A Look at the History of Municipal Bankruptcy

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NACo National Association of Counties

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Municipal Bankruptcy

In 1995, Orange County, CA became the largest municipality, and the first county, to declare bankruptcy under Chapter 9 of the United States Code. In recent months, Jefferson County, AL has had to face a bankruptcy filing and the cities of Vallejo, CA, Central Falls, RI and Harrisburg, PA have also filed for bankruptcy. With the current economic slowdown, declining housing values and revenue shortfalls facing many local governments, bankruptcy is once again a looming issue for many local governments.

Following the devastation of Hurricanes Katrina and Rita, several southern parishes and counties took a long hard look at bankruptcy. The longstanding economic downturn and the looming debt for employee retirement benefits, including healthcare, have many counties facing a struggle to survive.

What issues can bring a county government to the brink of bankruptcy? What role do the states play in addressing municipal fiscal stress? What are the states' roles in handling municipal fiscal stress? How can a county prevent filing for bankruptcy? A quick look at the lessons learned from the Orange County bankruptcy, as well as the history of other municipal bankruptcies, will help shed light on this issue.

Chapter 9

The US Bankruptcy Code was amended in 1934 to allow municipalities to declare bankruptcy. Chapter 9 of the US Bankruptcy Code was developed in 1934 when municipalities faced the strain of the Great Depression and has been amended multiple times since it was declared constitutional in 1937. In 1933, 24 mayors marched on Washington asking President Roosevelt for federal loans to help them meet their local financial responsibilities.[1] Although nearly everyone on Capitol Hill was sympathetic, no one was in favor of loaning them federal funds. President Roosevelt was opposed to loaning money to local governments because he believed 1) the demand might increase to more than $10 billion and 2) local governments would have to surrender their independence to Washington and the federal government.[2] As a result of the President's decision and with his support, legislation was drafted for what became Chapter 9 of the Bankruptcy Code that would allow them to declare bankruptcy. Section 109 of the Bankruptcy Code establishes four conditions that a municipality must meet to declare bankruptcy under Chapter 9:

- The entity must be a municipality (defined in the Code as a "political subdivision or public agency or instrumentality of the state.")
- It must be specifically authorized by its state to be a debtor
- It must be insolvent
- It must desire to reorganize debts

1 Time Magazine, June 12, 1933

2 Time Magazine, June 12, 1933

Chapter 9 provides municipalities with protection from creditors while at the same time giving them the space and time to adjust their debt. Since the establishment of Chapter 9 bankruptcy fewer than 500 municipalities have filed for bankruptcy and most of these have been special purpose districts. Chapter 9 is similar to private sector bankruptcy in that it gives the debtor breathing room from its creditors and allows the county or city an opportunity to reorganize its debt. The filing must be voluntary on the part of the debtor. Even though municipal bankruptcy is similar to private sector bankruptcy, it differs in several ways. A private sector bankruptcy allows for the liquidation of the debtor's assets in order to pay creditors in the reorganization phase. Since municipal governments perform essential public duties, their assets cannot be liquidated. In this way, the federal bankruptcy court has very little power. It cannot liquidate assets and it cannot, assign a trustee to oversee the case, because of the 10th Amendment reserves certain rights to states. The bankruptcy court does not involve itself in matters of local politics.

Role of the State

The protection of the sovereignty of the states is what made writing a federal bankruptcy statute for local governments problematic. The original municipal bankruptcy code legislation was ruled to be in violation of the 10th Amendment in 1934 by the U.S. Supreme Court[3] and had to be amended in 1937 to be constitutional.

The role of the state in municipal bankruptcy is crucial. The state must give specific authorization to the municipality to declare bankruptcy. Some states have authorization statutes that allow municipalities to file Chapter 9 bankruptcy, often with preconditions. Georgia and Iowa are 2 of the 25 states that do not allow their municipalities to file bankruptcy. Others, like Alaska and Alabama, do not have statutes on the subject at all, meaning that since they do not give specific authorization to do so, municipalities may not file Chapter 9. Because the municipality is under control of the state, the state can set preconditions to bankruptcy or do anything in its power to prevent the municipality from declaring bankruptcy.

