

MUNICIPAL BANKRUPTCY OVERVIEW

Disclaimer – These written materials distributed and the presentations made are intended for educational and discussion purposes only. Any views expressed herein are not intended to be attributable to the City of Costa Mesa or the Pension Oversight Committee and are not intended to bind any speaker/presenter to any positions that they may or may not take in any actual matter. I am not a licensed attorney and, as such, cannot provide any legal advice. Consult your own attorney for further information.

Introduction

1. Basic Bankruptcy Definitions

- a. **Debtor/Debtor-in-Possession.** The debtor is the individual or business entity filing bankruptcy. The debtor-in-possession is the name given to the debtor continuing to manage and run the business after a bankruptcy petition is filed (post-petition). Once filed, the proceedings are generally referred to as cases.
- b. **US Trustee.** The US Trustee is a component of the Department of Justice responsible for overseeing the administration of bankruptcy cases and the private trustees.
- c. **Private Trustees.** Individuals, generally bankruptcy lawyers, assigned to manage Chapter 7 and 13 cases. Sometimes appointed in chapter 11 business cases when circumstances warrant.
- d. **Bankruptcy Judge or Court.** All bankruptcy cases are heard in the Federal Bankruptcy Courts. Upon filing of a petition, a judge is assigned by the court clerk to decide all matters connected with the case.
- e. **Creditors.** Individual or business entity to whom the debtor owes a debt incurred before the filing.
- f. **Examiner/Receiver.** Any party in interest, including the US Trustee, can request the court to appoint an independent examiner/receiver to monitor or review any aspect of the case including specific issues or transactions. The court may appoint a receiver to take over and manage the entire business even in chapter 9 if requested by the municipality.

2. Common Types of Bankruptcy Filings.

a. Individual bankruptcy – Chapter 7 or 13.

Chapter 7 is a liquidating bankruptcy. A court-supervised private trustee is appointed to assemble the debtor's assets, reduce them to cash, and make distributions to various creditors based upon their priority.

Chapter 13 is generally called a wage earner or adjustment of debts plan. A standing (private) chapter 13 trustee is appointed by the court to take control over the debtors' income and calculate the debts owed. Those debts are paid over a time frame according to the plan. Once all of the scheduled payments are made under the plan, a discharge of debts is entered.

b. Business Bankruptcy – Chapter 7 or 11.

Chapter 7 is a liquidating bankruptcy defined above.

Chapter 11 is generally a reorganization of the commercial entity business liabilities and contractual obligations – all occurring while the business continues to operate.

c. Chapter 12 – Family Farmer or Family Fisherman Bankruptcy.

d. Chapter 9 - Municipal bankruptcy.

A special chapter in the bankruptcy code for use only by municipalities (cities, towns, villages, counties, taxing districts, municipal utilities and school districts). There is no provision for liquidation of municipal assets to be distributed to creditors. Municipalities are not reorganized but ultimately develop a plan of debt adjustment.

Out of almost 90,000 municipalities in the country, there were fewer than 700 municipal filings over the last 75 years. That compares to over 1.2 million total chapter 7, 11, 12 and 13 filings last year alone.

Chapter 9 Municipal Bankruptcy

1. Purpose

The purpose of chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts and/or contractual obligations. It is a legal “time-out”. Similar to other chapters in some respects, chapter 9 is significantly different, as follows:

- a. There is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Such a liquidation or dissolution would violate the Tenth Amendment to the Constitution and the reservation to the states of sovereignty over their internal affairs.
- b. Due to the severe limitations placed upon the power of the bankruptcy court in chapter 9 cases (required by the Tenth Amendment and the Supreme Court's decisions in cases upholding municipal bankruptcy legislation), the bankruptcy court generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under chapter 11. The functions of the bankruptcy court in chapter 9 cases are generally limited to approving the petition (if the debtor is eligible), confirming a plan of debt adjustment, and ensuring implementation of the plan. As a practical matter however, the municipality may consent to have the court exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy, in order to obtain the protection of court orders and eliminate the need for multiple forums to decide issues.

2. Eligibility

The municipal debtor bears the burden of establishing that it is eligible to file bankruptcy under chapter 9. Section 109(c) of the Bankruptcy Code sets forth four additional eligibility requirements for chapter 9:

- a. the municipality must be specifically authorized to be a debtor by State law or by a governmental officer or organization empowered by State law to authorize the municipality to be a debtor;
- b. the municipality must be insolvent, as defined in 11 U.S.C. § 101(32)(C) – (generally not paying its debts as they become due unless such debts

are the subject of a bona fide dispute or unable to pay its debts as they become due.) Stockton (debt) and San Bernardino (cash flow).

- c. the municipality must desire to effect a plan to adjust its debts; and
- d. the municipality must either:
 - i. obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan in a case under chapter 9;
 - ii. negotiate in good faith with creditors and fail to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan;
 - iii. be unable to negotiate with creditors because such negotiation is impracticable; or
 - iv. reasonably believe that a creditor may attempt to obtain a transfer that is avoidable as a preference.

3. Commencement of the Case

Municipalities must voluntarily seek protection under chapter 9 of the bankruptcy code. California is one of about 28 states that allow for municipal bankruptcies filings.

Effective January 9, 2012, California enacted AB506, which must be followed before any municipality can file for bankruptcy. Before that, any municipality could file for protection without any state approval or pre-conditions.

