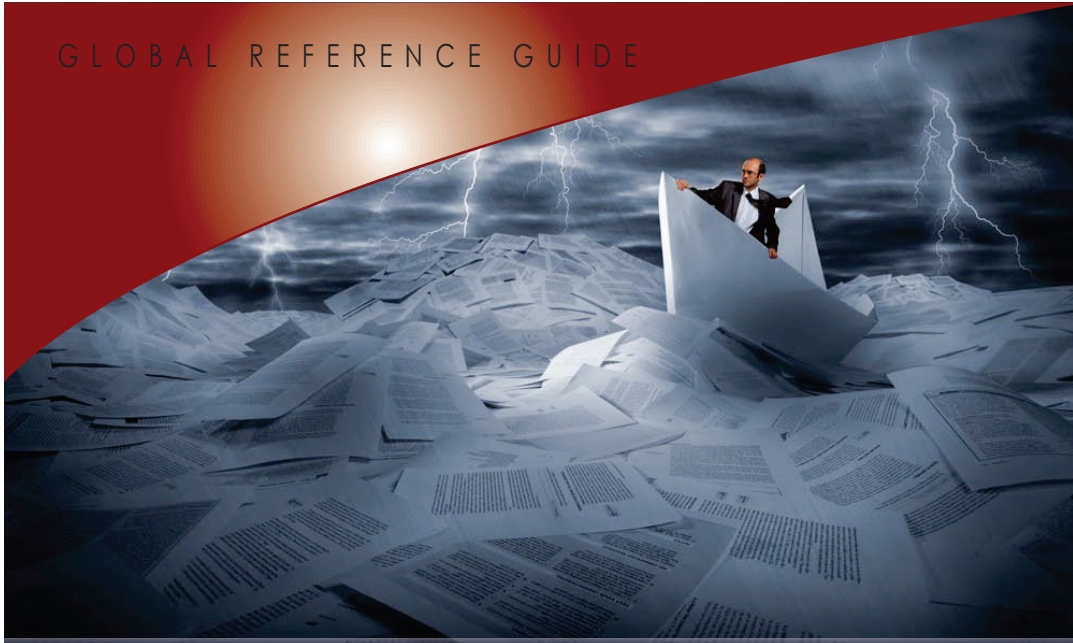


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## NORTH AMERICA

**Chapter 9 bankruptcies: prompting legislatures to protect municipal bondholders**


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by *John S. Mairo and Kelly D. Curtin* | Porzio, Bromberg & Newman, P.C.

IN THE AFTERMATH of the economic recession, US cities, towns and other municipalities facing the threat of budgetary and financial catastrophe are turning to Chapter 9 of the US Bankruptcy Code for protection. Previously rarely utilised, Chapter 9 allows qualifying municipalities to ‘adjust’ debts by means of a ‘plan of adjustment’ (see 11 U.S.C. § 941). As tested in the Chapter 9 proceeding of *Vallejo, California* (Case No. 08-26813), the debts that can be readjusted include collective bargaining agreements, which can be rejected in a Chapter 9. Significantly, unlike other chapters, Chapter 9 is only available to an eligible ‘municipality’ (see 11 U.S.C. § 109(c)). This term is defined in the Bankruptcy Code as a “political subdivision or public agency or instrumentality of a State,” and includes cities, counties, townships, school districts and other special districts, but not states (see 11 U.S.C. § 101(40)). In addition, eligibility for a Chapter 9 filing requires, among other things, that the municipality obtain specific state authorisation to be a debtor (see 11 U.S.C. § 109(c)(2)).

Chapter 9 presents a number of unique challenges and implications, which are highlighted by recent high-profile filings, including *Jefferson County, Alabama* (Case No. 11-05736), *City of Harrisburg, Pennsylvania* (Case No. 11-06938) and *City of Central Falls, Rhode Island* (Case No. 11-13105). One contestable area of a Chapter 9 case is a debtor’s eligibility or authority to file. On 9 November 2011, Jefferson County, Alabama, filed the largest municipal bankruptcy in US history citing over \$4bn in debt, including more than \$3bn in the form of special revenue warrants issued to finance the construction and repair of its sewer system. The indenture trustee for the holders of such warrants challenged the county’s eligibility for Chapter 9 by arguing that the location of the state’s bankruptcy authorisation in the municipal bond section of the Alabama Code meant that state law did not authorise the county, which issued warrants instead of bonds, to file for bankruptcy. Overruling objections, on 4 March 2012 the bankruptcy court held that the county was eligible for Chapter 9.

Aside from a debtor’s eligibility or authority to file, another issue that has engendered controversy in the Chapter 9 arena is the negative impact that a bankruptcy may have on the municipality’s credit ratings, which directly correlates to a municipality’s ability to borrow. Some states have affirmatively passed legislation prohibiting such filings. One of the most notorious examples of

this is found in the Chapter 9 filing of Harrisburg, Pennsylvania. Harrisburg filed Chapter 9 on 11 October 2011 in an attempt to alleviate the massive debt of a trash incinerator project. Prior to its filing, effective 30 June 2011, state law was amended to prohibit certain municipalities (including Harrisburg) from filing for bankruptcy. Consequently, the bankruptcy court dismissed Harrisburg's unauthorised filing.

Rather than issuing a complete moratorium on Chapter 9 filings, other states are taking steps to control the bankruptcy process of their municipalities. Central Falls, the smallest city in Rhode Island, filed Chapter 9 on 1 August 2011. Just two weeks prior to the filing, the Rhode Island legislature passed a law that gives bondholders a first lien on property taxes and general fund revenues. In essence, the law increased the creditworthiness of municipal bonds by making bondholders virtually untouchable in Rhode Island and decreased the merit of relative obligations owed to retired workers. The practical result is most aptly demonstrated by Central Falls' Chapter 9 plan of adjustment, wherein bondholders suffered no losses, but pension and benefit obligations were severely reduced, some by 55 percent.

Most states have laws restricting or conditioning Chapter 9 filings by their municipalities because states would prefer to impose austerity measures upon their municipalities than risk a feared drop in credit ratings of their state and municipal bonds caused by a Chapter 9 filing. For example, New Jersey state law requires a two-thirds vote of the governing body of the municipality and approval by the state municipal finance commission before a municipality may be deemed authorised to file Chapter 9.

In sum, Chapter 9 bankruptcy will likely continue to be viewed favourably by some as a way to address difficult municipal finance problems, such as rich collective bargaining agreements. While the debate continues over whether the detrimental effects of a Chapter 9 bankruptcy exceed its benefits, at least some states have proven that they are willing to thwart or modify the bankruptcy process in order to protect their municipalities' credit ratings. With the likelihood of continuing municipal distress due to the current economic environment, time will tell if more states follow Rhode Island's suit and make Chapter 9 more palatable to the municipal bond market by enacting legislation that essentially protects the returns of bondholders in a Chapter 9 proceeding. ■