Municipal Bankruptcy

Research Memorandum No. 520

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Foreword

The 2016 General Assembly enacted House Concurrent Resolution 13, which directed the staff of the Legislative Research Commission to conduct a study of municipal bankruptcy issues, including a review of federal and state law on the subject as well as prevention practices implemented in other states to address municipalities in fiscal distress. Legislative Research Commission staff would like to acknowledge the assistance of the Pew Charitable Trusts, which provided information on this topic.

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Summary

The 2016 General Assembly enacted House Concurrent Resolution 13, which directed the staff of the Legislative Research Commission to conduct a study of municipal bankruptcy issues, including a review of federal and state law on the subject and prevention practices implemented in other states to address municipalities in fiscal distress. Staff conducted a literature review not only on federal municipal bankruptcy law itself, but also on related issues including trends in municipal bonded indebtedness, credit rating agency methodologies, and litigation surrounding several recent notable bankruptcies and the resulting debt adjustment plans.

This report presents the following conclusions.

- The federal municipal bankruptcy law is codified as part of Title 11 of the United States Code, which is the bankruptcy law. Chapter 9 of that title is applicable to various forms of local public entities. It differs from the other forms of bankruptcy available to individuals and business entities, largely because of the 11th amendment to the United States Constitution and the status of states as sovereign governments.

- Municipal bankruptcy has been widely discussed in recent years because of the effects of the Great Recession of 2007-2009 and the bankruptcy filing by Detroit, Michigan, which made history as the largest municipal filing to date. However, use of this legal recourse remains rare.

- Twelve states specifically authorize their municipalities to file under Chapter 9. Another twelve states, including Kentucky, provide some form of conditional authorization to do so. Four states have more limited authorization. Only Georgia has an explicit prohibition against doing so. The remaining 21 states have no statutory provision either allowing or prohibiting a filing.

- Since 1942, Kentucky has statutorily authorized any municipality to file a bankruptcy petition pursuant to Chapter 9. Counties are authorized to do so only after first having the proposed plan of debt adjustment approved by the state local debt and local finance officers. This statutory authorization ties to the federal definition of *municipality*, which in this instance is a broad term encompassing any political subdivision or public agency or instrumentality of a state, rather than in the more narrow sense of a city government.

- Nationally, most entities that have filed under Chapter 9 have been small special districts (such as hospital, utility, sanitation, and water districts) rather than local governments such as cities and counties. In Kentucky, one small city and one small hospital district have filed under Chapter 9 in recent years.

- A wide variety of bankruptcy prevention practices, fiscal oversight, and intervention triggers exist across the nation. Although 19 states have some form of statutory intervention process for localities that experience fiscal distress, no single method is practiced among a majority of these states, and no method appears to be recognized as the best practice.

- In Kentucky, cities, counties, and special districts are constitutionally required to adopt an annual budget showing total expected revenues and expenditures for the year. The budget must be balanced. The constitution also limits the amount of total indebtedness that any city, county, or special district may incur. By statute, similar budget and debt provisions are in place for school districts.

- Kentucky has expansive financial, budgetary, and audit reporting requirements for the various types of localities. Unlike some other states, however, Kentucky has no explicit intervention or receivership provisions.

- The short-term effects of a bankruptcy filing by a municipality include reduced credit ratings and difficulty obtaining credit. Long-term effects in many cases appear to be limited and are of a more intangible nature relating to the reputation of the entity, rather than direct long-lasting impacts on credit ratings, availability, and affordability (absent other factors). Similarly, when a municipality files for bankruptcy, the impact on the state appears to be generally limited.

Chapter 1

Background And Study Description

What Is Bankruptcy?

For many people, the term *bankruptcy* evokes certain thoughts or images, such as the concept of an individual walking away from debt without paying it off, or perhaps of a business entity going out of business as its employees lose their jobs. To begin a review of bankruptcy law, and municipal bankruptcy in particular, it is important to first understand what the term means in a legal sense. The term itself is defined as the "quality, state, or condition of being without enough money to pay back what one owes."[1]

The US Constitution grants Congress the exclusive power to establish "uniform laws on the subject of bankruptcies throughout the United States" (US Const., art. I, sec. 8, cl. 4). Congress has established the bankruptcy laws of the United States under Title 11 of the US Code. It is the various chapters of this title that many people are most familiar with, such as Chapter 7 for liquidation of debts, Chapter 11 for reorganizations, and Chapter 13 for adjustment of debts of an individual.

Generally, bankruptcy proceedings are conducted in US Bankruptcy Court under the oversight, control, and ultimate approval of a federal bankruptcy judge. Proceedings consist of a full gathering and accounting of the debts that the debtor is unable to pay in full in a timely manner; the formulation of a plan to address the situation through some form of liquidation of the assets of the debtor; payment, adjustment, or release of debts; and possibly a forward-looking plan for the reorganization of the debtor with required payment of adjusted debts.

One of the lesser-known, and less frequently discussed, chapters of the federal bankruptcy code is Chapter 9, which provides for the adjustment of debts of a municipality. For purposes of Chapter 9, *municipality* is broadly defined as being a "political subdivision or public agency or instrumentality of a State" (11 USC sec. 101). This definition includes not only government entities such as cities and counties, but also special districts such as water, sewer, utility, hospital, and school districts. Although Chapter 9 filings have been relatively rare, compared to bankruptcies of individuals and business entities, the recent high-profile bankruptcy filing by Detroit, Michigan, has generated significant nationwide attention to this area of the law. Following that case, the filing by the small Kentucky city of Hillview drew still more attention to this topic locally.

