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# Can Governments Go Bankrupt? A Look at Chapter 9 Bankruptcy

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# Panelists



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# Introduction

- Inevitability of need for municipal debt adjustment
  - In pension area alone – debts vastly exceed ability to repay
    - California
    - Illinois
    - New York
- Other potential alternatives not likely
  - Federal bailout
  - Increase taxes (revenues)
  - Cut spending
  - Issue more debt
  - Privatize assets
  - “Emergency Manager”/oversight legislation
- Need to reduce pension obligation burdens

# Introduction

- Chapter 9 provides only mechanism to do this
  - Only federal bankruptcy court can override state laws (federal preemption)
  - Chapter 9 does not give substantive solutions, but provides mechanism and procedures for enforcing authorized treatment of unmanageable debts
  - Issues will arise in using Chapter 9, “grey areas” exist, but overall Chapter 9 is constitutional and provides a viable (probably the only viable) means to implement less than fully-consensual adjustments of municipal debts

# Chapter 9 Basics

- Who Is Eligible to File a Chapter 9 Case?
  - There are five requirements under § 109(c) of the Bankruptcy Code
    - The entity must be a “municipality” (a political subdivision, a public agency, or an instrumentality of a state);
    - The entity must be specifically authorized by state law to file under Chapter 9;
    - The entity must be insolvent;
    - The entity must desire to effect a plan to adjust its debts; and
    - The entity must have (a) obtained agreement with a majority of impaired creditors, (b) negotiated in good faith with creditors and failed to obtain such a majority, (c) been unable to negotiate with creditors because such negotiations would be impracticable, or (d) must reasonably believe that a creditor may attempt to obtain a preferential transfer under § 547 of the Bankruptcy Code

## Chapter 9 Basics (cont'd)

- Threshold Issues to Consider When Contemplating Chapter 9 as a Possible Solution
  - Authorization to File
  - Insolvency
  - Plan of adjustment

## Chapter 9 Basics (cont'd)

- How a Chapter 9 Case Differs From a Typical Corporate Bankruptcy Case
  - Bankruptcy court's limited role
  - Municipality's exclusivity with respect to proposing plan of adjustment
  - Municipality's broad powers to operate as usual while functioning under Chapter 9, without the need for bankruptcy court approval
  - No appointment of trustee or examiner
  - Retention of professionals
  - Post-petition financing

## Recent Legislative Initiatives

- California law regarding balanced budgets
- Emergency manager legislation (*e.g.*, PA Act 47)
- Oversight legislation (Michigan, NY)
- Rhode Island oversight of Central Falls
- Comparison to prior legislative initiatives in states such as Illinois and Massachusetts
- Potential for – and pros and cons concerning – action by congress?



# Municipal Financing Trends

- P3 – Public-private partnerships offer new source of capital for state and local governments
  - Alternative to traditional municipal financing
  - Harrisburg, PA and potential asset sales in connection with financial restructuring
- Concession model vs. availability of payment structures offer flexibility
  - Discussion of recent projects
  - Appropriation risk issues and bankruptcy considerations
- PPP Projects and bankruptcy considerations
  - PPPs are not immune from bankruptcy and restructuring: South Bay Expressway, Las Vegas Monorail, Southern Connector
  - Structures to protect state and local interests in event of bankruptcy

# Constitutional Considerations Relating to Chapter 9

- Tenth Amendment Concerns
  - A fundamental issue regarding municipal bankruptcy law is whether the scope of such a law interferes with state sovereignty over the affairs of its municipalities
- Constitutional Tensions are Already Recognized and Addressed in Chapter 9
  - Initiation of a Chapter 9 case is entirely voluntary (*i.e.*, no involuntary cases)
  - Municipality needs specific authorization from the state in order to file under Chapter 9
  - Preservation of state's power to control a municipality (§ 903)
  - Limitations on bankruptcy court's power (§ 904)
    - No interference with any political or governmental powers of the municipality
    - No interference with any of the property or revenues of the municipality
    - No interference with the municipality's use or enjoyment of any income-producing property

# Strengths and Limitations of Chapter 9

- Strengths of Chapter 9
  - Power to amend or terminate collective bargaining agreements and pension obligations
    - *Vallejo*
  - Plan of adjustment is binding on *all* creditors; cram-down powers
  - Automatic stay
  - A single, known forum and procedures
  - Familiarity and experience of bankruptcy courts in dealing with similar issues
  - Leverage in negotiations with creditor constituencies
  - Way to force politically unpopular decisions
  - Avoid legislative process
  - Remedy of last resort

# Strengths and Limitations of Chapter 9 (cont'd)

- Limitations of Chapter 9
  - Standing (enabling legislation)
    - Only 15 states specifically, and unconditionally, authorize municipal bankruptcies
    - Growing counter-movement by states to pass legislation barring municipal bankruptcies (Harrisburg, PA)
  - Impact on credit markets
  - Cost
  - Time
  - Distraction
  - Stigma
  - Lack of precedent

