

When Recovery Fails:

State Intervention and Local Government Bankruptcy



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Government Finance
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AUTHORS OF THIS REPORT

Marc A. Levinson, a restructuring lawyer in Orrick, Herrington & Sutcliffe LLP's San Francisco office, was the lead bankruptcy counsel in the chapter 9 cases filed by the Cities of Vallejo and Stockton, California.

John H. Knox, who was a public finance lawyer in Orrick, Herrington & Sutcliffe LLP's San Francisco office until his retirement, was the lead bond counsel in the chapter 9 cases filed by the Cities of Vallejo and Stockton, California.

Shayne C. Kavanagh is the Senior Manager of Research for the Government Finance Officers Association.



The Government Finance Officers Association (GFOA) represents approximately 20,000 public finance officers throughout the United States and Canada. GFOA's mission is to promote excellence in state and local government financial management. GFOA views its role as a resource, educator, facilitator, and advocate for both its members and the governments they serve and provides best practice guidance, leadership, professional development, resources and tools, networking opportunities, award programs, and advisory services.

GFOA's [Fiscal First Aid program](#) describes a comprehensive process for financial recovery. However, a government could fail to successfully navigate the recovery process. The purpose of this paper is to help local governments understand the more drastic options if recovery fails.

First, we will cover state intervention. This is where state government inserts itself into the business of the local government. The state government (either directly or through its agents) can encourage the local government to make decisions that will improve financial conditions.

Second, we will address bankruptcy. Local government bankruptcy is very rare, and GFOA strongly recommends that governments take every possible step to avoid it. Nevertheless, local government bankruptcy draws attention out of proportion to its prevalence. Therefore, we address common questions about local government bankruptcy to help local government decision-makers separate fact from fiction.

State Intervention

First, local government leaders must understand what role, if any, the state government has in helping distressed local governments. Laws between states vary. For example, one study found that fewer than half of states have laws allowing them to intervene in municipal finances.ⁱ

Generally, a state's posture toward financially distressed local government can fall into one of three categories.ⁱⁱ

1. **The state does not formally recognize distressed local governments** but attempts to provide relief measures for them with lower financial capacity. These measures include grants, guaranteed loans or bonds, or economic development tools.
2. **Formal distress legislation is written toward specific local governments** that have become distressed. This approach is ad hoc.
3. **A statewide policy toward distressed local governments is written into law.** Among other things, such legislation establishes criteria for defining distress, defines processes used to correct conditions causing distress, and establishes criteria for determining when it is appropriate to discontinue corrective programs. Specifics vary between states.

Once you understand your state's posture, develop a strategy on how to use what is available. For example, local governments whose state falls in the first category should understand the tools available and how to qualify for them.

Local governments in the second category may need to work with local legislators to push forward and craft favorable legislation.

Those in the third category should understand the programs available and how to use them. A few points to remember are:

- Such programs are usually reactive. They only come into effect after distress has occurred (e.g., defaulting on a bond, missing payroll).
- State programs often focus on managerial technical remedies and do not address structural problems such as changing demographics or erosion of the local economic base.
- Programs often implicitly assume that distress is short term and will disappear upon corrective managerial action. The problems may run deeper than managerial action can address.
- States differ on the resources that are available through program.ⁱⁱⁱ For example, almost all the states with a program will supervise the local government's finances or offer technical assistance. However, only a handful of states provide the authority to restructure disadvantageous labor agreements. Some provide the authority to increase taxes. Some provide the ability to renegotiate debts. Some provide access to emergency financing.

While such programs are laudable, local governments must be aware of their limitations. For example, overcoming a financial challenge often requires forming networked relationships with other local organizations to gain access to new resources and share responsibility for providing services to the public.^{iv} No state intervention program is capable of making this happen.

Local Government or “Municipal” Bankruptcy

In legal parlance, the word “municipal,” in the context of bankruptcy, refers to a political subdivision or public municipality or instrumentality of a state. Therefore, bankruptcy could be available to cities, counties, schools, and special districts. It is not limited to the popular meaning of “municipality”: a city, town, village, or similar entity. Therefore, when we refer to “municipal” bankruptcy in this paper, we refer to this broader, legal definition.

For many reasons, GFOA recommends that municipalities make every effort to avoid seeking bankruptcy relief. Bankruptcy will have a serious cost on the community's reputation and the government's creditworthiness. The harm to the community's reputation could sap its economic vitality and will increase the government's cost of borrowing. Also, the cash outlays required to go through the court proceedings are significant. Legal and consulting fees, as well as staff time, preparing for and attending hearings and responding to requests for information could reach into the millions of dollars (and more for larger governments). Moreover, bankruptcy is not a cure-all. A Chapter 9* plan of adjustment is unlikely to completely void the municipality's obligations (so debts, albeit restructured, will still need to be paid). As a matter of law, a bankruptcy judge cannot override provisions of state law such as requirements for voter approval of tax, bond, and other matters. Further, the municipal government is not dissolved by bankruptcy, and although bankruptcy provides additional latitude to local government officials, in the end, it is the municipality's management and elected officials who must make the hard choices required to reach financial health.