City Of Detroit Bankruptcy

The petition for what would become the largest municipal bankruptcy in American history was filed in July 2013 by the city of Detroit, Michigan. The amount of debt involved in this filing, approximately $18 billion, surpassed that of Jefferson County, Alabama, the county containing the city of Birmingham, which had filed a Chapter 9 petition in November 2011 involving a debt of more than $4 billion.[2]

Like much of the rest of the nation, the economy of Detroit had suffered during the Great Recession of 2007-2009.[3] The population of the city had also been declining for many years. The total amount of debt involved made this the largest municipal bankruptcy, which naturally provoked a great deal of interest among not only participants in the bond market and public sectors but also among the general public.

In November 2014, the bankruptcy court approved the proposed plan of debt adjustment reached between the city and its creditors. The final, confirmed plan reduced the total city debt by $7 billion, with the decrease coming in part from reductions in public employee pensions as well as reduced recoveries by bondholders, but it also allowed for $1.7 billion over a 10-year period for critical investments in city infrastructure improvements.[4] The plan also established new oversight mechanisms to control city finances, to be led by a commission that includes state officials.[5]

City Of Hillview Bankruptcy

In August 2015, the first city in the nation to file a Chapter 9 petition after Detroit was Hillview, Kentucky, population approximately 8,000.[6] The two cases were different in many respects, not the least of which being the population of the two cities. The total amount of outstanding debt was also very different, as was the nature of that debt. In Detroit, the amount of debt for which the city claimed an inability to pay as due was approximately $18 billion. The amount of debt owed by Hillview was less than $100 million, with the largest single debt being a court judgement of approximately $11.5 million, which arose from a contract dispute over the sale of a parcel of real property between the city and Truck America Training LLC.[7]

The bankruptcy case effectively ended on March 31, 2016, only 7 months into the proceedings after the city and its largest creditor, Truck America, reached a settlement for the repayment of the judgment.[8] In part, the settlement required the city to make an initial payment of $5 million, to be raised from a general obligation bond issue, and to pay 8.3 percent of its general fund revenue receipts to the company for 20 years.[9] The city also pledged to increase both its occupational license tax and insurance premiums tax rates to generate additional revenues.[10] Within a month of reaching the settlement, the credit rating agency Standard & Poor's raised the city's bond rating several notches, to BBB from B-minus, the level to which it had previously dropped the city upon the mere discussion of possible bankruptcy by the city leaders.[11]

Adair County Hospital District Bankruptcy

While those two cases drew a great deal of attention in the press and among municipal bond market participants, another Kentucky entity also filed under Chapter 9 in 2013 but received much less notice. The debts owed by the Adair County Hospital District amounted to approximately $20 million at the time it filed its petition on July 31, 2013.[12]

In this case, the district completed the bankruptcy process and had its plan of adjustment confirmed by the federal bankruptcy court on January 26, 2016.[13] Among its provisions, the final confirmed plan of adjustment required the district to sell its assets to T.J. Regional Health Inc., to become the new operator of the hospital. The plan also required the district to continue to assess

and collect its real property tax at the current rate, even though the district no longer operates the hospital, using the receipts thereof to repay debts as required by the plan.[14]

State Credit Ratings Over This Period

It is worth noting that, according to the state Finance and Administration Cabinet, during the 2 years surrounding these two Kentucky municipal bankruptcy filings (generally 2014-2015), the Moody's rating agency upgraded the state's own general obligation implied ratings outlook from negative to stable. During this period, the Standard & Poor's agency downgraded this state rating, citing the "chronic underfunding" of pension systems by the state.[15]

Study Description

After these bankruptcies and the attention they drew to this issue, the General Assembly enacted House Concurrent Resolution 13, signed into law on April 1, 2016, in order to gather more information on municipal bankruptcy laws as well as possible effects that a filing may have on the debtor municipality and on the state as a whole. Staff conducted a literature review on these issues, as well as a review of the relevant laws, court filings, credit rating agency methodologies, and other relevant items. This report is the result of that study.

Chapter 2

Chapter 9 Of The Bankruptcy Code

Legal Nature Of Municipal Bankruptcy

The bankruptcy process in all cases is intended to adjust or reduce the debts that individuals and entities are unable to pay. The process also allows a debtor to reorganize its debts, and perhaps also its organizational structure and operations, to address the underlying issues that led to the bankruptcy, with the goal of preventing the same problems from recurring.[16]

In the context of municipalities, however, Chapter 9 performs the debt adjustment function without the forward-looking reorganization function. In many cases, the debtor municipality will not only continue to exist after the proceedings but will also emerge in the same form as when it began the process, with the same boundaries, governing structure, powers and duties.[17] The basic reason for this situation is that, as political subdivisions of sovereign states, the power of the federal courts over municipalities is necessarily different from the power of the courts over private individuals and business entities. While the US Constitution grants Congress the power to enact uniform bankruptcy laws, the 11th Amendment further provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State."

