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Municipal bankruptcy: a primer on Chapter 9

Municipal bankruptcy filings remain rare, but high-profile Chapter 9 cases may be changing long-held views of the bankruptcy process and outcomes. This report explains the key components of Chapter 9, identifies entities eligible to file and reviews the possible outcomes of municipal bankruptcy.

RECENT CHAPTER 9 FILINGS

Municipal defaults and bankruptcies tend to lag recessions or times of economic stress, although filings remain rare. Investors may have feared an uptick in filings because of the Covid pandemic and its economic disruption. But this did not occur, mainly due to unprecedented federal aid that helped states and local governments manage through that crisis.

Since Congress added Chapter 9 to the federal bankruptcy code in the 1930s, there have been approximately 700 filings under Chapter 9. Comparatively, the commercial Chapter 11 filings generally number more than 5,000 per year. In 2023, only one entity (a hospital district) filed under Chapter 9, and thus far in 2024 only one entity (a special purpose district) has filed.

Puerto Rico is the most high-profile municipal bankruptcy in recent years. In 2017, five Puerto Rican entities, including the Commonwealth itself, initiated bankruptcy-like proceedings called Title III, pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). U.S. territories are not eligible to file for Chapter 9 bankruptcy protection. However, rulings in the Puerto Rican entities' cases may impact future treatment of creditors in Chapter 9 cases because PROMESA incorporates many provisions of Chapter 9.

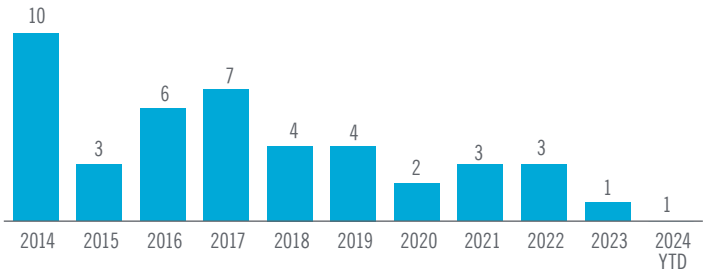
Puerto Rico exited bankruptcy for the Commonwealth's general obligation debt in March 2022. The Puerto Rico Electric Authority remains in bankruptcy.

Only four cities have filed for bankruptcy protection since Detroit's historic case in 2013. Most recently, in November 2022, the City of Chester in Pennsylvania filed for Chapter 9 after decades of financial distress. The City of Fairfield, Alabama, filed in 2020. In 2019, Perla, Arkansas, filed for Chapter 9 bankruptcy following a lawsuit for unpaid water services. Hillview, Kentucky, filed for bankruptcy in 2015, citing an inability to pay a large legal judgment. The case was dismissed after the city reached a settlement with its creditor.

Contrary to popular belief, municipal bankruptcies do not tend to stem from increases in spending. Moreover, the number of cities, towns or counties that have filed under Chapter 9 is small, and most municipal bankruptcy cases have come from hospitals, utilities, and special purpose districts.

Municipal Chapter 9 filings remain rare

Number of bankruptcy filings



Data source: PACER, 30 Sep 2024.

BACKGROUND ON CHAPTER 9

Chapter 9 is the section of U.S. bankruptcy code that allows municipalities to restructure their obligations. Under Chapter 9, the court provides protection from creditors to give municipalities time to file a plan of reorganization. The plan may allow some debts to be reduced or restructured so that the municipality can continue to function. The bankruptcy court can approve the plan and require creditors to comply with its terms.

Originally enacted in 1934 during the Great Depression, the U.S. Supreme Court upheld the code in 1938.

Because municipalities are instrumentalities of states, and federal control of states is limited under the 10th Amendment, the federal bankruptcy court has limited ability to interfere with municipalities' operations. The bankruptcy court cannot generally disapprove of a city's actions, require a city to curtail spending or cease the operation of a certain service or department. There is no ability to force the liquidation of municipalities' assets and subsequent distribution to creditors. Municipalities are for the most part perpetual entities — they cannot cease to exist as a private company can — and Chapter 9 recognizes this.

ELIGIBILITY REQUIREMENTS FOR FILING

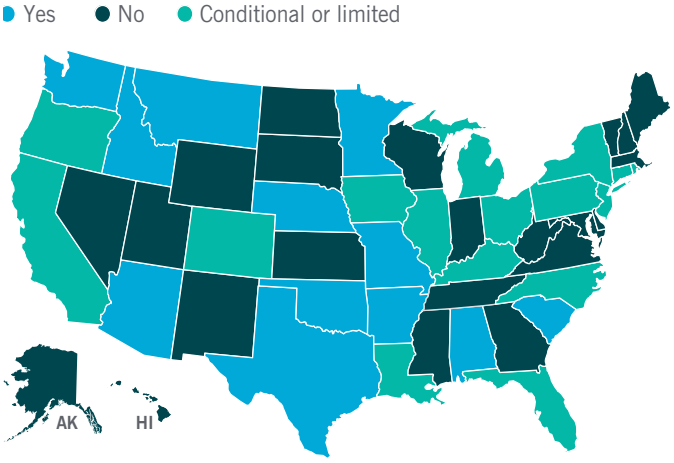
Chapter 9 applies only to municipalities, defined in the code as a "political subdivision or public agency or instrumentality of a state." States are not, however, authorized to file for bankruptcy protection under Chapter 9. For example, Vallejo, California, is authorized to file, but the state of California is not. An entity must meet the following requirements to file for Chapter 9:

