Pittsburgh.¹⁶

Incidence

Pennsylvania has seen very few Chapter 9 filings in the last thirty years. Prior to the passage of Act 47 and the specific requirements under which a financially distressed municipality could pursue a Federal action, two cases—one for the Borough of East Shenandoah in eastern Pennsylvania and the North and South Shenango Joint Municipal Authority—were filed. Both cases were dismissed.¹⁷

Since the inception of Act 47 twenty two municipalities have entered into distressed status. Five have since been removed. The remaining municipalities—including Pittsburgh—have not taken any action under the statute to pursue a Federal remedy. One municipality, Westfall Township in northeastern Pennsylvania, did file for bankruptcy without first being in Act 47 status. According to a party to the case the matter was settled without any substantive discussion of whether the municipality had the right to appear before a judge in a Chapter 9 proceeding without first being in Act 47.¹⁸

What Would a Court do With Pittsburgh's Legacy Costs?

What implications would Chapter 9 have for the City of Pittsburgh? On the chance that the City found itself in front of a bankruptcy judge there might be some nudging to renegotiate existing union contracts. That would be quite different from the procedures under Act 47: that law mandates that collective bargaining agreements negotiated while in Act 47 cannot violate the terms of the Recovery Plan. On the other hand, contracts in existence at the time Act 47 status is granted must remain in effect until the term of the contract expires. That's why when labor contracts have expired at some point in the last five years the Act 47 team has made what changes it can through the negotiating process.

For instance, the amended Act 47 plan notes that there have been

No further benefit enhancements, moderation of growth in the salary base used for pension calculations, elimination of retiree health care for employees hired

¹⁵ Ibid. The Act notes that one of the Coordinator's powers is to "analyze whether specific exclusive Federal remedies could help relieve the municipality's financial distress and whether filing a Federal debt adjustment would be appropriate".

¹⁶ Act 11 of 2004 "Limitation on Authority and on Assisted Cities to File Petition for Relief under Federal Bankruptcy Law"

¹⁷ Spiotto, Chapter 9 Cases Filed.

¹⁸ Phone conversation with Larry Young, Attorney at Law. Pocono News.Net "Westfall Township, Developer Settle for \$6 Million" (<http://www.pocononews.net/news/August09/26/26Aug09-3.html>)

after December 31, 2004, extension of police cost sharing requirements for retiree medical premiums to City firefighter retirees, reevaluation of City pension contribution levels¹⁹

Going forward into the coming contract years, the Act 47 team has recommended that the City put an additional \$10 to \$14 million per year toward pensions, to explore pension obligation bonds, to avoid future or retroactive pension enhancements, eliminate overtime calculation for pensions for the firefighters, the exploration of new defined benefit plan for new hires, and other recommendations.²⁰

However, in a Chapter 9 filing, as opposed to being in Act 47 status alone, a municipality would be able to void an existing contract and renegotiate more favorable terms if the judge so ordered.

This could involve an alteration of pension benefits, and it might stand. The Pennsylvania Constitution (Article I, Section 17) prohibits laws that impair contracts, and the Department of Community and Economic Development's "Municipal Pension Handbook" notes "the Pennsylvania Supreme Court has applied [this provision to mean]...pension benefits cannot be taken away unilaterally, by statute, ordinance, or similar action".²¹

But a judge in a Chapter 9 proceeding would not be making law: he would be adjusting the municipality's debts (analogous to what happens in Chapter 11 proceedings and as provided for by the U.S. Constitution). This type of adjustment could well include pensions if the judge deemed it necessary to solve the City's problems.

Conclusion

In sum, Chapter 9 municipal bankruptcies are quite infrequent and not as harsh as some observers might think. Both of these characteristics are true due to the fact that states are gatekeepers on filings, and often place state level oversight policies in place to temporize such filings, and a court does not wield unlimited power in a municipal bankruptcy. In short, the city or town cannot declare itself out of business, liquidate its assets to satisfy creditors, and close down.

On the other hand, the unique challenge that legacy costs like pensions and post-retirement health care pose to municipalities could lead to more filings in the future. In Pennsylvania, it won't be very surprising if the General Assembly revisits municipal (and likely school and state worker) pensions in the next few years. If a reform effort fails to mobilize then it could be possible for municipalities to enter Act 47 and then Chapter 9 not very long after.

¹⁹ Act 47 Amended Recovery Plan

²⁰ Ibid

²¹ Commonwealth of Pennsylvania, Department of Community and Economic Development, Governor's Center for Local Government Services "Municipal Pension Handbook" (www.newpa.com)