History Of Federal Municipal Bankruptcy Laws And Chapter 9

The first federal municipal bankruptcy law, enacted by Congress in 1934, was in response to the Great Depression and the crisis in local tax collections, which led to the inability of many municipalities to timely pay debts in full. The law created the first Chapter 9 of the bankruptcy code and was intended to temporarily address the crisis. It was titled "Provisions for the Emergency Temporary Aid of Insolvent Public Debtors and to Preserve the Assets Thereof and for other Related Purposes."[18]

The 1934 Act was held unconstitutional by the US Supreme Court in the case of *Ashton v. Cameron County Water Improvement District*, which involved the petition for debt adjustment filed by a small special district in Texas.[19] The majority opinion stated that, because the Chapter 9 process could "materially restrict [the municipality's] control over its fiscal affairs," it violated the 11th Amendment.[20]

Congress responded to the *Ashton* opinion by enacting amendments to the bankruptcy code in 1937. Some of the changes made in the new law included a limitation on the proceedings to only voluntary filings made by municipalities and upon the consent by the state for its political subdivision to enter into bankruptcy.[21] When this amended law was challenged on 11th Amendment grounds, the Supreme Court upheld it as a valid exercise of the bankruptcy power, in that it was "carefully drawn so as not to impinge upon the sovereignty of the State," which

"retain[ed] control of its fiscal affairs."[22] From this point on, the underpinnings of federal power over municipal bankruptcies were voluntary petitions made only by municipalities, and only upon the approval to do so granted by the relevant state government.

Following soon after the Supreme Court decision upholding the federal municipal bankruptcy laws, the Kentucky General Assembly statutorily authorized all taxing agencies and instrumentalities, as defined by the federal law, to "file a petition for the composition of its debts and to do all things necessary to comply with the provisions of the Federal Bankruptcy Act" (KRS 66.400, first enacted in 1942). In the case of counties only, as opposed to all other municipalities, the authorization is limited in that the proposed plan and any changes or modifications shall first be approved by the state local debt officer and the state local finance officer (KRS 66.400).

Summary Of Key Provisions Of Chapter 9

A Chapter 9 proceeding may begin only upon the voluntary petition of a debtor municipality, pursuant to 11 USC sec. 109(c).[23] To be found eligible, the municipality must satisfy four requirements in addition to meeting the definition of *municipality*:

- The municipality must be authorized by the law of its state.
- It must be insolvent, as defined by section 101(32)(c) of the code.
- It must desire to effect a plan to adjust its debts (only the municipality may propose the adjustment plan).
- It must either
  - obtain the agreement of creditors holding a majority in amount of claims of each class that the municipality intends to impair,
  - negotiate in good faith with its creditors and fail to obtain agreement from them,
  - be unable to negotiate with its creditors because doing so is impracticable, or
  - reasonably believe that a creditor may attempt to obtain a preference in negotiations.[24]

Upon filing a petition under Chapter 9, the municipality must provide public notice to bring awareness to creditors that have not already been involved in the petition. The normal automatic stay provision of the bankruptcy code is applicable to Chapter 9 cases, meaning that all collection actions against the municipality and its property, including state or federal court mandamus actions, are held in abeyance.[25] This stay does not apply to the payment of any special pledged revenues; therefore, any debt service payments to be made on a revenue bond, which are explicitly pledged in the bond indenture, continue to be paid.[26]

A couple of provisions unique to Chapter 9 are codified at sections 903 and 904 of the code. These provisions are necessary to allow for the limited role of the federal courts over state political subdivisions, as discussed previously.[27] Section 903 provides that

> This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

> (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
> (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

Similarly, section 904 provides that

> Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—
>
> (1) any of the political or governmental powers of the debtor;
> (2) any of the property or revenues of the debtor; or
> (3) the debtor's use or enjoyment of any income-producing property.

Like the role of the court itself, as demonstrated in those two federal code sections, the role of creditors is also more limited in Chapter 9 proceedings than in private bankruptcies in the other chapters.[28] Creditors may not propose their own alternative adjustment plans, and the municipality's plan may in some cases be binding on dissenting creditors.[29] Creditors may, however, continue to cooperate with the municipality in formulating its plan, and as in the Detroit and Hillview cases, it is often by settlement that the municipality and its creditors come to a negotiated plan.[30]

Pursuant to section 921(c), the court may dismiss a petition if it finds that the municipality did not file the petition in good faith, or that the petition does not meet the eligibility requirements. Petitions may also be dismissed during the proceedings upon a finding that there is unreasonable delay by the municipality, a failure to propose or confirm an adjustment plan by the deadline set by the court, or default by the municipality under a confirmed plan.[31]

Once a municipality has proposed a plan of adjustment, confirmation of that plan by the court must meet several conditions, including the following:

- The plan must comply with all provisions of Chapter 9, and relevant provisions of Chapter 11.
- All amounts to be paid by the municipality, or otherwise paid under the plan, must have been disclosed and found to be reasonable.
- The municipality must be legally authorized to take any action necessary to execute the plan.
- The plan must be found to be in the best interests of the creditors, and feasible (11 USC sec. 943(b)).

