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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. Bond investors may fear an uptick in filings in light of the challenges caused by the COVID-19 pandemic. Of course, the federal government's coronavirus state and local fiscal recovery funds are providing substantial support to offset the negative impacts. 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. Last year, two municipalities filed under Chapter 9 and thus far in 2021, three have 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 some provisions of Chapter 9. Puerto Rico's debt restructuring process remains ongoing, though the territory may be able to exit bankruptcy sometime in 2022 based on the current schedule.

Only three cities have filed for bankruptcy protection since Detroit's historic case in 2013. Most recently in May 2020, the city of Fairfield, Alabama, filed for Chapter 9 after years of financial challenges. 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.

These situations are not unique among bankruptcy filers. 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, since most municipal

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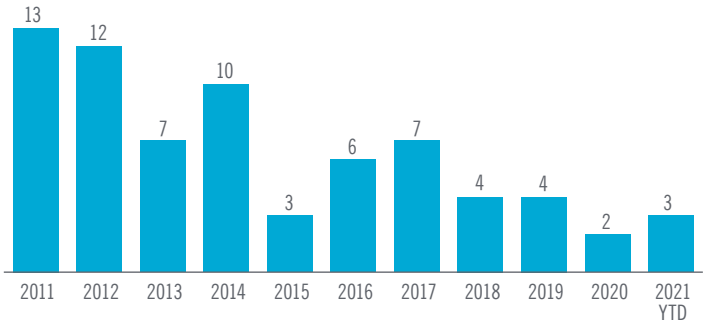
bankruptcy cases have come from hospitals, utilities and special purpose districts.

Municipal Chapter 9 filings remain rare

Number of bankruptcy filings



Data source: PACER, 30 Sep 2021.

BACKGROUND ON CHAPTER 9

History has shown that in times of severe stress, municipal issuers need a framework by which to restructure their obligations. Chapter 9 is the section of U.S. bankruptcy code that allows them to do so under bankruptcy protection. Municipalities cannot file under any other chapter, and in some states they may not be permitted to seek bankruptcy protection at all.

Originally enacted in 1934 during the Great Depression, Chapter 9 faced some hurdles relating to the powers of federal and state government. Federal law governs the bankruptcy code, and Chapter 9 was deemed unconstitutional in 1936 for impeding states' rights. After Congressional modification, the U.S. Supreme Court upheld the code in 1938.

Chapter 9 recognizes the issue of state versus federal control under the 10th Amendment, so the federal bankruptcy court has limited ability to interfere with municipalities' operations. The bankruptcy court cannot generally approve or disapprove of a city's actions, or 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 a "political subdivision or public agency or instrumentality of a state." It does not authorize states themselves to file bankruptcy. As an example, Vallejo, California, is authorized to file, but the state of California is not.

An entity must meet these requirements to file for Chapter 9:

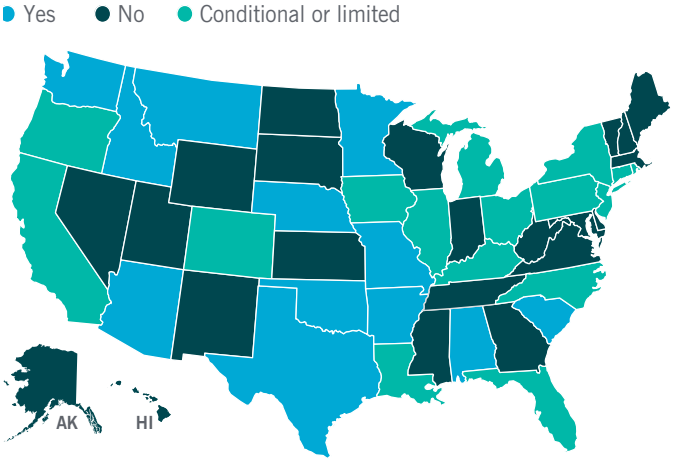
- A municipality must be specifically authorized to file by its home state; silence on the matter means municipalities within the state cannot file. More than half of the states (28) have passed legislation authorizing their local units of government to file for Chapter 9; 22 have not. Some states that 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.
- 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 of 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.

STATE LEGISLATION RELATED TO CHAPTER 9 FILING

Although many states allow some or all of their local municipalities to file Chapter 9, several

Not all states authorize Chapter 9 filing



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

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. Following this, there are multiple possible outcomes: the implementation of an emergency manager or state-appointed receiver, negotiation of consent agreements, and many others, including 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, 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 amount of 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. California's actions have been more hands-off. 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. Although, 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.

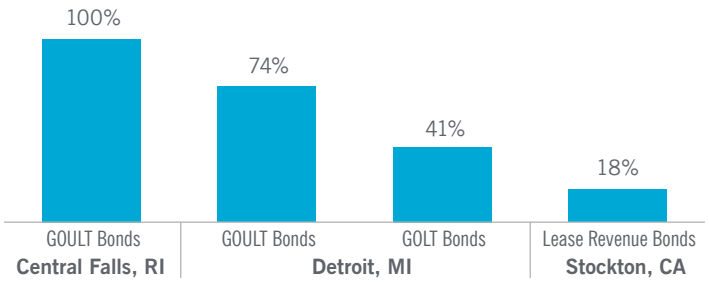
The bankruptcy code defines special revenues as those generated from transportation, utility or other services; special excise taxes imposed on particular transactions; tax increment financing (TIF) revenues and taxes specifically levied to finance a project.

Historically, many municipal market participants believed that special revenue bonds were exempt from the automatic stay. However, a ruling in 2018 during the Puerto Rico Highway and Transportation Authority's proceedings under PROMESA undermined this view. The judge ruled that special revenue bonds did not qualify for an exception under the bankruptcy clause. The U.S. Court of Appeals for the First Circuit upheld the ruling and the U.S. Supreme Court declined to hear an appeal, so this decision could affect all municipal special revenue debt. 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.

In some instances, the bonds' 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. Ultimately, creditor recoveries vary from case to case and depend in 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.

Treatment of creditors varies under plans of adjustment



Data source: 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, November 7, 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, February 27, 2015.

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. http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter9.html

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Endnotes

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