3 *Ashton v. Cameron County Water Improvement Dist. No. 1, 298* U.S. 513, 532 (1936).

By having to go through the state to declare bankruptcy, the municipality is at the mercy of the state and how it decides to handle the fiscal problem. The state, in its gatekeeper function, does not have to allow the municipality to even declare bankruptcy. In that case, the state would be looked upon to provide financial and technical assistance in order to bail the county out of its financial distress. Some states, like New York and Pennsylvania, have enacted municipal distress statutes which are the equivalent of state bankruptcy procedures. In the case where the state does allow the filing of the bankruptcy petition, they can appoint a trustee to oversee the bankruptcy and prepare a readjustment plan.

To recap, for a municipality to be eligible for Chapter 9:

- The municipality must be authorized to be a debtor by state law
- The municipality must be insolvent
- The municipality must want to adjust its debts
- And must deal with its creditors in one of several specified ways.

Generally, a state will do what it can to prevent a municipality from filing for bankruptcy. The bankruptcy will not only affect the credit and bond rating of the participating county, but it could also have a negative effect on the rest of the state. According to US News and World Report[4], in the week after the Orange County bankruptcy filing, share prices of single state California closed-end muni-bond funds dropped by an average of 5 percent. The risk for all municipal bonds across the nation is also raised as a result of municipal bankruptcy.

4 US News and World Report, December 11, 1994

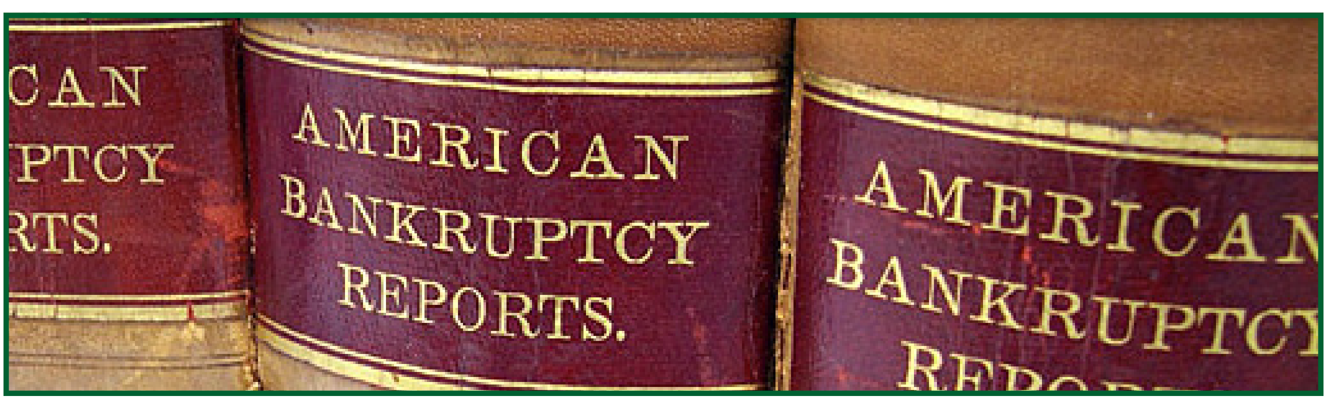
Why Bankruptcy?

How do counties get to the point of going bankrupt? It is important to note that not all fiscally distressed counties or municipalities file for bankruptcy even when that option is available. All sides try to prevent that situation from happening. But what causes a county's fiscal situation to become so dire that bankruptcy is a legitimate option?

There are many reasons for extreme fiscal distress in counties. An Advisory Commission on Intergovernmental Relations report examined many of the root causes of financial distress on municipalities.[5] The report found that "the principle cause of financial emergencies in the 1972-83 period continued to be unsound financial management." Bad budgeting and accounting practices led to losses in liquidity, the study found. In the case of Orange County, some bad investments led to over $1 billion in losses.