The test for whether a proposed plan is in the best interest of the creditors is generally whether the plan is better than the alternative available to the creditors, which with regard to municipalities is only a complete dismissal of the case with limited recourses.[32]

Finally, after the court confirms the plan, the case will be dismissed upon a finding that the municipality has deposited any amount to be paid as consideration for the plan itself, and that provisions have been made for the payment of all plan obligations.[33] As in the cases of Detroit, Hillview, and the Adair County Hospital District, some examples of such provisions for payment

include the issuance of bonds, the sale of assets, or the covenant to assess taxes for payment of amounts due.

Frequency Of Chapter 9 Filings

Over the entire history of Chapter 9, including through the Great Recession of recent years, Chapter 9 filings have been rare in relation to the number of municipalities in the country, the number of bond issuances, and especially in relation to the number of private bankruptcy petitions filed under the other chapters of the federal bankruptcy code. The use of Chapter 9 has been limited, and the majority of all filings are not by cities and counties, but by small special districts, many of which have only one revenue stream such as user fees for a single infrastructure project.[34]

In fact, between 1937 and 2012, only approximately 633 cases were filed, a number which national experts have stated is low, given that the current number of local government entities nationwide is approximately 89,000.[35] More recently, during the period from January 1, 2010, through August 21, 2015, there were 51 Chapter 9 filings. Of those, only nine were by cities or counties. Three of those cases were dismissed, and still another—Hillview—was settled.[36]

The rarity of Chapter 9 filings by all municipalities, and especially by general-purpose governments such as cities and counties, gives context to a statement by Matt Fabian, the managing director of Municipal Market Advisers, after the filing by Hillview. When interviewed for comment on the case, he stated that cases like it occasionally occur, and that it is a typical risk for the municipal bond market and not one to worry about as the activity of small entities getting into trouble "has always been with the muni market and likely always will be."[37]

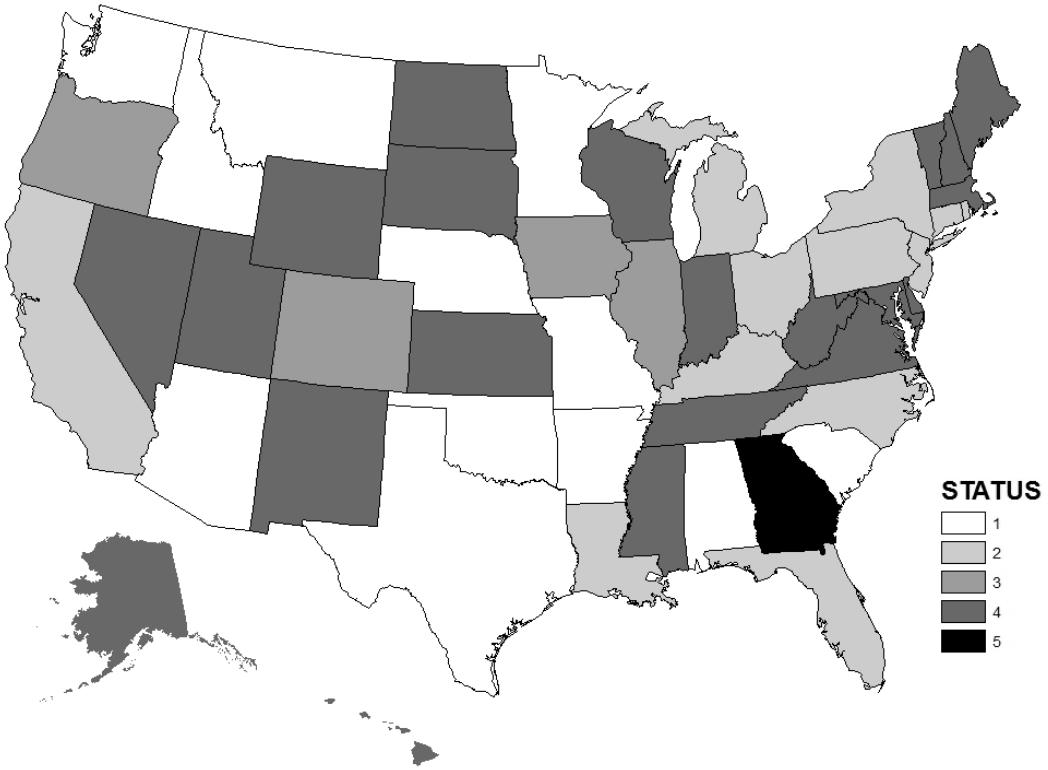
Chapter 3

State Laws Involving Municipal Bankruptcy

States Authorizing Municipal Bankruptcy Filings

A state must authorize a municipality to petition for debt adjustment under Chapter 9. As shown in Figure 3, 12 states have specifically done so through generally broad statutory provisions authorizing a filing: Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas, and Washington.[38]

Figure 3
Current Chapter 9 Petition Authorizations By State



Note: Status 1: State specifically authorizes Chapter 9 filings; Status 2: Chapter 9 filing is authorized upon conditions met and action of state, officials or other entity; Status 3: Municipalities have limited authorization; Status 4: No Chapter 9 authorization is outlined, laws are unclear or filing is otherwise prohibited; Status 5: Chapter 9 filings are explicitly prohibited.
Source: LRC staff using data from Spiotto, James E., Ann E. Acker, and Laura E. Appleby. *Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies*. Chicago: Chapman and Cutler LLP, 2012.

