

# Adjusting Municipal Debts: Chapter 9

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## I. INTRODUCTION

Chapter 9 of the Bankruptcy Code<sup>1</sup> provides a mechanism for eligible governmental entities to restructure debt. Chapter 9 is designed to enable a financially distressed municipality to continue providing essential services to residents while working out a plan to adjust its debts. However, “[m]unicipal bankruptcy is quite unlike bankruptcy for individuals or private corporations.”<sup>2</sup> In fact, application of the term “bankruptcy” to Chapter 9 is a misnomer since Chapter 9 is designed as a way to allow financially distressed municipalities to continue in existence.

The primary differences between a Chapter 9 and Chapter 11 bankruptcy are the result of the constitutional mandate of the Tenth Amendment guaranteeing state sovereignty.<sup>3</sup> Congress has the power to establish uniform laws on the subject of bankruptcies throughout the United States.<sup>4</sup> Moreover, the Constitution prohibits the states from passing any law that impairs the obligation of contracts.<sup>5</sup> Accordingly, “[o]nly federal law can give the type of relief afforded by chapter 9.”<sup>6</sup>

## II. ELIGIBILITY

Access to protection under Chapter 9 is limited to entities that satisfy the requirements of Section 109(c). First, only a “municipality” is eligible.<sup>7</sup> The Code defines “municipality” as a political subdivision, public agency, or instrumentality of a state,<sup>8</sup> but it does not define these terms. Courts have held that a public agency or authority is a municipality for purposes of Section 109(c)(1) if it is subject to control by public authority, state or municipal.<sup>9</sup>

Second, a municipality’s access to Chapter 9 protection is conditioned upon specific state authorization.<sup>10</sup> If the debtor is specifically authorized, in its capacity as a municipality or by name, to seek relief under

Chapter 9, the lack of authorization from any entity empowered to grant it does not effect any specific authorization that exists otherwise under state law.<sup>11</sup>

Third, a municipality must be “insolvent” in order to be eligible for Chapter 9 relief.<sup>12</sup> For most bankruptcy purposes, insolvency is a balance sheet test. However, insolvency of a municipality instead has the following meaning:

“[I]nsolvent” means . . . with reference to a municipality, financial condition such that the municipality is (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due.<sup>13</sup>

The reference point of the analysis is the filing date of the Chapter 9 petition. Thus, if at the time of the commencement of a Chapter 9 case a municipality is generally not paying its undisputed debts as they become due, the insolvency requirement is satisfied. Alternatively, the determination of whether a municipality is “unable to pay” requires a prospective analysis. Courts have rejected the argument that, in order to satisfy the requirement that it is insolvent because it is “unable to pay its debts,” a municipality must demonstrate that it is unable to raise the revenues required to meet its obligations through taxation, rate increases, or other efforts.<sup>14</sup>

Fourth, a municipality must desire to effect a plan to adjust its debts.<sup>15</sup> It has been held that a municipality may satisfy this requirement even if it is “unwilling, at least at this [early] juncture, to adopt a flexible approach or agree to any compromise concerning the provisions of that plan.”<sup>16</sup> In any event, a municipality would not be able to file a Chapter 9 petition in good faith if it lacked the desire to effect a plan to adjust its debts.<sup>17</sup>

In order to be eligible for relief under Chapter 9, an insolvent municipality specifically authorized to file a Chapter 9 petition must do more than desire to effect a plan to adjust its debts. Section 109(c)(5) provides four alternative methods of satisfying the final requirement for Chapter 9 eligibility. The first alternative is fulfilled if the municipality has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in the Chapter 9 case.<sup>18</sup> Because obtaining a sufficient and satisfactory prepetition agreement is unlikely in most circumstances, municipalities generally meet the requirement of subsection (c)(5) by one of the other options.

The second alternative for satisfying Section 109(c)(5) requires that the municipal debtor has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan.<sup>19</sup> In instances where serious negotiations occurred prepetition between the municipal debtor and creditors holding sufficient debt, courts have found the municipality to have satisfied the requirement.<sup>20</sup> Other courts have held that where the municipal debtor failed to engage in serious prepetition negotiations regarding a feasible payment plan, it failed to satisfy the requirement.<sup>21</sup>

The third alternative for satisfying Section 109(c)(5) is met if the municipal debtor is unable to negotiate with creditors because such negotiation is impracticable.<sup>22</sup> Impracticability may be viewed as a matter of degree. At some point, the sheer number of creditors involved or, among other possibilities, severe time constraints facing a municipal debtor, may make negotiation impracticable.

Finally, a municipal debtor satisfies Section 109(c)(5) if the debtor reasonably believes that a creditor may attempt to obtain a preferential transfer that is avoidable under Section 547.<sup>23</sup> In order to fulfill this final option, the debtor should demonstrate the reasonableness of its belief that the creditor may attempt to obtain a transfer and its belief that such a transfer is avoidable under Section 547.

