

## MUNICIPAL BANKRUPTCY OVERVIEW

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### **Part 2**

#### **13. Claim Classes – Payment Priority**

- a. Administrative Claims
  - i. Trustee administrative expenses
  - ii. Professional Fees
  - iii. Other post-petition administrative expenses
- b. Priority Claims – Governmental/Taxing authorities expenses
- c. Secured Claims
- d. Unsecured Claims
- e. Interest Claims – Equity Holders

#### **14. Bondholder and Other Lender Treatment**

- a. General Obligation Bonds

Municipalities are not required to make either principal or interest payments during the case. The obligations of general obligation bonds are subject to negotiation and possible restructuring.
- b. Special Revenue Bonds

These bonds are secured obligations which require continued servicing based upon the identified revenue stream.

## **15. Powers of the Municipal Debtor**

The municipal debtor can:

- a. use its property, raise taxes, and make expenditures as it sees fit, without court approval;
- b. adjust burdensome non-debt contractual relationships through rejection of executory contracts and unexpired leases, subject to court approval;
- c. reject collective bargaining and retiree benefit plans, subject to court approval;
- d. borrow funds without court approval; and/or
- e. employ and compensate professionals without court approval.

## **16. Confirmation of a Plan (“Plan”)**

Only the municipality can file a Plan of Adjustment of Debts. Neither the creditors nor the court can propose a Plan.

Plan voting is tabulated by claim class. Impaired (the Plan changes the claimant’s legal, equitable, and contractual rights) class creditors vote to accept or reject the Plan. Unimpaired classes have no vote.

The bankruptcy code lists specific detailed requirements that the court follows in approving the Plan. Two major requirements for Plan confirmation are, as follows:

### **a. Best Interests of Creditors**

This test in chapter 9 has frequently been interpreted to mean that the Plan must be better than the other alternatives available to the creditors. Generally, the alternative would be dismissal of the case. The courts have usually applied the test to require a reasonable effort by the municipality that is a better alternative to dismissal.

### **b. Cram Down Provisions**

The court may confirm a Plan, under the “cram down” provisions of the bankruptcy code, if ;

- i. all other requirements are met;
- ii. at least one class of impaired creditors votes to accept the Plan; and
- iii. the Plan does not discriminate unfairly and is fair and equitable.

## **17. Discharge of Debts**

The municipal debtor receives a discharge of debt in chapter 9 after:

- a. confirmation of the Plan;
- b. deposit of consideration to be distributed under the Plan with the disbursing agent appointed by the court; and
- c. court determination of the validity of the securities deposited.

There are two exceptions to debt discharge:

- a. debt excepted from discharge by the Plan or order confirming the Plan; or
- b. debt owed to an entity without actual notice of the case.

Within 180 days after entry of the confirmation order, the court may revoke the order if it was procured by fraud.

## **18. Impacts of Filing for Municipal Bankruptcy**

- a. Benefits of filing
  - i. Just the threat of filing may motive creditors and contractual parties to negotiate a consensual out-of-court restructuring.
  - ii. The benefit of the automatic stay stops all collection efforts including liened properties.
  - iii. Sufficient time to closely examine the municipal finances without being “under the gun”. The review can illuminate whether spending cuts or higher taxes may sustain the municipality over time. If not, it can act as a catalyst to renegotiate executory contract terms.
  - iv. Utilization of an expert arbiter. Either the AB506 expert or the bankruptcy judge.
  - v. Renegotiate or reject burdensome collective bargaining agreements to sustain the fiscal viability of the municipality over the long term.
  - vi. The municipality can impose a plan of debt adjustment without unanimous consent.
  - vii. Potential reduction of outstanding unfunded pension/medical liabilities.

- b. Disadvantages of filing
  - i. Public relations nightmare and major distraction for employees and political leaders.
  - ii. Municipal services may be reduced and local taxpayers may suffer. The filing will have an adverse affect on the local business climate.
  - iii. Public employees risk losing their jobs and benefits.
  - iv. Downgrades in bond ratings and ability to borrow in the future.
  - v. Massive costs for professionals, complying with reporting requirements, negotiating with creditors and unions and developing a plan. (Jefferson County spent \$1,000,000 per month on such costs and AMR total fees exceed \$300 million)
  - vi. The minute a collective bargaining agreement is rejected, you are right back at the bargaining table with very unhappy union negotiators.
  - vii. The ultimate nightmare scenario would be the Plan is not confirmed and the case is dismissed. The automatic stay is not applicable and all of the debts and contractual obligations are still owed.

## **19. Recent Rulings and Hot Button Issues**

- a. San Bernardino/CalPERS – 7/24/13. CalPERS is sponsoring legislation that would give them a present lien on ALL assets of a contracting public entity in the amounts owed to CalPERS. Not determined if it would include unfunded or just current amounts due.
- b. The CalPERS vs. bond insurers battle in the San Bernardino and Stockton bankruptcies is widely watched because of the potential for a precedent-setting decision: Can pension debt be cut in bankruptcy, and if so whose pensions would be cut? Is a pension obligation “special” as CalPERS claims or general unsecured debt?
- c. In the San Bernardino bankruptcy, where CalPERS opposes the city’s eligibility, the judge was impatient this month with CalPERS requests for more financial information from a short staff with recent turnover in two top positions.
- d. Detroit – 7/24/13. City proposal includes, moving all workers to Obamacare, freezing pensions for current workers, moving everybody else to 401K style, elimination of retiree health with a move to Medicare, and cancellation of all retiree life insurance plans. Elimination of all accrued vacation and sick days and suspension of seniority rules is also under consideration.

The unions claim that the state constitution protects the pensions of government workers, but the case will be heard in federal court.

- e. In the City of Pritchard, Alabama case, the court determined that both delinquent pre- and post-petition obligations are not administrative expenses but general unsecured claims.
- f. Today the Washington Post reported that Detroit may be required to liquidate its art museum and zoo, if it's determined that those are city assets.
- g. In an apparent bid to protect CalPERS from any potential adverse bankruptcy court decisions, discussions are underway in Sacramento regarding new legislation that would delay or require any municipality to obtain state approval before filing. No target date yet.
- h. The underlying unresolved issue is whether federal bankruptcy law prevails over California's perceived state protection of public employee pensions. This is uncharted territory for everyone. Generally, federal law prevails over state law. It will be a showdown.
- i. Is there a "too-big-to-fail" argument to be made when requesting a federal bailout?
- j. The political will required to contemplate filing and then stay the course is enormous. After the Vallejo bankruptcy many of the hard-fought union concessions achieved during the bankruptcy were given back by a new Vallejo city council.

## **20. Closing**

As we have seen, chapter 9 offers considerable tools and strategies to a struggling municipality that are simply not available otherwise. In some cases, it may be the only alternative for those municipalities facing significant budget deficits and excessively burdensome pension and other obligations.

While municipal bankruptcy may still be considered a "last resort", it is losing its stigma. However, if municipal budgets continue to be stressed due to oversized pension and/or debt obligations, more filings will occur. Early collaborative discussions with all stakeholders regarding infrastructure and policy revisions could avoid the necessity of filing. The consensus is that everyone involved will have to give something back. Everyone must share the pain. It is inevitable.