Twelve other states, including Kentucky, have granted some form of limited statutory authorization, typically requiring a state-level approval of the petition: California, Connecticut,

Florida, Kentucky, Louisiana, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Rhode Island.[39]

Colorado, Illinois, Iowa, and Oregon have granted more limited authorizations, and only Georgia has enacted an explicit prohibition on filings. The remaining 21 states have no statutory provisions either authorizing or prohibiting a Chapter 9 filing.[40]

Appendix A provides a more detailed listing of the statutory provisions of these states.

Kentucky Statutory Authorization

Kentucky's statutory authorization is codified at KRS 66.400. In full, the statute reads as follows:

> Any taxing agency or instrumentality as defined in Chapter IX of the Federal Bankruptcy Act as amended by the Acts of Congress of August 16, 1937, Chapter 657, June 22, 1938, Chapter 575, March 4, 1940, Chapter 41, June 28, 1940, Chapter 438 and acts amendatory and supplementary thereto or acts extending the date of expiration thereof, as the same may be amended or extended from time to time, may file a petition for the composition of its debts and to do all things necessary to comply with the provisions of the Federal Bankruptcy Act. No county shall file a petition as provided in the Federal Bankruptcy Act unless the proposed plan is first approved by the state local debt officer and the state local finance officer, as defined in KRS 68.001. No changes or modifications shall be made in the plan of composition after the filing of the petition without the approval of the state local debt officer and the state local finance officer. The state local debt officer and the state local finance officer shall approve or disapprove the proposed plan of composition or any changes or modifications thereof under the same procedure and for the same reasons as bonds are approved or disapproved under KRS 66.280 to 66.390.

Pursuant to this statute, of all the types of local entity that may use Chapter 9 proceedings, only county governments are required to seek and obtain the approval of the state government in order to do so.

Nature Of Local Government Fiscal Oversight In Kentucky

The broader issue of laws governing fiscal operations of municipalities in general is relevant to the issue of state laws involving municipal bankruptcy. In Kentucky, state involvement with local fiscal matters consists primarily of oversight and information reporting.

Kentucky cities, counties, and taxing districts are constitutionally mandated to adopt a budget on a fiscal year basis showing total expected revenues and expenditures for the year, and no such entity shall expend any funds in excess of revenues for that year (Ky. Const. sec. 157b). Section 158 of the constitution limits the total amount of debt that a city, county, or taxing district may

incur, except in cases of emergency, on a sliding scale based on the percentage of the value of taxable property within each given entity, as follows:

- Cities with a population of 15,000 or more—10 percent
- Cities with a population of 3,000 to 14,999—5 percent
- Cities with a population of less than 3,000—3 percent
- Counties and taxing districts—2 percent

In part to execute and enforce these constitutional mandates, and in part to monitor local fiscal operations in general, there are numerous statutory provisions under which cities, counties, and the various other special districts (including those qualifying as special purpose governmental entities) are required to submit their budgets, various financial and demographic data, and financial audits, statements, or attestation engagements, to the state Department for Local Government, or to the Department of Education in the case of school districts, each year. Special rules were recently enacted for certain fire departments (2016 Ky. Acts ch. 91). This information is not actively used to identify or engage with any municipality that may be experiencing financial distress. The primary requirements are discussed more fully below.

Debt Obligation Approval

KRS 65.117 requires cities, counties, and special purpose governmental entities, as defined by KRS 65A.010, to notify the state local debt officer within the Department for Local Government before entering into any financing obligation of any nature, including leases of more than $200,000, any bond issuance, or any other long-term debt. No approval of the obligation is required, however, except in the case of a lease entered into by a county which exceeds $500,000 (KRS 65.944).

In the case of school districts, under KRS 160.160, approval of the state Department of Education is required prior to executing any mortgage or other encumbrance on property, as well as any lease agreement.

Budget Submissions And Audits

Pursuant to KRS 68.250, each county must adopt an annual budget, which is submitted to the state local finance officer for approval as to form and legality. In the case of school districts, an annual budget must be submitted to, and approved by, the Department of Education (KRS 160.460 and 160.470).

With regard to oversight of financial operations and compliance with the budget, pursuant to KRS 65.905, each city and county is required to annually complete a uniform financial information report, to be submitted to the Department for Local Government. These types of governments are also subject to audit by the auditor of public accounts or, in some cases, by a certified public accountant selected by the municipality (KRS 43.070 and 91A.040). School districts are audited at least once annually, as overseen by the State Committee for School District Audits, pursuant to KRS 156.265.

In the case of special purpose governmental entities, annual budgets must be adopted and submitted to the Department for Local Government (KRS 65A.080). In addition, annual financial statements must be submitted, and depending on the annual receipts of the entity, either an annual or a quadrennial audit or attestation engagement must be performed and submitted to the Department for Local Government (KRS 65A.030).

The combined effect of these various statutory requirements is a comprehensive budgeting and financial auditing structure for most, if not all, of the entities in Kentucky that would qualify to petition for debt adjustment under Chapter 9, by virtue of KRS 66.400 and the federal definition of *municipality*. However, in some instances a fiscal crisis may arise suddenly from unforeseeable circumstances such as a legal judgment. In such a case, even regular financial accounting and planning may not adequately prevent an inability to timely pay debts, and thus the possible need to consider Chapter 9 debt adjustment.