For these reasons, municipal bankruptcy is rare. Only a handful of cases have been filed by general-purpose governments since 1930. Many of these were by very small towns that experienced a financial shock from an outside event, such as a large court judgment related to environmental or real estate development issues.

* Chapter 9 refers to municipalities, whereas the more commonly known Chapter 11 refers to private entities.

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When all else fails in the recovery process, local governments may have the ability to file for protection under Chapter 9 of the United States Bankruptcy Code. If bankruptcy becomes an option, then the municipality should engage stakeholders to renegotiate obligations to avoid bankruptcy. Labor unions may prefer to renegotiate rather than submit to having their contract voided in court, which is what happened in the City of Vallejo, California, Chapter 9 case in 2009. Capital markets creditors may be willing to restructure debts as well.

Governments need to consider other possibilities to resolve their fiscal distress and understand what bankruptcy can and can't do before moving forward. The following are key questions about bankruptcy. For more detail, read "[Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress](#)".^v

Q: What is the definition of "bankrupt" for a municipality?

A: In common parlance, "bankrupt" usually refers to the condition of being unable to pay current obligations. In other words, "insolvent." However, in bankruptcy cases, the term "insolvent," rather than "bankrupt," is used. An insolvent municipality either must not be paying its undisputed debts as they come due at the time of filing or be unable to pay such debts when they become due in the near future. Insolvency is a cash flow test. Does the government have the cash to meet its obligations as they come due? Further, a government will have to show that it has accessed its discretionary resources (e.g., reserves)

before becoming eligible for bankruptcy protection. The government also will have to show that any restrictions on funds that prevent the funds from being used to meet the debts in question are true restrictions (e.g., user fee revenues from a city-owned water utility cannot be used to pay police salaries).

If a creditor challenges the Chapter 9 filing by contending that the municipality is not insolvent, the bankruptcy court will conduct an evidentiary hearing to determine the issue.

There are other threshold requirements for eligibility for Chapter 9 protection. A municipality must "desire to effect a plan to adjust its debts." The plan does not have to exist before filing, but there must be evidence that the municipality wants to effect a plan through the bankruptcy case. The municipality must show that it has attempted to avoid the bankruptcy filing by proposing a plan to its key creditors and that they were unable to reach an agreement. Or it must prove that negotiating a plan prior to filing was impracticable, perhaps due to the number of creditors such as retirees with health care and pension benefits.

Q: How common is municipal bankruptcy?

A: Chapter 9 is rare for general-purpose governments. Only a few hundred cases have been filed since the 1930's. Only a handful of these have involved cities or counties; most have been special districts. The number of cities and towns to have declared bankruptcy is less than 40.^{vi} Of the general-purpose governments that have filed, many were small towns that experienced an outside shock, such as the loss of a dominant revenue stream or losing a lawsuit.

Q: Can any local government declare bankruptcy?

A: Any municipality can seek bankruptcy protection, assuming it is permitted to do so by state law. Only about half of the states have enacted laws relating to municipalities' eligibility for Chapter 9 relief. Some states that have such laws have added conditions that must be satisfied before a municipality can file for Chapter 9 relief. For example, Connecticut requires the governor to approve a Chapter 9 filing.^{vii}

A municipality in a state without a law enabling Chapter 9 relief must work with the legislature and the governor on the enactment of legislation specific to it.

Q: When would it be necessary to declare bankruptcy?

A: Filing for bankruptcy protection should be a last resort after all else has failed. Bankruptcy provides latitude to alter or adjust a municipality's obligations, but it does not fix the underlying problems that caused the deteriorated financial position, such as weak economic conditions, a poor tax base, or unsustainable choices about a local government's cost structure. Bankruptcy can provide some relief from debt and other obligations that have been preventing the municipality from getting on a stable financial footing. Ultimately, it is the municipality that must make the choices and take the actions that lead to long-term financial sustainability.

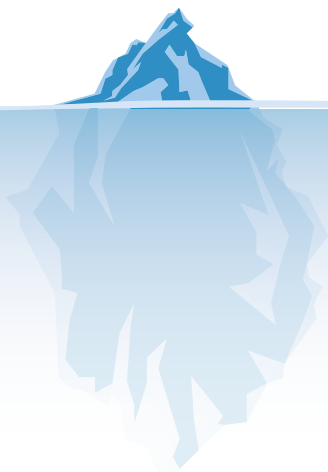
Q: In bankruptcy cases, do judges take over the management of municipality? For example, can the court make you sell off public property? Are liens placed on public**property? Does a judge decide what bills will be paid? Can a court require you to raise taxes to pay your bills?**

A: The answer to these questions is "no." The municipality is not dissolved, and its management is not replaced by the court. The municipality's trustees (e.g., elected officials, professional managers) decide how to manage payments to creditors in the plan of adjustment they cause the municipality to file. Further, a bankruptcy judge cannot change or supersede state law. For example, if state law requires a vote of the citizens to raise taxes, a judge cannot authorize the municipality to raise taxes without such a vote.

It is worth noting that some state laws have provisions for the state to intervene directly in the decisions of a financially distressed municipality. However, this is a matter of state law, not the Bankruptcy Code.