A municipality must be specifically authorized to file by its home state; silence on the matter means municipalities within the state cannot file. More than half of the states (28) have passed legislation authorizing their local units of government to file for Chapter 9; 22 have not. Some states that permit Chapter 9 filing require specific, case-by-case permission from the state before a filing can proceed (e.g., Connecticut).

- The municipality must be insolvent, defined in the code as generally not paying debts or unable to pay debts when due.
- The municipality must want to file; Chapter 9 is voluntary, so a municipality cannot be forced into bankruptcy by its creditors.
- The municipality must have, among other things, attempted to negotiate with, but come to an impasse with, its creditors, or there must be a finding that such negotiations would be futile.

If an entity meets all these eligibility requirements, other considerations may impact a decision to file. A municipality might weigh the pros and cons of issues such as the stigma and cost of filing, impaired access to the capital markets, increased publicity and scrutiny, or potential problems created with vendors, creditors and employees, particularly those subject to collective bargaining agreements.

Not all states authorize Chapter 9 filing



Data sources: Nuveen and *Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies*; Spiotto, James E., Chapman and Cutler LLP, 2012.

STATE LEGISLATION RELATED TO CHAPTER 9 FILING

Although many states allow some or all their local municipalities to file Chapter 9, several have an intervention framework that allows the state to play an active role in preventing or allowing the filing or grant certain protections to creditors affected by the filing. States like Pennsylvania and Michigan have had these processes in place for some time. Other states, such as Rhode Island and California, have passed legislation specifically in response to recent filings or potential filings by local municipalities.

Michigan and Pennsylvania. Both Michigan and Pennsylvania have a process for financially distressed municipalities prior to filing for Chapter 9. Municipalities must go through a financial review by the state and be declared distressed. Then, there are multiple possible outcomes: the implementation of an emergency manager or state-appointed receiver, negotiation of consent agreements, and filing Chapter 9. If at any point an issuer pursues bankruptcy, both states may step in with further action. In Michigan, the state may place contingencies upon the government that files for bankruptcy, whereas in Pennsylvania, the state historically has had to approve the filing.

Rhode Island. In the face of a Chapter 9 filing by Central Falls, the state of Rhode Island passed the Fiscal Stability Act in May 2010, which established the state's role to intervene in financially ailing cities and towns. The result was a three-stage process for state intervention in stabilizing fiscally distressed communities.

The Rhode Island legislation goes further than any other state's by specifically placing general obligation bondholders at the front of the line when a municipality files for bankruptcy. Also, city officials who fail to budget for debt service can be held personally liable for the payment. In the case of Central Falls, the city filed for Chapter 9 bankruptcy protection, but principal and interest continued to be paid on time.

California. Prior to 2011, the state had no preconditions to a municipality filing for bankruptcy.

Following the filing of Chapter 9 by Vallejo, the state passed AB 506 with the intention of deterring municipalities from filing and possibly reducing the time and expense of a municipal bankruptcy. The legislation requires municipalities to enter mediation with bondholders, bond insurers, collective bargaining groups and retirees for 60 days and demonstrate good faith negotiation before filing Chapter 9.

In 2015, the state passed legislation (SB 222) that explicitly grants a statutory lien on voter-authorized general obligation bonds secured by property taxes issued by local agencies (i.e., cities, counties, school districts, community college districts, or other special districts). In approving this bill, California has codified general obligation bondholders' liens on revenues generated by the debt service levy, a notable protection in a Chapter 9 filing.

> ***Bankruptcy and default are not synonymous.*** *An entity can default on its debt without filing for bankruptcy and vice versa.*

TREATMENT OF CREDITORS

Bankruptcy and default are not synonymous. Filing for bankruptcy does not necessarily mean an entity will fail to pay its debts; conversely, an entity can default on its debt without filing for bankruptcy. In some cases, debtors have chosen to continue making payments on certain bonds after filing for Chapter 9. Like other types of bankruptcies, Chapter 9 creates an automatic stay of collection efforts by creditors, which means bonds may see payment interruption during a Chapter 9 case.

Special revenue bonds are bonds issued by municipalities for utilities and transportation systems. The bonds are backed by a lien on revenues of the systems. Historically, based on language in Section 928 of the bankruptcy code, many municipal market participants believed that bondholders had a lien on current and future revenues of the system and that lien would continue post-petition, that is after the bankruptcy filing. In addition, investors believed that special revenue bonds were exempt from the automatic stay and would continue to be paid during bankruptcy.