Chapter 4

State Intervention And Prevention Practices Relating To Local Fiscal Distress

States across the nation have taken very different approaches to oversight and assistance for local governments that are experiencing fiscal distress. According to a report by the Pew Charitable Trusts, only 19 states have enacted any form of process for the state to intervene in municipal finances. Some of those states, such as North Carolina and Pennsylvania, have implemented extensive intervention programs, while others take a more "hands-off" approach.[41] Overall, Pew determined that most states react to local government crises instead of working to prevent them; even when a state does intervene, it is often to protect its own financial standing and to maintain public safety and health.[42]

The 19 states having an intervention process in place are Connecticut, Florida, Illinois, Indiana, Maine, Massachusetts, Michigan, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Texas. The range of intervention programs implemented includes mechanisms to place a municipality in state receivership or under the control of a manager or overseer, to provide emergency financing, to restructure local debt by a state agency or official, to require an increase in local taxes, and to dissolve or consolidate a municipality, among other mechanisms. In most of the states, the entire program contains several of these options.[43]

There does not appear to be any single method used by a majority of states that is recognized as the best practice. This lack of a standard approach may be due to the fact that every municipal financial situation will be unique, and each may call for one strategy over another.

Apart from the requirements for budget approval and financial audits discussed previously, Kentucky is not considered to be among the states that have implemented an explicit local financial intervention procedure.

Appendix B provides a chart illustrating the statutory provisions available in each of these 19 states.

Chapter 5

Effects Of Bankruptcy On The Municipality And On The State

The most direct and important short-term effect not only of a municipality filing a Chapter 9 petition, but of a municipality even publicly discussing the option of doing so, is that the major credit rating agencies will most likely downgrade that municipality's rating. A downgrade reflects negatively on the municipality's financial status and makes credit more difficult and more expensive to obtain.

This pattern is clear from the ratings actions taken in regard to Detroit and Hillview, as well as other recent notable Chapter 9 cases, looking before and after the petition filings took place. In the case of Hillview, the rating agency Standard & Poor's had rated the city's general obligation debt at A-minus until February 2015, when the city leaders began discussing a possible bankruptcy. At that time, the agency dropped the city's rating to below investment grade, 6 months before the eventual filing of the Chapter 9 petition.

Even more quickly, however, after the settlement and the dismissal of the case in March 2016, the same agency raised the rating several notches to BBB, once again an investment grade rating, on April 20. In Jefferson County, Alabama, a similar rating increase followed only 2 years after that county emerged from what was at that time the largest municipal bankruptcy in history, returning that entity's general obligation debt to investment grade.[44]

It should not be surprising that experts have considered the new debt issued by municipalities that have emerged from bankruptcy to be of investment grade, considering that one of the purposes of Chapter 9 is to provide a fresh start to a municipality, with a plan for adjustment premised on the idea that the municipality "will become more productive if freed from the burden of debt."[45] In fact, new debt issuance is included as a component of many Chapter 9 adjustment plans.

Looking to the effect of a municipal bankruptcy on the state and its credit ratings, the Pew study noted that, although states may suffer a stigma after a bankruptcy and may wish to intervene to avoid such a stigma, nonetheless it is unclear whether a state's credit rating would suffer due to a Chapter 9 filing by one of its municipalities.[46] In fact, the report found that while Standard & Poor's includes local government financial difficulties as one of many criteria that may affect a state's rating, it and the other major rating agencies place greater weight on the state's overall economy, budget stability, and debt management.[47] As of 2013, Standard & Poor's had never lowered a state's rating as a direct result of any distress among its municipalities, nor because of the lack of a state intervention program.[48]

To further illustrate the importance of a municipal bankruptcy on a state's credit ratings, an overview of the general factors and their weights as used by one of the three major credit rating agencies is useful. According to the state Finance and Administration Cabinet, Moody's analysis of a state's credit rating takes into account four general factors: economy, governance, finance, and debt.[49]

The economy category is given a 20 percent weight; it examines the major industries and business enterprises in the state, employment volatility, and income.

The governance category is given a 30 percent weight; it takes into account the financial policies and flexibility of the state.[50] The agency will also note whether the state legislature has a pattern of adopting a balanced state budget in a timely fashion.

The finance category, at a weight of 30 percent, examines the state's revenues, fund balances and cash reserves, and liquidity.

Lastly, the debt category, at a weight of 20 percent, looks at the amount of bonded debt held by the state and its issuing agencies, as well as state pension liabilities.[51]

Appendix A

Selected State Statute Provisions Involving Chapter 9 Authorizations

Alabama: Ala. Code Section 11-81-3—Each "county, city or town, or municipal authority" may pursue municipal bankruptcy "for the readjustment of its debts."

Arizona: Ariz. Rev. Stat. Section 35-603—"Any taxing district in this state is authorized" to pursue municipal bankruptcy as part of a "plan of readjustment."

Arkansas: Ark. Code Ann. Section 14-74-103—All "taxing agencies or instrumentalities" named under state law may "avail themselves" of municipal bankruptcy. Under Ark. Code Ann. 14-74-102, "taxing agencies or instrumentalities" include local improvement districts; public school districts; cities, towns, villages, or other municipalities; and any entities cited in Acts of Congress.

