

# Municipalities in Crisis: Now That It's Broke, How Does It Get Fixed? The Alternatives

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**Editor's Note:** See also the *Affairs of State* article on page 12.

Since the 2008 financial meltdown, there has been a lot of talk about the broken state of the Union. Unquestionably, municipalities all across the nation are in crisis, and in an era where chapter 9 is uttered more than in the near century it has existed, few are willing to pull the trigger on this little-used section of the U.S. Bankruptcy Code, with many good reasons why.<sup>1</sup>



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Take just a few high-profile situations as an example of the fears and realities facing America's cities and states. Vallejo, Calif., has been under chapter 9 protection since May 2008.<sup>2</sup> Jefferson County, Ala., has

been struggling with a failed sewer district project and no consensus on debt relief for more than three years.<sup>3</sup> The city of Harrisburg, Pa., is weighing a chapter 9 filing, but its counsel is suggesting many possible alternatives to avoid the same. The story goes on and on.

In recent months, discussions have ensued on the state and federal level regarding how to best deal with municipalities in crisis. While chapter 9 remains at the foundation of these discussions, aside from consideration of a state's potential right to file for bankruptcy protection, the current movement seems to steer away from the bankruptcy option.

States such as Michigan have expanded a long-standing law regarding the use of emergency managers to cope with municipal failures.<sup>4</sup> Chicago and other cities in crisis have created monetization options to close budget

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deficits. Whether a consensus on how to effectuate the best result to quell the coming storm can be reached will be both a test of time and political will. However, the alternatives are worthy of analysis and consideration.

## Chapter 9: The Answer, or a Powerful Threat?

Chapter 9 was enacted in 1934 to aid debt-stricken municipalities in need of debt relief. In its original form, Pub. Law 251, 48 Stat. 798 (1934) was found unconstitutional by the U.S. Supreme Court as an improper interference with

be a gateway to protracted and complicated litigation. There is also the underlying fear that credit markets will look negatively on municipalities that file for chapter 9, along with the ripple effect that states may encounter as a result.<sup>8</sup>

## Harrisburg and Jefferson County: To 9 or Not to 9?

On March 31, 2010, Cravath, Swaine & Moore LLP, the law firm retained to assist Harrisburg, Pa., in its municipal financial crisis, issued a memorandum for the city council to consider regarding its various options to address its municipal debt (the "Cravath Report").<sup>9</sup> The report is telling of the current thinking on chapter 9, taking very seriously its risks even more so than its benefits while examining at great length alternative debt-relief options.

On the one hand, the Cravath Report warns that a nonconsensual chapter 9 can cause damage to a city's reputation

## Feature

the sovereignty of the states.<sup>5</sup> Congress revised the law (Pub. L. No. 302, 50 Stat. 653 (1937)), which was upheld as constitutional in 1938.<sup>6</sup> Since its enactment, fewer than 500 municipal bankruptcies have been filed in the U.S. Thus, despite the talk of an expected wave of chapter 9 filings, this section of the Bankruptcy Code is still rarely used.

A municipality cannot file for chapter 9 protection unless the state, where the municipality exists allows it to do so.<sup>7</sup> Currently, 24 states allow such filings to occur, and of those, many still require approval of an oversight board before the filing may occur. Most states exercise some consensual control over the filing, if not complete prohibitions of the use of this debt-relief mechanism.

Chapter 9 bankruptcies can be very costly, and since the municipality is footing the bill, in essence taxpayers are paying the municipality's way. Thus, the benefit vs. the gain must be weighed on a cost-analysis basis since chapter 9 can

for business and in the credit markets.<sup>10</sup> Moreover, creditors will either be worse off as a result of a court-approved plan that impairs their position or, if the court does not approve a nonconsensual plan, dismissal of a chapter 9 case will leave creditors with competing *mandamus* actions, the result of which the report indicates could spell destruction for a city that has no clear path to recovery.<sup>11</sup>

While the Cravath Report does not completely rule out the use of a chapter 9 filing for Harrisburg and does set forth the legal merits of such a course, it is careful to be both fair in its assessment of the process while offering a cohesive analysis of viable alternatives to a filing. One of those alternatives, which has gained popularity in other municipalities facing heavy debt loads, are monetiza-

<sup>1</sup> The two most recent high-profile municipalities facing financial crisis, Harrisburg, Pa., and Jefferson County, Ala., have deferred a decision on the filing of chapter 9 petitions, attempting to explore a variety of other options to achieve debt reduction, some of which are explored in this article.

<sup>2</sup> The Vallejo, Calif., chapter 9 case was confirmed on July 28, 2011.

<sup>3</sup> Close to a debt-reduction deal, Jefferson County deferred on a decision regarding a chapter 9 filing until Sept. 16, 2011. "A County in Alabama Puts Off Bankruptcy," *New York Times*, Aug. 12, 2011.

<sup>4</sup> See Michigan Public Act 72 of 1990, the original Emergency Financial Managers Act. In March 2011, Public Act 4 was signed into law, greatly expanding the role of emergency managers in Michigan.

