



# BANKRUPTCY LAW REPORTER



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## Municipality

### **Bankruptcy Attorneys Don't Forecast Waves Of Ch. 9 Municipal Filings, But See Problems**

**B**ankruptcy attorneys do not expect a wave of municipalities like Vallejo, Calif., filing for bankruptcy under Chapter 9 in the near future, but do foresee long-term problems for municipalities if certain legacy costs aren't addressed, according to panelists at an Oct. 7 teleconference sponsored by the American Bankruptcy Institute.

If there is a downward turn in the economy in the next few years, that will expedite more Chapter 9 filings, according to Lisa Hill Fenning of Arnold & Porter, Los Angeles, who was one of three attorneys on the panel.

Fenning noted, however, that over the long-term, municipalities will have to deal with legacy costs that keep escalating. "They aren't going to go away," she said, noting that future problems could develop within the next 10 to 20 years.

**Legacy Costs Piling Up.** Legacy obligations that exceed payroll are a problem, Fenning said. As an example, she noted the possible Chapter 9 filing of San Diego, which arose several years ago when retirees were promised "huge, generous packages." These legacy obligations kept piling up until they exceeded the payroll by a huge factor, according to Fenning, who served as a U.S. Bankruptcy Judge for the Central District of California from 1985 to 2000. Ultimately, she said, San Diego didn't file for Chapter 9 protection, but the problems are still around. Fenning also indicated that legacy problems are typically seen in steel companies, airline companies, and other traditionally unionized businesses.

Panelist Marc Levinson of Orrick, Herrington & Sutcliffe, Sacramento, Calif., who is the lead attorney in the Chapter 9 filing of the city of Vallejo, Calif. (20 BBLR 649, 5/29/08), said that he didn't foresee a wave of

Chapter 9 filings in the future. Vallejo filed May 23, 2008, he noted, and he hasn't seen one since then.

According to Levinson, when the California legislature was considering a bill (A.B. 155) that would require local public entities to secure approval from the California Debt and Investment Advisory Commission before filing for bankruptcy protection, the unions argued that a wave of Chapter 9s were coming. Levinson said he didn't believe that was true because of the requirements that a municipality must meet before filing Chapter 9.

**'Trigger' for Chapter 9.** A municipality files for Chapter 9 protection when it simply runs out of cash, according to panelist Bruce Bennett of Hennigan, Bennett & Dorman, Los Angeles, who was the lead debtor's counsel in the country's largest Chapter 9 bankruptcy of Orange County, Calif., which was filed in 1994. "They have gotten to the end of their ability to pay the next debt coming due," he said. It is a "liquidity crisis," Bennett explained. He also noted that if you look at the cases historically, you will see that there was some major financial shock that threatened the municipalities' ability to pay current bills.

That is what happened with Vallejo, Levinson said. Vallejo filed, he said, because they ran out of cash and California law prohibits running an unbalanced budget. There was simply no choice, but to file under Chapter 9, Levinson said. The city's general fund doesn't have money, so the city can borrow from restricted funds, and then pay it back within a year, he said. Vallejo couldn't pay the money back within that time frame and would thus be in violation of California law, according to Levinson. The city lacked the funds to pay their first payroll of 2008, he said.

To file under Chapter 9, a debtor must be insolvent, Levinson said, and that is defined under Bankruptcy Code Section 101(32)(C) as "out of cash." He also noted that the state must authorize a municipality to file Chapter 9, and indicated that some states require a municipality to acquire approval by the state legislature in order to file Chapter 9.

The problem for municipalities, according to Fenning, is that due to their high legacy costs, they may not be out of cash today so they can't meet the standard for insolvency even though the municipalities can't meet their long-term obligations. She said, however, that there is no clear answer to address this problem.

**Effect of Filing Chapter 9.** Bennett explained that there are two general categories of filings: a general purpose municipality, like Vallejo; and a special purpose municipality, like the Ventura Port District, which didn't even own real property. He noted the pattern in Chapter 9 cases after filing is that the creditors suggest that the municipality should be able to cut costs somehow.