Q: What latitude does bankruptcy give a municipality to adjust or alter its obligations? Can a court eliminate labor agreements, pension obligations, and/or debt obligations?

A: Bankruptcy provides broad latitude to reduce or extend and restructure the claims to which the government is subject. However, there are limits on how these adjustments can be made, and creditors have a say—but not a veto—about how adjustments are made. Further, it is unlikely that a judge would agree to eliminate any obligation of the municipality. Remember that a judge cannot override state law voter approval requirements.



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Q: What laws govern municipal bankruptcy?

A: Chapter 9 of the United States Bankruptcy Code is preeminent, but as with other chapters of the Code, the judge will look to state law for guidance in certain areas. For example, the amount of damages for a rejected contract (a contract that courts adjust for the municipality) typically would reference state law on the matter.

Q: What are the negative consequences of a municipality bankruptcy?

A: Credit market reaction. Municipalities that seek or even consider bankruptcy protection should expect a swift and harsh reaction from the credit markets. Even if bonds are paid in full, bankruptcy may leave a stigma that lasts for years, making it difficult to access credit and/or obtain favorable rates.

Cost and distraction. Bankruptcy is expensive, with consulting and legal fees potentially reaching into millions of dollars (or more for larger governments). Those standing to lose from a bankruptcy (e.g., unions) may spend large sums resisting it, and the government will have to expend funds to respond. Bankruptcy also will require a great deal of staff time for the technical/legal proceedings as well as dealing with the political repercussions and reactions from the public.

Stigma on the community. Bankruptcy may tarnish the good name of the community, reduce civic pride, and deflate the business climate. All of this may hurt the economic viability of the community and weaken the local government's financial position.

Q: Besides adjusting or altering obligations, what are the other advantages of bankruptcy?

A: Protection. A bankruptcy filing offers a municipality and its elected officials and residents an automatic stay (i.e., an injunction) against actions

that might be taken by creditors. The stay lasts for the pendency of the case, although it can be modified by the bankruptcy judge.

Breathing space. Bankruptcy provides the municipality with time to take the actions needed for financial stability. In the absence of bankruptcy protection, the municipality may spend a lot of time fending off creditors or dealing with consequences of the actions it is forced to take to deal with its financial challenges.

Access to an expert arbiter. Bankruptcy judges have specialized expertise and experience in their craft. They can be valuable in helping stakeholders reach a solution, and they can move quickly to resolve disputes that cannot be negotiated away.

Q: What is the key differentiator between states when it comes to bankruptcy laws for municipalities?

A: The key differentiator is whether municipalities are permitted to seek Chapter 9 protection in the first place. As mentioned, about half of the states permit Chapter 9 relief. Many condition the permission to seek bankruptcy relief on prior approval of the state. For example, in one state, a municipality in a financial emergency must be put under a state-appointed manager who might then recommend bankruptcy if recovery efforts fail. Another requires that the municipality enter mediation with its key creditors. The other half of states are either silent on the issue of bankruptcy and one state prohibits it. In these states, though, it might be possible to get legislation permitting bankruptcy for an individual municipality, but that would be difficult.

Q: Since municipalities are subdivisions of the state, wouldn't state government have to bail out an insolvent municipality?

A: This is determined by state law; but in many cases, the state is under no such obligation.

Conclusion

When the recovery process fails, a local government may have to consider more dramatic options, like the two we described in this report. Unfortunately, neither of these options is a cure-all for local government financial distress. Local governments will have to do the hard work needed to turn the financial situation around. Furthermore, bankruptcy entails significant monetary and reputational costs. Therefore, local governments will be better off if they recover on their own and avoid the options described in this paper. GFOA's [Fiscal First Aid: 12 Steps to Financial Recovery](#) provides comprehensive guidance on how to do just that.

Endnotes

- ⁱ “The State Role in Local Government Financial Distress.” The Pew Charitable Trusts. July 2013.
- ⁱⁱ Anthony G. Cahill; Joseph A. James; Jean E. Lavigne; Ann Stacey. Public Productivity & Management Review, Vol. 17, No. 3, Changing Government: Pressures, Reality, Responses: Proceedings of the Sixth National Public Sector Productivity Conference. (Spring, 1994), pp. 253-264.
- ⁱⁱⁱ “The State Role in Local Government Financial Distress.” The Pew Charitable Trusts. July 2013.
- ^{iv} Shayne C. Kavanagh and Vincent Reitano. *Financial Foundations for Thriving Communities*. GFOA. 2019.
- ^v John H. Knox, Marc A. Levinson, and Devin S. Brennan. “Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress, 2nd edition.” Paper published by Orrick, Herrington & Sutcliffe LLP. 2020.
- ^{vi} According to an interview on National Public Radio in 2010 with the late Jim Spiotto, who was a leading municipal bankruptcy lawyer, since 1980, only 32 cities and towns have declared bankruptcy. Since 2010, a handful of other cities have declared bankruptcy, keeping the total under 40.
- ^{vii} “The State Role in Local Government Financial Distress.” The Pew Charitable Trusts. July 2013.



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203 N. LaSalle Street, Suite 2700, Chicago, IL 60601
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