California: Calif. Government Code Sections 53760-53760.7—A local public entity may pursue municipal bankruptcy if it participates in a neutral evaluation process or if it declares a fiscal emergency and adopts a resolution by a majority vote of the governing board of the local entity. "Local public entity" includes "any county, city, district, public authority, public agency, or other entity" considered a municipality under federal law.

Colorado: Colo. Rev. Stat. Sections 32-1-1403, 37-32-102—Municipal bankruptcy is confined to special districts and irrigation or drainage districts.

Connecticut: Conn. Gen. Stat. Section 7-566—"No municipality shall file a petition to become a debtor … without the express prior written consent of the Governor." Under Conn. Gen. Stat. Section 7-560, "municipality" includes "any town, city, borough, consolidated town and city, consolidated city and borough, any metropolitan district, any district as defined in section 7-234 (NOTE: fire, sewer, lighting, or other improvement districts), and any other political subdivision of the state having the power to levy taxes and to issue bonds, notes, or other obligations."

Georgia: Georgia Code Ann. Section 36-80-5—Municipal bankruptcy is explicitly prohibited for any "county, municipality, school district, authority, division, instrumentality, political subdivision, or public body created under the Constitution or laws of this state."

Florida: Fla. Stat. Ann. Section 218.01—Under state law granting the authority to accept the benefits of federal bankruptcy laws, "municipalities, taxing districts, and political subdivisions" may pursue municipal bankruptcy.

Idaho: Idaho Code Ann. Section 67-3903—"Any taxing district" in the state may pursue municipal bankruptcy.

Iowa: Iowa Code Ann. Sections 76.16, 76.16A—Municipal bankruptcy is prohibited, but Iowa law permits municipal bankruptcy if a municipality is "rendered insolvent" by a debt "involuntarily incurred" and consequently adopts a resolution saying that the debt would have to be paid from a general tax levy and that such a levy would have "a severe, adverse impact" on the ability of the municipality to provide necessary services.

Illinois: 50 Ill. Comp. Stat. Ann. Section 320—The Financial Planning and Supervision Commission has authority to recommend that "units of local government" with populations less than 25,000 pursue municipal bankruptcy. The statute uses definitions from Illinois Constitution Article VII, Section 1, which defines "units of local government" to mean counties, municipalities (cities, villages, and incorporated towns), townships, special districts, and units, designated as units of local government by law, that exercise limited governmental powers or powers in respect to limited governmental subjects, but the definitions do not include school districts.

Kentucky: KRS 66.400—"Any taxing agency or instrumentality" as defined under federal bankruptcy law "may file a petition for the composition of its debts and to do all things necessary to comply with the provisions of the Federal Bankruptcy Act." County bankruptcy plans must be approved by the state local debt officer and state local finance officer, those offices being embodied by the commissioner of the Department for Local Government or a designee under KRS 66.011 and 68.001.

Louisiana: La. Rev. Stat. Ann. 13:4741, 39:619-620—Either the State Bond and Tax Board or the governor and attorney general must give written approval for a parish (Louisiana's equivalent to a county), municipality, political subdivision, public board or corporation, taxing district, or other agency of the state to pursue municipal bankruptcy.

Michigan: Mich. Comp. Laws Sections 141.1558—Local governments, including school districts, may pursue municipal bankruptcy only through the recommendation of an emergency manager with the approval of the governor. The governor may place contingencies on the local government in order to proceed with municipal bankruptcy. Section 141.1552 defines "local government" to mean "municipal government or a school district" and defines "municipal government" to mean "a city, a village, a township, a charter township, a county, a department of county government if the county has an elected county executive … an authority established by law, or a public utility owned by a city, village, township, or county."

Minnesota: Minn. Stat. Section 471.831—Municipalities are defined to mean counties, statutory or home rule charter cities or towns, housing and redevelopment authorities, economic development authorities, or rural development financing authorities. They may pursue municipal bankruptcy if they "file a petition and seek relief available" under federal law.

Missouri: Mo. Stat. Ann. Section 427.100—"The consent of the state is hereby granted to … any municipality or political subdivision organized under the laws of the state" to "institute any appropriate action authorized by any act of the Congress of the United States relating to bankruptcy on the part of any municipality or political subdivision."

Montana: Mont. Code Ann. Sections 7-7-132 and 85-7-2041—"A local entity may submit itself and a proposed plan of adjustments to the jurisdiction of the bankruptcy court having jurisdiction of the matter." "Local entities" include cities, towns, improvement districts, and irrigation districts, all of which may pursue municipal bankruptcy, but counties are explicitly excluded.

Nebraska: Neb. Rev. Stat. Ann. Section 13-402—"Any county, city, village, school district, agency of state government, drainage district, sanitary and improvement district, or other political subdivision of the State of Nebraska is hereby permitted, authorized, and given the power to file a petition in the United States Bankruptcy Court … to incur and pay the expenses incident to the commission of a plan of adjustment of debts as contemplated by such petition."

