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Will Legacy Costs Force Pittsburgh Into Chapter 9 Bankruptcy?

"…the notion that the second largest city of this Commonwealth would record the unprecedented status of bankruptcy is simply an unacceptable alternative"—
Report of the Intergovernmental Cooperation Authority, April 12, 2004

Five years ago when the City was new to Act 47 status and the oversight board was getting its bearings there had to be some inkling of a very real possibility Pittsburgh could find itself in front of a bankruptcy judge. 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.

The issue of legacy costs—pensions, post-retirement health care, debt, and workers' compensation—was serious then and has become even more severe. The Act 47 team recently noted they "have reached unsustainable levels". This is especially true of the City's pension situation. Consider that in 2003 the plans contained 41 percent of the assets needed to meet liabilities; that ratio has fallen to as low as 28 percent in recent months. Indeed, at 41 percent funded, dramatic and immediate steps were called for but were not forthcoming. Instead, procrastination and hope for a miracle were the City's policy response.

Currently, the City and the state are at cross purposes on the issue of Pittsburgh's pensions. There is a plan in the Legislature to turn administration and management of the pensions over to the Municipal Retirement System, heretofore a voluntary organization. However, the City wants to opt out of the legislative plan and wants to hang its fate on trying to lease parking garages and lots for an upfront payment of at least $200 million net of debt repayment and transaction costs. That money would be used to bring the funded ratio of the plans to above 50 percent.

Here's the problem. It is not clear the lease will generate a net of $200 million and even if it did, the level of current liabilities has not been updated and $200 million, if achievable, might not lift the funding ratio above 50 percent. Moreover, simply reaching 50 percent funded still leaves a giant hole in the pension plans' ability to meet obligations.

And still worse, what if neither plan is capable of restoring the City's pensions to good financial health? Could the possibility of bankruptcy be in the offing?

For certain, the state and the City will do everything in their power to avoid going forward with bankruptcy, formally known as a Municipal Debt Adjustment under Chapter 9 of the U.S. Bankruptcy Code. 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).

Under amendments made to Chapter 9 in 1994, municipalities must be *specifically* authorized by their state to be a debtor under the law. Pennsylvania is one of nineteen states that do have such an authorization, and states are free to attach as many pre-conditions on filing as they wish. Pennsylvania uses Act 47 as a temporizing program, and the Act 47 statute lays out the stipulations for a Chapter 9 filing (coordinator has to sign off on it, creditors don't like the recovery plan, etc.). Then too, Pittsburgh is more strictly limited by the law creating the oversight board that prohibits a Chapter 9 action without the direct consent of the Governor. Note that unless renewed by the Legislature, the oversight board goes away in 2011.

Other provisions in the Bankruptcy Code require the municipality: (a) to be insolvent, (b) to want to put together a plan to adjust their debts, and (c) to have an agreement from the majority of their creditors that a Chapter 9 filing would be appropriate.

Given these restrictions and, given the fact that bankruptcy is seen as a "last resort" for local governments, it is understandable that, despite having the force of law since 1937, municipal bankruptcies across the nation are quite rare (only 566 in 72 years, an average of 8 per year). Since 1980 (about a third of all municipal bankruptcies have occurred since then) 60 percent of the municipal bankruptcies have occurred in four states; CA, CO, NE, and TX. Bankruptcy filings by general purpose governments (counties, cities, and towns) constituted about one-fifth of the filings. The majority of filings are accounted for by municipal utilities and special district governments.

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. Pennsylvania saw two local governments file for Chapter 9 in the 1980s (prior to the passage of Act 47) and both cases were dismissed.

Should Pittsburgh or another municipality enter a bankruptcy proceeding the court is limited in its power to "interfere with the political or government powers of the debtor" and instead is focused on adjusting debts and trying to get a reasonable and fair settlement. This can include dismissing collective bargaining agreements that are deemed burdensome. A rejection of these agreements would necessitate renegotiating contracts. Meanwhile, the municipality cannot be forced to liquidate its assets and distribute the proceeds to creditors.

Five years after the oversight board raised the possibility of bankruptcy and the belief that such an action would be unacceptable, the state continues its supervision of the City's finances and could soon be the caretaker of the pension funds. Along with as much as $600 million in unfunded pension liabilities, there looms a large unfunded liability for post-retirement health care ($360 million), workers' compensation ($124 million), and general obligation debt ($723 million). Officials likely believe that they can undertake steps sufficient to enable the City to climb out of the hole created by legacy costs while avoiding having to file for Chapter 9 bankruptcy.

The burning question of the next few years will certainly be; "Can they muster the political will to solve their legacy cost problems?" History tells us the odds of that occurring are quite low—not without even stricter state oversight than we have seen over the last five years.

Eric Montarti, Senior Policy Analyst **Jake Haulk, Ph.D., President**

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Allegheny Institute for Public Policy
305 Mt. Lebanon Blvd.* Suite 208* Pittsburgh PA 15234
Phone (412) 440-0079 * Fax (412) 440-0085
E-mail: aipp@alleghenyinstitute.org