

Municipalities: Revenue Crunches and Chapter 9 Bankruptcies on the Horizon

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I. Introduction

Last year many states and municipalities across our country as well as the elected officials who led them celebrated our nation's low unemployment, increasing tax revenue and the zenith moments of what was the longest economic expansion on record. States like South Carolina even started the year with a \$2 billion budget surplus and politicians started the legislative session in January salivating over how the excess funds would be spent. However, other states and municipalities started the year without having fully recovered from the financial effects of the Great Recession and faced and continue to face massive shortfalls in pension and other liabilities. Those challenges existed even before the first cough, fever and death was reported in the United States because of COVID-19. Since then, seemingly no country or economy in the world has escaped economic havoc caused by the coronavirus. Businesses have shuttered, jobs have been lost and, you guessed it, tax revenue streams have evaporated.

Our elected leaders in Washington, D.C. have responded to date by opening up our nation's checkbook to the tune of nearly \$3 trillion to support struggling businesses and their employees by passing the CARES Act (which includes the popular Paycheck Protection Program – or PPP Loans – and Economic Injury Disaster Loans – or EIDLs). But what about relief for states and municipalities? The answer to what relief, if any, may come from Washington is unclear, and Senate Majority Leader Mitch McConnell (R-KY) stated recently that state and local governments should be able to “use the bankruptcy route.” While the likelihood of state bankruptcies is more remote and the legal path to accomplishing it remains less than certain, our Federal Bankruptcy Code (11 U.S.C. §§ 101 *et seq.*) contains provisions for municipality bankruptcies in Chapter 9 of the Bankruptcy Code.

II. Overview of Chapter 9 of the Bankruptcy Code

Chapter 9 addresses the adjustment of debts of a municipality (*i.e.*, a reorganization for municipalities). Municipal reorganizations are not novel and grew in frequency following the Great Recession as tax bases in some areas eroded and pension obligations increased (*e.g.*, City of Detroit, City of Vallejo, Orange County, California). The plight of rural healthcare has also led to an increase in Chapter 9 filings for county and government run hospitals across our country and COVID-19 may very well exacerbate the hospitals' fiscal challenges.

One critical issue commonly confronted by bankruptcy courts in Chapter 9 cases involves the debtor's eligibility to be in Chapter 9 in the first place. A bankruptcy court's analysis of eligibility to be a Chapter 9 debtor requires highly factual determinations. Section 109(c) of the Bankruptcy Code specifies who may be a debtor under Chapter 9 of the Bankruptcy Code. Specifically, Section 109(c) states that an entity may be a debtor under chapter 9 if the entity:

- 1) is a municipality [which is defined as a “political subdivision or public agency or instrumentality of a State”];

- 2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
- 3) is insolvent;
- 4) desires to effect a plan to adjust such debts; and
- 5) (A) 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 a case under such chapter;
(B) 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 in a case under such chapter;
(C) is unable to negotiate with creditors because such negotiation is impracticable; or
(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

The test set forth above is conjunctive, with the exception of subsection 5 (which requires that only one of the four criteria in (A)-(D) be satisfied). Consequently, each element (1)-(5) must be satisfied. The debtor has the burden of proving its eligibility for relief under Chapter 9.

Chapter 9 cases can only be filed by the debtor (involuntary bankruptcy cases can only be commenced against debtors under Chapters 7 and 11 of the Bankruptcy Code). Municipalities are ineligible for relief under Chapter 7 (a liquidation) and 11 (a reorganization).

Chapter 9 cases have other peculiarities worth noting. First, not all provisions of the Bankruptcy Code are applicable to Chapter 9 debtors. However, some of the primary ones (such as a debtor's ability to assume, assume and assign or reject executory contracts and unexpired leases of nonresidential real property) are applicable. Second, the court plays a significantly more limited role in a Chapter 9 case because of the limitations of the Tenth Amendment to the United States Constitution (which reserves powers to the states regarding how they manage their internal affairs). In Chapter 9 cases, bankruptcy courts cannot interfere with a municipality's political or governmental powers, property or revenues, or use or enjoyment of income producing property. In addition, a municipality cannot be forced into liquidation. If the Chapter 9 debtor cannot get a plan to adjust its debts confirmed by the court, the case cannot be converted to Chapter 7 (liquidation), as is often the case when a Chapter 11 debtor fails to confirm a plan of reorganization. Instead, the case will likely be dismissed and the municipality will continue to exist, and it, as well as its creditors, will have to look to enforce their rights under applicable state law.

III. Conclusion

As the U.S. economy undoubtedly slips into a recession, the depth and duration of which is uncertain, municipalities across our country will face increased financial pressure. Some municipalities are in a solid position to weather this storm while others will likely need to consider restructuring options. Although it is not clear whether additional funding relief will come to affected municipalities from Washington, D.C. in the coming weeks and months, Congress already provided municipalities with a mechanism to adjust and restructure their debts and that tool is found in Chapter 9 of the Bankruptcy Code.

For additional information about Chapter 9 bankruptcies, please contact:

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