New Jersey: N.J. Rev. Stat. Section 52:27-40—"Any county, municipality, school district or other political subdivision of this state … shall have the power to file a petition or petitions with any United States court or courts in bankruptcy … for the purpose of effecting a plan for readjustment of its debts … petition or petitions shall not be filed unless the approval of the municipal finance commission … be first had and obtained."

New York: N.Y. Local Finance Law (Chapter 33-a) Sections 85.00-85.90—Municipalities or their emergency financial control boards may pursue municipal bankruptcy. "Municipality" is defined to mean county, city, town, or village.

North Carolina: N.C. Gen. Stat. Section 23-48—"With the approval of the Local Government Commission of North Carolina and with the consent of the holders of such percentage or percentages of indebtedness as may be required" under federal law, "any taxing district, local improvement district, school district, county, city, town, or village in the State of North Carolina is authorized" to pursue municipal bankruptcy.

Ohio: Ohio Rev. Code Ann. Section 133.36—Upon approval of the tax commissioner, subdivisions of the state may pursue municipal bankruptcy. Under Section 133.01, "subdivision" includes counties, municipal corporations, townships, school districts, regional water or sewer districts, joint township hospital districts, and a number of other types of improvement districts or taxing districts.

Oklahoma: Okla. Stat. Sections 62-281–62-283—"A debtor municipal corporation or political subdivision of this state is hereby permitted and authorized, as a debtor, to initiate and conduct proceedings provided by the Bankruptcy Acts of the United States for the readjustment of municipal debts according to the provisions of said Bankruptcy Acts." A "debtor municipal corporation" is "a municipal corporation or other political subdivision of this state which is insolvent or unable to meet its debts as they mature."

Oregon: Oregon Rev. Stat. Section 548.705—Municipal bankruptcy is confined to irrigation or drainage districts.

Pennsylvania: 53 P.S. 11701.261—Municipalities are eligible to pursue municipal bankruptcy if they are in imminent jeopardy of an action by a creditor likely to interrupt or restrict the ability of the municipality to provide health and safety services, or if creditors rejected a plan and

efforts to negotiate over a 10-day period have been unsuccessful, or if a condition substantially effecting the municipality's financial distress is solvable only by using federal municipal bankruptcy law. Municipalities must apply to the Department of Community and Economic Development for approval of a municipal debt adjustment action. Under 53 P.S. Section 117.103, "municipality" includes every county, city, borough, incorporated town, township, and home rule municipality.

Rhode Island: R.I. Gen. Laws Section 45-9-7—If a budget commission established under Rhode Island law "concludes that its powers are insufficient to restore fiscal stability to the city, town, or fire district, it shall notify the director of revenue and shall forward to the director of revenue a statement of the reasons why it has been unable to restore fiscal stability to the city town, or fire district. Upon receipt of such statement, the director of revenue shall terminate the existence of the budget commission … and the director of revenue shall appoint a receiver for the city, town, or fire district for a period as the director of revenue may determine." Receivers have the following powers: all powers of the fiscal overseer and budget commission; the power to exercise any function or power of any municipal or fire district officer or employee, board, authority or commission, elected or otherwise, relating to or impacting the fiscal stability of the city, town, or fire district; the power to file a petition in the name of the city, town, or fire district under Chapter 9 of Title 11 of the US Code, and to act on the behalf of the city, town, or fire district in any such proceeding, and the receiver shall have the right to exercise the powers of elected officials of the city, town, or fire district relating to fiscal stability.

South Carolina: S.C. Code Ann. Section 6-1-10—Any "county, municipal corporation, township, school district, drainage district or other taxing or governmental unit" may pursue municipal bankruptcy.

Texas: Tex. Local Government Code Section 140.001—"A municipality, taxing district, or other political subdivision … may proceed under all federal bankruptcy laws intended to relieve municipal indebtedness."

Washington: Wash. Rev. Code Ann. Section 39.64.040—Any taxing district in the state is authorized to file a bankruptcy petition. Under Wash. Rev. Code Ann. 39.64.020, "taxing district" includes any "municipality or other political subdivision of the state, including (but not hereby limiting the generality of the foregoing) any county, city, borough, village, parish, town, or township, unincorporated tax or special assessment district, and any school, drainage, irrigation, reclamation, levee, sewer, or paving, sanitary, port, improvement or other [taxing] district."

Appendix B

State Intervention Strategies

	Receiver Or Overseer	State Agency	State Appointed Board	Debt Restructure	Labor Restructure	Tax Restructure	Emergency Financing	Technical Assistance	Dissolution Or Consolidation
Connecticut	•		•	•	•	•		•	
Florida		•	•				•	•	
Illinois	•	•	•	•	•	•	•	•	
Indiana	•	•			•		•	•	
Maine		•	•	•		•	•	•	
Massachusetts	•	•	•	•		•	•	•	
Michigan	•	•	•	•	•		•	•	•
Nevada	•	•		•	•	•	•	•	•
New Hampshire	•						•		
New Jersey	•	•	•	•		•	•	•	
New Mexico		•					•	•	
New York			•	•	•		•	•	
North Carolina		•	•	•		•		•	
Ohio	•		•	•				•	
Oregon			•	•				•	
Pennsylvania	•	•	•	•	•	•	•	•	
Rhode Island	•		•	•		•		•	
Tennessee	•	•		•		•	•	•	•
Texas	•							•	

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