

More Municipalities Are Considering Bankruptcy



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Jefferson County in Alabama, and the cities of Harrisburg in Pennsylvania, Central Falls in Rhode Island, Vallejo, Stockton, Monmouth Lakes, and San Bernardino in California. It is not a tsunami, but it may be a trend. The past few years have seen a marked increase in the number of municipalities and counties resorting to Chapter 9 of the United States Bankruptcy Code to address their financial woes. Over the previous several decades, Chapter 9 was more often used by local utilities, authorities, hospitals and other entities.

Leading investment and economic experts have spoken of this trend. In December of 2010, Wall Street analyst Meredith Whitney warned of significant coming municipal bond defaults. More recently, legendary investor Warren Buffett observed that this year's California municipal bankruptcy filings have reduced the stigma associated with Chapter 9, increasing the likelihood that more distressed municipalities will consider this action.

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Speaking to the League's Educational Foundation this summer, Professor Raphael J. Caprio of the Edward J. Bloustein School of Planning and Public Policy at Rutgers University predicted that the financial stresses facing New Jersey's municipalities will come to a head sometime after 2015. And a recent report on the financial condition of states and municipalities by former Federal Reserve Chairman Paul



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Volcker and former New York Lieutenant Governor Richard Ravitch forecast a difficult economic future.

The growing use of Chapter 9 by municipalities should not be ignored. It is a symptom of the difficult financial environment faced by our communities, and it has lessons to teach about the tools available for municipal restructuring.

Financial Pressures Are Growing The pressures leading to the gloomy assessments are well known. Labor related costs, especially those from pensions and benefits, have continued to increase dramatically. Supplies and services are expensive, as are the costs of meeting bond debt maintenance and covenant obligations. At the same time, ratables have declined and property tax increases have been capped. Foreclosures, tax appeals and reassessments are also reducing revenues. Severe weather events and other unscheduled resource drains also impact budgets. Finally, the State of New Jersey is facing its own financial pressures, rendering it less able to provide ongoing aid and funding for new projects.

Non-Bankruptcy Restructuring Options

A municipality facing economic crisis has a number of non-bankruptcy restructuring tools available. The labor force can sometimes be reduced by attrition or by selectively eliminating positions. Services can be discontinued, cut back or shared with neighboring communities. Municipal officials can attempt to renegotiate union contracts. In some instances, costs can be reduced through sales of assets, sales and lease backs of property, or through privatization of facilities and services.

The tools for increasing revenues are more limited, due to real estate property tax limitations. Some municipalities are charging higher fees for licenses and permits as a way of increasing revenues. None of these measures is easy to achieve even in the face of dire financial circumstances. Each presents its own set of legal, political and practical difficulties. Even after using the available cost-cutting and revenue enhancing tools, a municipality may find itself unable to meet its financial obligations.

State Involvement If all other options fail, a debt-laden municipality is left with the State Municipal Insolvency

procedure or the filing of a Chapter 9. New Jersey has a comprehensive set of statutory provisions to address economically stressed municipalities. Under these provisions, through the Division of Local Government Services and the Local Finance Board, the state is vested with extraordinary power over municipal affairs. N.J.S.A. §52:27-1, et. seq. A municipality may have state supervision forced on it or may seek it voluntarily. Depending on the desires of the state, this "take over" or "hand over" may last until all past debts have been satisfied and a reserve for a year or more of coming debts has been funded.

A MUNICIPALITY FACING ECONOMIC CRISIS HAS A NUMBER OF NON-BANKRUPTCY RESTRUCTURING TOOLS AVAILABLE.

Chapter 9 Bankruptcy The Bankruptcy Code requires that, before filing Chapter 9, a municipality be authorized "by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be debtor..." 11 U.S.C. §109(c)(2). This provision gives states broad discretion in setting the parameters under which a municipality may seek protection under Chapter 9.

By statute, New Jersey requires that a municipality obtain the vote of two-thirds of the members of its governing body (N.J.S.A. §52:27-41) and the consent of the state, through the Local Finance Board (N.J.S.A. §52:27-40), before filing a Chapter 9 petition. The Bankruptcy Code also requires that a municipality demonstrate that it is insolvent and that it is proceeding in good faith (meaning that it has the support of a majority in amount of each class of creditors to be impaired under a plan of adjustment, it has negotiated in good faith to obtain such agreement and failed, or that it is impracticable to do so). 11 U.S.C. §109(c)(3), (5).

On the filing of a Chapter 9 bankruptcy petition, as in other bankruptcy

cases, an automatic stay applies immediately and puts a hold on most creditor collection efforts. A notable exception in the case of Chapter 9 bankruptcies is that the stay does not apply to special revenue bonds. The purpose of the automatic stay is to give the debtor the opportunity to work out a reorganization without the immediate pressures of creditor action. The State Municipal Insolvency procedure provides for a more limited stay.

In a Chapter 9, a municipality will have great leverage with dealing with unions. This is because a municipality in Chapter 9 may be able to reject collective bargaining agreements if it can convince the bankruptcy court that it has tried to resolve its union issues through other means, the collective bargaining agreement is a significant burden, and that rejection is the best option on balance.

The ability to reject agreements in Chapter 9 goes beyond collective bargaining agreements. As is the case with a Chapter 11 debtor, a municipality in Chapter 9 may reject burdensome executory contracts and leases. Some unique features of Chapter 9 are that a municipality is not required to file schedules, does not need Bankruptcy Court approval to retain or pay professionals, and payments on bonds are not voidable as preferential payments. In addition, the Tenth Amendment limits the Bankruptcy Court's authority to interfere with the political and governmental powers of the municipality, and the municipality's property and revenues remain under its control.

Will New Jersey Follow the Trend?

Because of the state's commitment to protecting New Jersey public entities in the bond market, the state will be reluctant to permit a New Jersey municipality to enter bankruptcy. As long as the state has the resources to provide a financial rescue, it is unlikely that we will see any of New Jersey's 566 municipalities filing Chapter 9. However, the state faces its own growing financial pressures. Accordingly, there may come a day when the state is unable to bail out failing municipalities. At that point, the state's attitude toward Chapter 9 may change. Given the trends noted above, that day may not be as far off in the future as some may think. ▲