There was another underlying cause for the Orange County bankruptcy. In the state of California, Proposition 13 had severely limited all counties' ability to raise revenue through property tax. With this in mind, counties felt pressured to raise revenue in other capacities. The Orange County Investment Pool was creating that needed revenue. State cutbacks, in general, have left counties grasping for ways to fund programs that are essential to life in their county, especially in the areas of health and human services. These unfunded mandates and reduction in state funds in general have forced many counties into a financial bind.

5 *Bankruptcies, Defaults and other Governmental Financial Emergencies*, Advisory Commission on Intergovernmental Relations, March 1985



Another cause of financial hardship that the report identified is the result of court judgments against municipalities. This is especially true for smaller governments that are hit with large sum judgments. For example, Bay St. Louis, Mississippi was issued a $375,000 judgment by federal district court while the total budget of the city was $728,294. The bankruptcy was dismissed because the city couldn't comply with the court order to borrow the money from a bank and had to turn to the state to get approval to borrow money to successfully pay the judgment. In 1984, Wapanucka, Oklahoma faced a similar situation where it had insufficient funds to satisfy a judgment against the town. As a result of court rulings, small governments can find themselves in a hole for which they had not budgeted. These examples may only be a preview of things to come for county governments. The report concludes that "the trend toward a broadening of local government liabilities and exposures to lawsuits appears likely to cause more emergencies in the future."

Yet another reason for financial hardship is demographic changes, especially when local governments lose their population and their tax base. This issue is currently under debate in Pittsburgh, PA. Although they have not filed for bankruptcy, years of out-migration in the area has caused the city to lose 50 percent of its population in the last 50 years, ravaging its tax base. It is nearly impossible to keep up with services when half of the tax base has left. Allegheny County, PA felt the crunch as well, since many of the communities in the county, not just Pittsburgh, are experiencing the same loss of population.

Jefferson County, AL

In the current economic environment many counties are struggling with major revenue shortfalls and grappling with meeting their economic responsibilities. Primary among recent counties in this situation is Jefferson County, AL. Jefferson County has been on the brink of bankruptcy for a number of years, largely due to actions taken to repair and rebuild its sewer system to settle a lawsuit for violating the Clean Water Act in 1996. The county sold bonds to finance the project raising $555 million. The county also purchased a derivative connected to some of the fixed rate debt.

After nearly 10 years of refinancing and occasional accusations of corruption by local government officials (several were found guilty) the county saw itself unable to pay its debt and on the verge of bankruptcy. The county initiated a new tax to increase revenue and raise the potential of paying its debt, but the tax was struck down by the State Supreme Court on a technicality. After attempting for the last three years to renegotiate the sewer debt to avoid default, the county finally reached an agreement with its creditors in mid September 2011 to stave off bankruptcy.[6]

Unfortunately, on November 20, 2011, the agreement with their creditors fell apart because the creditors apparently refused to go along with the economic concessions that had been negotiated earlier. The county then voted to file the petition for Chapter 9 bankruptcy citing $5 billion indebtedness, making it the largest municipal bankruptcy in U.S. history.

Other Governments Consider Bankruptcy

Another county that resorted to bankruptcy to settle the amount it owed because of a lawsuit is Boise County, ID. The county was involved in a lawsuit brought by a developer who balked at the restrictions the county placed on its development of a proposed residential treatment facility that would house 72 boys in the small county. The developer brought suit under the federal Fair Housing Act and won a judgment of $4 million and $1.4 million in attorney's fees. The county both appealed the decision and attempted to negotiate an agreement with the developer but both failed. With a county operating budget of less

6 Marketwatch.com, September 16, 2011

than $10 million, this county of 7,500 people had no choice but to file for bankruptcy. Upon review by the federal bankruptcy court in Idaho, the judge's finding was that the county had sufficient funds available to pay the judgment against it and still maintain services for its residents and dismissed the case, on September 2, 2011, denying the bankruptcy petition.[7]