As noted under *Eligibility* above, the Bankruptcy Code already requires that a municipality engage in negotiations with its creditors before filing. AB506 now requires that a municipality participate in a “neutral evaluation process” before filing. This process effectively mandates mediation under the auspices of a qualified third-party neutral, among the municipality and the numerous creditor constituencies – including unions.

The only exception that enables a municipality to avoid the neutral evaluation process is a declaration of a fiscal emergency (after a noticed public hearing, the municipality must issue a resolution stating that “the financial state of the municipality jeopardizes the health, safety, or well being of the residents of the municipality’s jurisdiction absent protections of Chapter 9”, plus include a finding that the municipality will be unable top pay it’s obligations within the next 60 days).

4. Neutral Evaluation – AB506

The neutral evaluation process is a procedurally complex mandatory mediation, as follows:

- a. The municipality/debtor is required to give 10 business days notice to all creditors with non-contingent claims of at least \$5 million (or claims that comprise more than 5% of the municipality's total debt). The municipality must also give notice to indenture trustees, unions that have collective bargaining agreements with the municipality, committees of creditors and retirees, pension funds, and other enumerated parties. Under the Bankruptcy Code, the municipality need only negotiate with creditors holding a majority of each class of debt that a forthcoming Chapter 9 plan would impair.
- b. Assembly Bill No. 506 envisions that the "neutral evaluator" will be selected through a mutually agreed-upon process, but includes detailed regulations concerning the multi-step selection process if an agreement cannot be reached. The bill also provides that the entire process not last for more than 60 days after the evaluator is selected, unless all interested parties agree to an extension for another 30 days. Further extensions are available if the municipality and a majority of the participating interested parties consent. The municipality "shall pay 50 percent of the costs of neutral evaluation, including but not limited to the fees of the evaluator, and the creditors shall pay the balance."

California's AB 506 process was intended to help a municipality in restructuring its debt obligations and avoid bankruptcy. California's recent wave of municipal bankruptcies tend to show that the AB 506 process has not changed this reality, but rather made a difficult process longer and more arduous. Stockton went through the AB506 process for 90 days without success. Creditors accused them of not negotiating in good faith. San Bernardino declared a fiscal emergency and skipped AB506.

5. Assignment of Case to a Bankruptcy Judge

A significant difference in chapter 9 cases is that the chief judge of the court of appeals for the circuit (instead of the court clerk) assigns the case to a particular judge. This removes politics from the assignment and ensures that the case will be handled by a judge who has the time and expertise to do so.

6. Noticing/Objections/Order for Relief

At the commencement of the case, the Bankruptcy Code requires notice be given via mail to all creditors and other parties in interest, plus newspaper publication. If there are objections to the filed petition, the court will hold a hearing on the objection. If the municipality did not meet the requirements or file in good faith, the court may dismiss the petition. If the court rules for the debtor, the Bankruptcy Code requires the court to order relief and the case proceeds.

7. Automatic Stay

This is the “Time-Out”. The stay operates to stop all collection efforts against the debtor. It does not stay any pledged special revenue funds from being paid to indebtedness secured by such revenues.

8. Court’s Limited Power

Because of constitutional issues, the court’s role is limited. The court may not interfere with:

- a. any of the debtor’s “political or governmental powers”;
- b. any of the property or revenues of the debtor; or
- c. the debtor’s use and enjoyment of any income producing property, unless the debtor consents or the plan provides.

The debtor’s day-to-day operations are not subject to court approval and the debtor may borrow funds and employ professionals without prior approval. The court may not appoint a trustee or convert the case to liquidation.

9. Role of the US Trustee

The UST Trustee has a very limited role in chapter 9 filings. It appoints a creditor committee, but does not

- a. examine the debtor at the 341(a) first creditor’s meeting;
- b. have the authority to request the appointment of a trustee or examiner;

- c. supervise the administration of the case;
- d. monitor the financial operation of the debtor; and
- e. review the fees of professional retained in the case.

10. Creditor's and Creditor Committee's Role

In larger cases, the US Trustee will appoint various creditors to serve on a Creditor Committee(s) to represent similarly situated creditors. Their role is more limited in chapter 9 than in other cases. They can not propose a competing plan and, if certain requirements are met, the debtor's plan is binding on the dissenting creditors. The creditors committee can:

- a. select and employ various professional to represent them;
- b. consult with the debtor concerning the case administration;
- c. investigate acts, conduct, assets, liabilities and overall financial condition of the debtor;
- d. participate in formulation of the plan; and
- e. perform any other services in the best interest of the committee.

11. Parties in Interest Right to be Heard

The Bankruptcy Code provides that the following parties may intervene or be heard on any issue before the court:

- a. The Secretary of the Treasury of the United States;
- b. State representatives;
- c. SEC;
- d. municipal employees;
- e. local residents;
- f. non-resident owners of real property;
- g. local tax payers;
- h. securities firms; and
- i. local banks.

12. Dismissal

After notice and a court hearing, the judge may dismiss a chapter 9 case if :

- a. the debtor did not file the petition in good faith; or
- b. the petition did not meet the filing requirements;
- c. there is unreasonable delay during the pendency of the case;
- d. the debtor does not propose or confirm a plan within the time fixed by the court; or
- e. there is a material default by the debtor under a confirmed plan;

Stay tuned for next week's discussion of:

13. Bondholder and Other Lender Treatment

14. Powers of the Debtor

15. Confirmation of a Plan

a. Cram Downs

b. Confirmation Standards

16. Impacts of Filing for Municipal Bankruptcy

17. Recent Rulings and Hot Button Issues

18. Closing