# Addressing the Pension Issues

- Ability to reject collective bargaining agreements
  - Federal power to create uniform laws on bankruptcy (Art. I § 8 cl 4) vs. reservation of rights not delegated to U.S. stay with states
  - States cannot enact laws abridging contracts – U.S. can
    - State pension laws can be overridden by federal law
  - § 365 – rejection of executory contracts (including CBAs) – specifically incorporated into and applicable in Chapter 9
    - Bankruptcy Court can authorize rejection of CBA and enforce it
      - Rejection of CBA in *Vallejo*

## Addressing the Pension Issues (Cont'd)

- Process for rejection of CBAs unclear
  - § 1113 not specifically incorporated into Chapter 9
  - Procedure for rejection “more relaxed” than Chapter 11
    - No need to comply with state labor laws
    - *Bildisco* test?
      - CBA is burdensome to municipality
      - Equities favor rejection
      - Prospect of revised deal in future is not good
  - Issues surrounding ability to propose rejection, alternative CBAs

# Conclusion

- Chapter 9 provides mechanism to adjust municipal debt
  - Chapter 9 is constitutional
    - Voluntary only
    - States determine who can file (enabling legislation)
    - Only debtor can propose plan
    - No usurpation of sovereign power
    - Limited injunction
  - No solutions per se, but mechanism/procedure to implement solutions
    - Specifically, rejection of executory contracts (including CBAs), adjust debt
    - Can be done/enforced only in bankruptcy

## Conclusion (Cont'd)

- Issues
  - Scope of federal preemption vs. sovereign states rights/control over municipal affairs
  - Need for enabling legislation/state consent
  - Limits on judicial power (taxes, budgets)
  - Process for rejecting CBAs/executory contracts unclear (§ 1113 doesn't apply; *Bildisco* standards?)
  - Need for political will (enabling legislation), but ability to “pass the hot potato” (manager, bankruptcy judge)
- Ultimately, may be the only way out for a less than fully-consensual adjustment of debt



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# Presenter Profiles

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# Presenter Profiles



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## **David Narefsky**

David Narefsky's law practice is focused primarily on public law, municipal finance and government relations. He provides comprehensive advice on state and local government matters, with particular emphasis on legislative, administrative, land use and zoning financial, real estate and development, state and local tax, and constitutional issues. David also represents issuers, investment bankers and borrowers in all aspects of tax-exempt financing involving airports, solid-waste general obligations, housing and urban development, tax increment financing, transportation, education, and health care. In addition, David provides individuals and corporations with legal and strategic advice on transactions and relationships with federal, state and local government entities.

## **Education**

The University of Michigan Law School, JD, cum laude, 1979 • State University of New York, BA, with honors, 1976; Phi Beta Kappa

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## **Sean T. Scott**

Sean Scott represents institutional lenders, bank groups, hedge funds and other creditors in out-of-court workouts and in-court bankruptcy proceedings. In the course of his practice, Sean also advises corporate clients on issues relating to distressed asset sales and acquisitions and counsels lenders and issuers in structuring complex debt transactions. In 2008, Sean was named by Institutional Investor News as one of its ten “Rising Stars of Bankruptcy/Restructuring Law and Workouts.” More recently, Sean was recognized by Law 360, a leading newswire for business lawyers, as one of its “10 bankruptcy lawyers under 40 to watch” among all practitioners nationwide. Sean also was named a “Rising Star” in the 2010 edition of Illinois Super Lawyers published by Law & Politics.

## **Education**

University of Notre Dame Law School, JD, magna cum laude, 2000; Articles Editor, Notre Dame Law Review • Washington University, BA, with College Honors, 1997; Phi Beta Kappa; Pi Sigma Alpha

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## **J. Robert Stoll**

Bob Stoll focuses his practice on representing large institutional lenders and creditor groups in loan workouts and restructurings and Chapter 7 and Chapter 11 cases.

Notable among cases that he has recently handled are complex Chapter 11 bankruptcy cases involving lending institutions such as Bank of America/Merrill Lynch, Bank of Montreal, Toronto-Dominion Bank and Canadian Imperial Bank of Commerce. He has acted as lead counsel for lender groups in the recent workout and/or Chapter 11 cases of Tokheim (ABN AMRO), Loewen Group International, Inc., Adelphia Communications Corp., Teleglobe Communications, Inc., Kimball Hill, Pamal, Summit Business Media Group (Bank of Montreal); TSR Wireless LLC (Bank One); KCS Energy, Enron Corporation (Canadian Imperial Bank of Commerce); Benedek Broadcasting, Globenet and 360 Americas, International Wireless, Kenetech, Metrocall and AHERF (Toronto-Dominion Bank); and Greektown Casino and Rustick (Bank of America/Merrill Lynch). He also represented the Hong Kong and various other Asian liquidators in the Lehman Bankruptcy cases.

## **Education**

Columbia University Law School, JD, 1975 • Haverford College, BA, magna cum laude, 1972; Phi Beta Kappa

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