Nassau County, NY is in a state that does not allow municipal bankruptcy. As observers watched over the years, they saw that this wealthy county outside of New York City which had little or no tax hikes was getting deeper and deeper into debt. Former County Executive Tom Suozzi came into office to a system where the convoluted and inconsistent tax assessment system left the county holding the bag for refunds to homeowners who challenged their school tax assessments. This at a time that the county was giving 65 percent of the collected tax revenue to a school district over which it no control. Most challengers won their appeals. In recent years these overpayment refunds have been in the tens of millions forcing the county to borrow $100 million each year in short term loans to refund tax overpayments to homeowners. Coupling these refunds with the ongoing economic recession, increasing healthcare costs, social services delivery cost increases, police overtime and union contracts, the county saw its average tax bill go to $11,500, one of the highest in the country and in late 2010, saw its credit rating downgraded making it even harder to borrow the money it needed each year.

7 Idaho Statesman, September 3, 2011

Finally, the state of New York stepped in appointing the Nassau Interim Finance Authority, which took over the county's financing and put a stop to the short term borrowing.[8] Finance Authority members believe that the county's bookkeeping system needs examination and that the hopes the county executive has to realize concessions through future labor contract negotiations may go unrealized. However, the authority's role is to work with the county executive and other county officials to help stabilize the county.

Prevention of Bankruptcy

There are some alternatives to declaring bankruptcy. As we have seen, financial hardship can come without warning, pushing county governments to the brink of bankruptcy. There are some measures available for preventing that fall off the cliff.

State Bailout

It is usually the state that comes to the rescue of its failing local governments. Since many states are the gatekeepers of bankruptcy, they can do anything allowed constitutionally in order to prevent that from occurring. State bailouts are one way the state can prevent a municipal bankruptcy. This happened in 1990 in the case of Butte County, California. Butte

8 New York Times, January 26, 2011

County was on the verge of becoming the first county to declare Chapter 9 bankruptcy before the state assembly stepped in at the 11th hour and voted to provide the county with a $15 million bailout.

The bailout, however, is only a temporary stopgap and doesn't necessarily solve a long-term fiscal crisis the municipality may be in. This is the situation New York City found itself in during recent budget years. City officials turned to Albany for recurring revenues and savings but Governor Pataki responded with one-shots, money available only for one fiscal year. New York City had already raised property taxes and was seeking to impose a commuter tax. The state, like most states in the Union, was also facing its own budget gap and finding it difficult to find the desired long-term aid for local governments.

Local Cuts

State bailouts are not a reliable resource because of today's budget shortfalls. In order to prevent fiscal catastrophe, county governments are cutting back programs, spending, and employment to manage their deficits. In 1990, Butte County[9] cut everything it could before threatening bankruptcy. Closing libraries, slashing payrolls, and freezing cost of living raises to employees were some of the methods the county turned to in order to save money. Any further cuts would have rendered the county government useless.

As previously discussed, New York City has tried to generate more revenue by raising property taxes 18.5% and has cut significant spending to adjust its finances. Other programs potentially facing cuts included drug counseling programs in city jails and scaling back summer school for children whose presence was not mandatory. But citizens have not been receptive to a tax hike.

Voters rejected a referendum following Orange County's bankruptcy that would have increased countywide sales tax by .5% for 10 years. The County was forced to cut 41% of the General Operating Budget and reduced full-time positions by 16%.

In mid 2010, Modoc County, CA hired a bankruptcy attorney, as well as requested a $12.5 million loan from the state of California. For more than a decade, Modoc County had been funding its hospital using money intended for other purposes, such as education and transportation projects. An audit in 2009 by the state controller's office determined that the county was violating state law by shifting dollars away from their intended purpose, prompting the county's current financial crisis.