The truth is, they have already cut costs to the point that there is almost nothing else to cut, Bennett said. So, it basically comes down to revenue raising, Bennett explained, which involves issues such as (1) can taxes be raised? and (2) How much can taxes be raised? According to Bennett, the courts have gotten involved in this area, and primarily use the "death spiral" standard. The question is how much can the taxes be increased before people will leave the municipality, causing it to atrophy.

**'Drastic,' But Necessary Remedy.** Levinson noted that Vallejo had already exhausted all of its general fund cushion before its Chapter 9 filing. So, they had to cut back on community-based funding like the police, libraries, and roads.

Vallejo's largest costs, according to Levinson, were the fire and police contracts, which he said were "overly generous" to retirees. The city just couldn't live under their collective bargaining agreements (CBAs), he said. Levinson noted that two of the agreements were rejected, but they are currently negotiating the fire contracts, and a few miscellaneous contracts represented by the International Brotherhood of Electrical Workers Local 2376 (20 BBLR 649, 5/29/08); (21 BBLR 1286, 9/17/09); (21 BBLR 1334, 9/24/09).

Chapter 9 has been a "drastic, painful and expensive remedy, but it was nonetheless required," Levinson said.

**Gaps, Pitfalls.** Levinson pointed out that many of the protections and provisions of Chapter 11 don't apply in Chapter 9 filings. For example, he noted that the provisions under Bankruptcy Code Section 365 regarding dealing with executory contracts and expired leases don't apply. The CBAs are simply contracts, according to Judge Michael McManus of the U.S. Bankruptcy Court for the Eastern District of California, where Vallejo is currently pending (21 BBLR 1286, 9/17/09). The question, Levinson said, is are the contracts burdensome to the city?

According to Levinson, the balance "tilted in favor of the city," and McManus required the city to enter mediation, which allowed the city to reach an agreement with the firefighters.

The process was "painful and expensive," Levinson said, but "the city was successful in rejecting these contracts."

Fenning noted that while it is not clear why Congress decided that Section 365 would not apply to Chapter 9 filings, it has produced some "anomalous results." For example, the test in Section 1113 for rejecting CBAs just doesn't apply, she said.

Most of these issues, however, end up in settlement, Fenning said. In addition, the appellate system in bankruptcy cases is a major deterrent in that the process can take years to accomplish. That is why so many cases settle, she said, and there is almost no case law.

**Limits to Readjusting Debts?** According to Bennett, for most purposes, in Chapter 9 filings, similarly situated creditors must be treated the same. Labor unions always feel as if they have been singled out, he said, but they can't be. Bennett also explained that plan confirmation has to meet the "best interests" test.

"Has the municipality done enough," he queried, as far as raising taxes and cutting surpluses? Beyond that, there isn't a lot of content, Bennett said, and courts are given a lot of leeway in this area. Bennett also said attorneys can use their "creativity" here too in showing that the plan is in the best interests of the municipality.

Levinson declined to comment on Chapter 9 plans, saying that Vallejo is currently in the process of formulating a plan. The Official Unsecured Creditors Committee of Retirees has asked the court in *Vallejo* to dismiss the case if the city fails to file a "Plan of Adjustment" by Nov. 30 (*In re City of Vallejo*, E.D. Calif., No. 08-26813, *motion to establish deadline filed 9/24/09*). The court has set an Oct. 26 deadline for hearing the motion.

**Role of Judge in Chapter 9.** The pressures in a Chapter 9 case are immense, according to Fenning. She noted that everyone is working toward a consensual plan. The goal in Chapter 9 is to "try and make a deal if possible," she said.

The role of the judge in Chapter 9 cases is somewhat of a hybrid, Fenning explained, in that the judge must be a mediator and an arbitrator. As a mediator, the judge must get people to agree on issues, and ask questions so that the parties will begin to realize the situations that they are in, she explained. The case becomes a "structured, mediated/arbitration," she said.

Fenning noted that in Chapter 9 cases, the chief judge of the court of appeals for the circuit embracing the district in which the case commenced designates the bankruptcy judge to hear the case.

Chapter 9 judges can only go so far, however, Fenning said. Getting the right judge is very important—much more so than in Chapter 11 cases, she said. If the judge says to raise taxes because it is the only way, this gives the politicians some cover, she said, because that is viewed as part of the judge's job.

BY DIANE DAVIS