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What Happens in a Chapter 9 Bankruptcy?

In a previous *Policy Brief* (Volume 9, Number 51) we raised the question of whether Pittsburgh's legacy costs could force the City to seek relief under Chapter 9 of the U.S. Bankruptcy Code. Under Chapter 9 a judge would oversee a readjustment of debts. Pennsylvania's Act 47 permits a municipality in financial distress to pursue a Chapter 9 filing if one of the following conditions is present:

- 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 coordinator

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 (Pittsburgh has the additional requirement of petitioning the Governor under legislation that created the oversight board, which supersedes the Act 47 requirements). Bear in mind that debt readjustment for municipalities is qualitatively different from a Chapter 11 bankruptcy by a private entity. Because the municipality cannot "go out of business" there is no prospect of all assets being liquidated with the proceeds apportioned among creditors.

After a Chapter 9 filing has been made, what then? Various parties would be asking this question—City officials, City residents, unions, creditors, the media, etc.—so it is worth looking at a recent Chapter 9 case in Vallejo, California to get an idea of how the question might be answered.

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.

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”.

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”.

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).

What implications would this 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. However, in Chapter 9, a municipality would be able to void an existing contract and renegotiate more favorable terms if the judge so ordered.

And it could involve an alteration of pension benefits. 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”. 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.

Draconian? Perhaps, but that is why Chapter 9 contains so many hoops for a municipality to jump through before getting to a debt adjustment proceeding. It is supposed to be the last resort. And it is also why there are so few such filings nationwide. Whether

Pittsburgh or any of the other 16 municipalities currently in Act 47 ever end up in Chapter 9 remains a very big question. In view of the fact that Act 47 coordinators would have to approve (undoubtedly requiring the Governor to agree) along with the enormous heavy political pressure and resistance labor unions would bring to bear in opposition to Chapter 9, the City will probably be have to be insolvent, unable to meet payroll, unable to pay bills, and facing legal action by creditors to ever vote for Chapter 9.

At that point, Chapter 9 could be more desirable than having a judge issue an order to pay even if it means the City would have to raise taxes to make the ordered payments.

Eric Montarti, Senior Policy Analyst

Jake Haulk, Ph.D., President

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<p>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</p>
