And the Last Shall be First - A Primer on the Ascendant Chapter 9 of the U.S. Bankruptcy Code

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A wave of municipal bankruptcies - in dimension not seen since the Great Depression - is bearing down on us. While there have been less than 300 issuer defaults in the last year, the growing imbalance between local government revenues and expenditures suggests more failures are likely. Little studied Chapter 9 of the Code addresses municipal bankruptcy, and the implications of this section are complex and far reaching.

Introduction

Bankruptcy practice in the legal profession has always been gritty and unglamourous work. Most years, assuming a normal growing economy, there is work but within limits. Once a decade or so, when the economy tanks, these low profile practitioners become stars for a short period of time until the tide again ebbs and the cycle repeats.

Even in this world however, the practice of bankruptcy has generally been about Chapters 7, 11, and 13 of the United States Bankruptcy Code. Bankruptcy legislation is an enumerated power granted the federal government in Article I, Section 8 of the U.S. Constitution. Chapter 7 of the code addresses straight liquidations, whether for individuals or business entities. Chapter 11 addresses business reorganizations, and Chapter 13 provides a similar recourse to individuals in so-called but mis-named wage earner plans.

In the last year or so, a whole slew of non-legal professionals, ranging from city managers to muni-bond traders to public sector union bosses have started to notice another chapter in the Code, our subject 9. Whether the legal profession has shown the same sensitivity is open to debate. Indeed, an informal survey by this author suggests it has not. Chapter 9 was a mid-twentieth century addition to the bankruptcy laws, largely in response to wide spread municipal insolvencies of the 1930s. For a reason we will get to however, the modern Chapter 9 really only dates from the bankruptcy reform efforts of the late 1970s. Since that time, the section has seen little use and there have only been a few higher profile applications. This is about to change.

A study of Chapter 9 must start with two acknowledgments. First, this section has been so little utilized, there is little confidence in the details of its application. Indeed, there are several conflicting sections such as one might expect with new legislation, and as various scholars start to examine what is here, there is a great deal of uncertainty. That uncertainty is enhanced by the second acknowledgment. Chapter 9 sits at a very unusual vortex in the law. While we might expect municipal reorganization to be similar to corporate (11) or individual (13) reorganizations, there are some significant differences, beginning with the Constitutional context. Municipal insolvency must be addressed by federal law because the states are prohibited from revising contractual commitments by the contract clause. Equally however, the Tenth Amendment suggests the federal government can go only so far in addressing local governmental activity without infringing on state sovereignty. The takeaway here is that Chapter 9 requires a light hand.
Early iterations of the effort generally failed as violating state independence and that is why the modern section took the better part of 30 years to strike the right constitutional balance.

With that foundation laid, let us turn to why this area is about to become relevant. Most local governmental insolvencies have typically taken one of two paths. Revenue bond commitments have always been viewed by credit markets as more risky than general obligation paper, because the supported project could prove uneconomic. And from time to time, this has happened. Where general obligation credits have gotten into trouble, and this has been much rarer, it has usually been caused by one large investment commitment, such as a misunderstood financial investment (think derivatives and Orange County) or an ill considered physical investment (think of Harrisburg this summer and its trash facility). What appears to be changing is the number of general obligation issuers with trouble and the number of fronts on which many issuers are seeing that trouble. Public sector welfare (pension and related benefit) commitments across the country are increasingly seen as over promised and under funded. Throw in a nasty recession, and we have the perfect storm for municipal bankruptcy. In reorganizations generally, the code often works by jettisoning the most odious financial problems, as a cost for saving the remaining creditors. This “cram down” idea shows up in various circumstances but most recently we saw the GM bondholders crushed as a price for keeping the car maker alive. Unfortunately, where we have multiple wounds, this cram down is tougher to execute.

The issue has been further complicated by changes in the muni world. In years past, one recourse for creditors may have been municipal bond insurance. The last several years however have illustrated that the bond insurers do not have the capital to address a widespread problem. Indeed, for most of the last year Assured Guaranty has been the only remaining player in the muni insurance industry with Warren Buffet having removed his General Re from the business, saying it was too risky. And just several days ago (10/25/10), Assured lost its triple A rating, so that they really have no “guarantee” to sell, at least to relatively highly rated issuers. While there is discussion within the trade as to what extent falling demand for insurance is the chicken or egg side of the problem, for our purposes it matters not. Insurers will not be part of the remediation effort.

Discussion

Going forward, this author sees 3 paramount questions. The first question is to what entities is Chapter 9 relief available? The Code suggests it is available to a “political subdivision...of a state”. Towns, cities, and special revenue entities are clearly covered. Is a state a political subdivision of itself? Probably not (for the aforementioned constitutional problem), but the issues in California are extreme and certainly call out for reorganization capability, and as the situation deteriorates, I think we will see some interesting arguments. State law compounds the complexity. Rhode Island, for example, has essentially prohibited municipalities from filing, providing an in state receivership alternative as we saw this summer with Central Falls. Pennsylvania also has state provided pre-filing alternatives, etc. These laws attempt to contain the problem in the political sector, rather than allow its transfer to the judicial. That may not be a Constitutional constraint. Another unique aspect in this area is the overlap of authority across various municipal entities. For example, Orange County consisted of various communities, special taxing districts, projects, and so forth. These were not stand alone entities, and the
responsibility for debt was not unshared. Accordingly, what does a filing portend for an affiliated debtor?

The second broad question is the impact on the muni-bond market. This in turn has 3 components. Broadly there is the concern to what degree a 9 filing will impair muni obligations, long thought safe. There is the technical question, seen in the Orange County filing, of what restrictions attach to securities liquidation upon the event of a filing. Remember, it is often these very securities that produced the problem. The impact here is on the marketplace, not so much the entity. Finally, there is the matter of priorities. We noted previously that general obligation debt has long been considered safer than special revenue obligations and priced accordingly. In bankruptcy however, the lien provided to special revenue projects on dedicated income flows may prove superior to general obligation claims that are stayed and adjusted, thus turning the world on its head. This then presents a pricing problem for the marketplace.

The last issue is the impact on public sector union commitments, the problem area that is presently exploding due to over promising, under funding, and stagnating growth. The only thing certain here is that Congress, while uncomfortable with treating labor contracts like other executory contracts in the bankruptcy process in the private sector, appears not to have even recognized the possibility in the public sector. While first instance and imposed modifications by the debtor may not be possible, certainly post-negotiation and last resort adjustments are going to be permitted. The only question is where the line falls, and the legal history here is very unclear.

Conclusion

The only clear summation on these three large fronts is “stay tuned”. There are also a couple of other related things to watch. Economic growth, to the extent it happens or not, will shape much of this uncertain future. So too will the response, whether economic or political, by Washington leaders. I suspect they, like their state level brethren, will be generally reluctant to let the judiciary dictate local political solutions. Equally however, they cannot stand in front of a tsunami and that may be what is evolving.

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