The bankruptcy code defines special revenues as those generated from transportation, utility or other services; special excise taxes imposed on particular transactions; tax increment financing (TIF) revenues; and taxes specifically levied to finance a project.

However, a ruling in 2018 during the Puerto Rico Highway and Transportation Authority's (HTA) proceedings under PROMESA refuted this view. The judge ruled that special revenue bonds were not required to be paid during the bankruptcy but could be paid should the municipality chose to do so. The U.S. Court of Appeals for the First Circuit upheld the ruling.

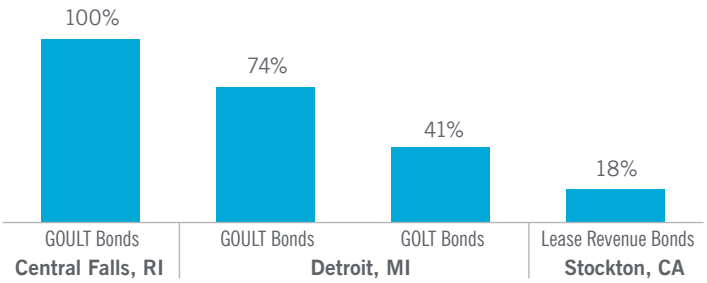
This decision could influence debtors with special revenue debt in the future. While this ruling is not binding on other courts, it could impact future bankruptcy proceedings since there is limited precedent from other Chapter 9 cases. The issue of whether the special revenue lien applies to future revenue was raised under HTA, although the parties settled before it was decided.

In March 2023, the bankruptcy judge in the Puerto Rico Electric Authority's (PREPA) proceedings ruled that the trust indenture for PREPA's special revenue bonds only granted bondholders a security interest in a sinking fund account, not in future utility revenues. This ruling is in contrast with the historically held view that a security interest in system revenues gave bondholders the rights to future revenues as well.

In June 2024, the U.S. Appeals Court for the First Circuit issued a ruling reversing several of the bankruptcy court's prior rulings on special revenue bonds and the PREPA bonds' security pledge. The appeals court ruled that the bonds in fact have a security interest in PREPA's net revenue, both current and future. The court also affirmed the market's general understanding of special revenue bonds, that is, that a lien on revenue continues after an issuer files for bankruptcy protection. The appellate decision was considered positive for the municipal market and special revenue bonds in general. Though positive, the decision potentially undermines the current bankruptcy restructuring plan and should prolong the PREPA bankruptcy process.

The market's municipal bankruptcy cases are limited, but serve to highlight that certain bond protections may be unclear or may not be as strong as initially perceived. For example, in Michigan, it is questionable whether unlimited tax bondholders benefit from a statutory lien on property taxes. In Detroit's bankruptcy case, the city and unlimited tax bondholders settled on a 74% recovery rate rather than having the security structure adjudicated. In Stockton's bankruptcy case, in contrast, the city did not have general obligation debt, but imposed steep haircuts on appropriation-backed debt. Bondholder recoveries for Puerto Rico's general obligation bonds are estimated to be around 70% but will ultimately be determined by the future payments of a contingent value instrument that was part of the negotiated settlement. Creditor recoveries

Treatment of creditors varies under plans of adjustment



Data sources: U.S. Bankruptcy Court, District of Rhode Island Case 11-13105; Oral Opinion on the Record, In re: City of Detroit, Bankruptcy Judge Steven Rhodes, 07 Nov 2014. GOULT: general obligation unlimited tax; GOLT: general obligation tax; U.S. Bankruptcy Court, Eastern District of California, Case 12-32118-C-9, Amended Opinion Regarding Confirmation and Status of CALPERS, 27 Feb 2015.

vary from case to case and depend in large part on the municipality's willingness to pay. Under Chapter 9, only the municipality has the ability to submit a plan of adjustment to the court. Creditors can object, but they cannot submit a competing plan. Furthermore, although municipalities in Chapter 9 can reject collective bargaining agreements and retirement benefits, they are not required to do so. As evidenced by the variety of outcomes across similar creditor groups, the plans of adjustment can be influenced by a number of factors. It is up to the court to approve the reorganization plan, but only if certain conditions are met, including that the plan is feasible and would be in the best interest of creditors. However, determining whether a plan is in the creditors' best interests leaves room for interpretation.

CREDIT RESEARCH REMAINS KEY

Although it is used infrequently, Chapter 9 provides a framework for eligible distressed municipalities to bind creditors to a restructuring plan. Since that plan is formed by the issuer, it is difficult to predict potential outcomes for various creditor classes, particularly since few filings have been fully litigated. Fundamental credit research of distressed municipalities must be done on a case-by-case basis when looking for value in this market.

For more information, please visit nuveen.com.

Sources

"Bankruptcy Basics – Chapter 9," the Federal Judiciary.

"Municipalities in Distress?: How States and Investors Deal with Local Government Financial Emergencies" Spiotto, James E., Chapman and Cutler LLP, 2012.

"Avoiding and Using Chapter 9 in Times of Fiscal Stress," Orrick Herrington.

PACER (Public Access to Court Electronic Records).

Endnotes

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