On August 31, 2010 voters in Modoc County were able to avoid bankruptcy by approving a $195-a-year parcel tax in order to fund the county's hospital. The new parcel tax is set to generate $3.1 million a year for the hospital.[10]

Other Options

Insurance

In response to the rise in court actions against municipalities, many counties are obtaining some form of liability insurance. This would prevent a large court judgment from crippling the budget and the county's ability to perform its governmental functions.

9 Los Angeles Times, September 22, 1989

10 Associated Press, September 1, 2010

Oversight Boards

We have seen that when a municipality declares bankruptcy, it does so under state law. This leaves the municipality under the jurisdiction of the state during the bankruptcy proceeding. The state can impose a trustee to oversee the municipality's bankruptcy and its reorganization plan. While the state can give aid to the troubled municipality, it may also impose an oversight board in the municipality in order to prevent bankruptcy or default. These boards are put in place for governments that have been in a fiscal crisis for some time. A board was put in place in New York City in 1974 to oversee the City's budget and the state and federal government provided loans to the City to survive the crisis. The Control Board was responsible for most financial decisions in the City and helped prevent New York from declaring bankruptcy.

More recently, a control board was put in charge of the finances of Nassau County, NY after its failure to maintain and manage its own finances.

In 1991, the state of Pennsylvania created the Pennsylvania Intergovernmental Cooperation Authority (PICA) to oversee Philadelphia's financial situation, including the approval of a long-term fiscal plan, authority to issue bonds, and power to withhold state funds in the event that the government was not following the plan. One of the advantages of a state oversight board is that it is able to protect the elected officials from blame for difficult financial decisions. The Board is usually dissolved when the municipality is able to meet certain criteria, such as balancing the budget for consecutive years or repaying debt. The Board may also prove sufficient in re-establishing the municipality's bond status and improving investor confidence to make it easier for the municipality to re-enter the bond market, one of the major issues facing bankrupt governments.

What Happens after Declaring Bankruptcy?

Initially, a municipality that has declared itself bankrupt by being insolvent can expect to be punished by the markets. How long this punishment will last can be based on the following factors:

- The degree to which debt holders and guarantors are made whole
- The strength of the negotiated settlement or the plan for adjustment
- How much the stakeholders buy in or cooperate
- Whether voters and/or elected officials have contributed to the settlement or plan by approving new taxes, fees or other revenue sources
- Whether the municipality can show that it has stable and effective leadership and management in place
- How well the municipality communicates with the market and how timely and transparent the financial information is
- How well the settlement or plan of adjustment is implemented and monitored

Access to the capital markets will be more expensive and more limited than in the past. However, if the municipality focuses on the above factors, it can emerge from the effects of bankruptcy in a stronger and more stable financial situation that before they filed.[11]

11 Municipal Bankruptcy: Avoiding and Using Chapter 9 in times of Fiscal Stress, John Know and Marc Levinson, Orrick, 2009

Conclusion

In today's fiscal crisis, statewide budget deficits are the norm. In turn, there is more pressure on county governments to continue to provide services at the same time they are addressing declining revenue streams. Bankruptcy, however, should be an absolute last option for struggling counties.

"Chapter 9 really puts the judge more in the position of being a referee than somebody who can really run the county, said Paul S. Maco, partner with the firm of Vinson & Elkins who led the office of Municipal Securities at the Securities and Exchange Commission during the bankruptcy of Orange County, CA. "Chapter 9 doesn't take away the difficult political decision-making needed to address a financial credit problem. Their (Orange County's) path out of bankruptcy was difficult."[12]

We have seen that once bankruptcy is declared, it effects not only the county's credit rating but also may affect the entire state's rating, making it that much more difficult to provide services. The important thing is to know the state law regarding bankruptcy and fiscally distressed governments and to use all means to prevent the bankruptcy.

12 *Bankruptcy Rarely Offers Easy Answer for Counties*, New York Times, November 10, 2011

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11 U.S.C. § 109

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