<sup>5</sup> See *Ashton v. Cameron Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936).

<sup>6</sup> See *United States v. Bekins*, 304 U.S. 27, 54 (1938).

<sup>7</sup> 11 U.S.C. § 109(c)(1).

<sup>8</sup> Alabama Gov. Robert Bentley urged Jefferson County commissioners to avoid bankruptcy, concerned that it could affect the credit of the entire state. "A County in Alabama Puts Off Bankruptcy," *New York Times*, Aug. 12, 2011.

<sup>9</sup> See Cravath, Swaine & Moore LLP Memorandum for City Council Members dated March 31, 2011—Evaluation of Alternatives Available to the City of Harrisburg to Address Its Current Financial Situation. The Cravath Report is available at [remote.cravath.com/Harrisburg.pdf](http://remote.cravath.com/Harrisburg.pdf).

<sup>10</sup> Cravath Report at page 4.

<sup>11</sup> Cravath Report at page 5.

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## Alternatives for Municipalities in Crisis

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tion options aimed at both debt relief and revenue generation.<sup>12</sup>

In Jefferson County, Ala., the issue is sewer debt. The municipality, which has been struggling to deal with \$3.2 billion of debt, has been threatening chapter 9 for the better part of three years. Should it file, it would be the largest municipal bankruptcy in history. Thus far, Jefferson County has avoided this dreaded step, but that could all change since the Alabama Supreme Court recently struck down a local occupational tax as unconstitutional. The ruling leaves Jefferson County with revenue shortfalls that could be as high as a third of its operating budget, limiting the county's option if a consensual debt-reduction agreement cannot be reached. However, some see chapter 9 as a less-risky proposition.

Jefferson County seems, at least in part, to be using the threat of chapter 9 to attempt to get the state to assist with its debt. As of the submission of this article, Jefferson County was closer to a debt-reduction deal than it has been in years. Such a deal would not only refinance the county's debt, but would put its sewer system under the control of an independent authority. The proceeds derived from such a deal would be used to redeem defaulted securities. The state's "moral" support of such a deal would assist Jefferson County with its borrowing power thereafter.<sup>13</sup>

### Monetization: Short-Term Solution or Road to Recovery?

Monetization is yet another option being considered by municipalities to

sell their way out of debt. Proponents argue that it raises revenue fast, helps bolster reserves and rids municipalities of underperforming or formally poorly managed assets. Opponents argue that it is selling the future to save the present, simply deferring debt woes for the next generation to address and hoping things will otherwise get better.

The city of Chicago was one of the first to create a large-scale monetization of a municipal asset, in 2008, when it awarded a 75-year lease of the city's parking meters to a private consortium for \$1.157 billion. More than half of that revenue was earmarked to address short-term debt issues that occurred as a result of the recession. Chicago first did this in 2005 with the leasing of the Chicago Skyway toll bridge.<sup>14</sup>

The goals of leasing Chicago's parking meters was both short-term for cash and long-term for the city's cash reserves. Upon completion of this transaction, the city of Chicago received a one-time payment of just under \$1.2 billion, which satisfied its immediacy goal. Next, it established a \$400 million reserve. The expectation was to earn approximately \$20 million annually, which would replace the lost parking meter annual revenue.<sup>15</sup>

An additional \$325 million was earmarked to help balance the city's budget through 2012. Finally, the city took \$100 million to support "human infrastructure" programs for the needy and then created one additional reserve fund with \$324 million to tap into for

budget stabilization until the economy otherwise improved.<sup>16</sup>

Rating agencies responded with mixed reviews to the public-private partnership monetization plan. While praising Chicago for establishing reserves to help ease future worries, it was not without concern over the front-loaded cash payment, which was viewed as a short-term solution to a long-term problem.<sup>17</sup>

Even states where blue laws still live strong have succumbed to the realities of municipal debt. States such as Connecticut, Indiana and Texas have taken steps to lift bans on Sunday sales at "package" stores that sell alcohol for off-site consumption, all in an effort to generate additional tax revenue. These three states anticipate budgetary shortfalls over the next two years of \$3.5 billion, \$1 billion and \$27 billion, respectively, and are hard pressed with few options to raise revenue and reduce their debt loads.<sup>18</sup>

### Conclusion

The unchartered waters in which municipalities are trying to stay afloat are full of options, none of which creates the certainty necessary to regain fiscal stability. Chapter 9 provides little more than a road map to a negotiated settlement of debt and collective-bargaining issues. The possibility of state bankruptcy filings seems more theoretical than practical at this juncture, and monetization efforts in many municipalities can certainly provide an economic boost, but may only serve as short-term solutions to generational fiscal problems. ■

<sup>12</sup> Cravath Report at pages 6-12 and 169-79.

<sup>13</sup> See generally, "A County in Alabama Puts Off Bankruptcy," *New York Times*, Aug. 12, 2011.

<sup>14</sup> "Chicago Scores \$1.16B with Meter Deal Lease," *The Bond Buyer*, Dec. 3, 2008.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> "Strapped States Look to Alcohol for Shot at Cash," NPR, Feb. 2, 2011.

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