**III. LIMITATION ON JURISDICTION AND POWERS OF COURT**

The reconciliation under Chapter 9 of the constitutional requirements guaranteeing state sovereignty and prohibiting impairment of the obligation of contracts by the states is explicitly embodied in Sections 903 and 904 of the Code. Municipalities are political subdivisions of states from which they derive all of their rights and powers. Chapter 9 does not disturb that arrangement. That is, it does not give a city rights and powers independent of the state. Section 903 reaffirms the constitutional requirement that Chapter 9 not limit or impair state control over the state's subdivisions, agencies, and instrumentalities so that there is no interference with such control. In addition, Section 903(1) and (2) specifically implement the constitutional prohibition against impairment of the obligations of contracts by the states by providing that state composition procedures may not bind nonconsenting creditors. Section 904 prevents the court from interfering with the political or governmental powers of the municipality, any of the property or revenues of the debtor, and the municipality's use and enjoyment of any income producing property.

The severe limitations on the powers and jurisdiction of the court in a Chapter 9 case, as compared to cases under other chapters of the Code, is designed to preserve the constitutionality of Chapter 9. Section 904 provides an exception to its limitation on jurisdiction and powers of the court if the debtor consents or the plan so provides. This actually is a single exception since in a Chapter 9 case only the debtor may propose a plan. Without the consent of the debtor, the only real power and control that the court has over a Chapter 9 debtor is the power to reject confirmation of the plan if the requirements of Section 943 are not satisfied and/or the power to dismiss the case.

**IV. PLAN FOR ADJUSTMENT OF DEBTS**

**A. Filing of Plan**

Eligibility for relief under Chapter 9 is conditioned upon, among other things, a municipality's desire to effect a plan to adjust its debts.<sup>24</sup> Section 941 mandates that the

debtor demonstrate this desire by filing a plan. The Code does not set a deadline for the filing of a plan under Chapter 9. Rather, Section 941 provides that if a plan is not filed with the petition, the debtor shall file a plan at such later time as the court fixes. However, unlike the situation in Chapter 11, only the debtor can file a plan in a Chapter 9 case. Ultimately, if the debtor fails to file a plan within a reasonable period of time, the court may dismiss the case.

**B. Confirmation Requirements**

**1. GENERAL OVERVIEW**

Section 943(b) contains the standards for confirmation of a plan under Chapter 9. These requirements are discussed below. The court must confirm a plan if all of the requirements are satisfied.

**2. COMPLIANCE WITH APPLICABLE PROVISIONS OF THE CODE**

Section 943(b)(1) requires as the first condition to confirmation of a Chapter 9 plan that the plan comply with the provisions of the Code made applicable by Sections 103(e) and 901(a). Section 103(e) announces the general rule that, except as otherwise provided in Section 901, only the provisions of Chapters 1 and 9 apply in Chapter 9 cases. Section 901 incorporates into Chapter 9 many of the requirements for confirmation of a plan of reorganization under Chapter 11. The most significant of these requirements are set forth in Sections 1122 (classification of claims), 1123 (contents of plan), and 1129 (confirmation of plan), to the extent made applicable in Chapter 9 cases under the Code.

**3. DISCLOSURE AND DETERMINATION OF REASONABLENESS OF FEES AND EXPENSES AND PAYMENT OF ADMINISTRATIVE PRIORITY CLAIMS**

Section 943(b)(3) provides as a condition to confirmation of a Chapter 9 plan that all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable. In Chapter 11 cases, the court independently reviews and approves the fees of professionals employed in the case who

are being compensated from the estate. By contrast, in Chapter 9 cases, prior to considering confirmation of a plan, the court does not engage in any such independent review and only considers the fees and expenses of professionals involved in the case as a condition to confirmation. Section 943(b)(3) works in conjunction with Section 943(b)(5), which provides that allowed administrative claims must be paid in full on the effective date of the plan unless the holder of the claim agrees to different treatment.

**4. NOT PROHIBITED BY LAW**

Section 943(b)(4) provides that as a condition of confirmation the debtor must not be prohibited by law from taking any action necessary to carry out the plan. Generally the "law" to be considered under this provision will be state law. However, the language is not limited to state law. Courts have held that Section 943(b)(4) does not restrict municipal debtors from proposing plans that impair the rights of bondholders even if such rights could not be impaired under state law if the municipal debtor had not resorted to relief under Chapter 9.<sup>25</sup>

**5. REGULATORY OR ELECTORAL APPROVAL NECESSARY UNDER APPLICABLE NONBANKRUPTCY LAW**

Section 943(b)(6) requires obtainment of any regulatory or electoral approval necessary under nonbankruptcy law for carrying out any provision of the plan. Alternatively, the plan provision is expressly conditioned on such approval. The legislative history of Section 943(b)(6) states that "[t]hese regulatory approvals are not limited to rates, but extend often to such other matters as the acquisition or disposition of property or the incurring of indebtedness."<sup>26</sup>

**6. BEST INTERESTS OF CREDITORS AND FEASIBILITY TESTS**

The final conditions for confirmation of a Chapter 9 plan require satisfaction of the best interests of creditors and feasibility tests.<sup>27</sup> Under Chapter 11, the best interest of creditors test is designed to measure whether creditors will receive under a plan at least as much as would be received in a liquidation