EXPLORING THE CHAPTER 9 OPTION FOR OREGON'S MUNICIPALITIES

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I. INTRODUCTION

The City of Detroit's bankruptcy filing has shined a bright light on Chapter 9 of the federal bankruptcy code. Since the Great Recession of 2008, subnational governments have operated with growing budgetary shortfalls and unfunded pension obligations. While all levels of government have felt the effects of a new financial reality, local governments have borne the brunt. Cities and counties provide the bulk of essential services to state residents. Demand for these services has spiked since the Great Recession, but funding is disappearing.[1] The vast majority of cities and counties are experiencing declining tax revenues coupled with increased costs related to debt financing, health care, and pension benefits for employees.[2]

In Oregon, the loss of timber subsidies has caused particular financial distress in certain counties, forcing these counties to cut back public safety and social services.[3] Local government has all but disappeared in these counties. In light of recent county and city bankruptcies throughout the country, many states are considering whether federal bankruptcy is an appropriate and effective mechanism for addressing local government distress.

Chapter 9 of the federal bankruptcy code addresses municipal bankruptcy. At its core, Chapter 9 is a collective debt-adjustment mechanism that enables a municipality to modify its debt obligations over the objections of recalcitrant creditors, including bondholders, current employees and retirees, and private companies that contract with the municipality. Chapter 9 offers distressed municipalities a

1. *See* RICHARD RAVITCH & PAUL A. VOLCKER, REPORT OF THE STATE BUDGET CRISIS TASK FORCE 53–56 (July 17, 2012), *available at* http://www.statebudgetcrisis.org/wpcms/wp-conte nt/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

2. *See id.*

3. Vekshin, Alison, *Spotted Owl Listing Pushes Oregon County Near Insolvency*, BLOOMBERG, June 28, 2013, http://www.bloomberg.com/news/2013-06-28/spotted-owl-listin g-pushes-oregon-county-near-insolvency.html.

host of debt-relief mechanisms that can be employed with the ultimate goal of formulating a plan of adjustment that restructures existing and future debt obligations. In bankruptcy court, a municipality can disallow creditor claims and enter into new agreements with third parties on a prospective basis. The plan is adopted in federal bankruptcy court pursuant to federal law, and limitations imposed by state constitutional prohibitions on the impairment of contracts generally do not apply.[4]

Notwithstanding the power that Chapter 9 gives to distressed municipalities, it is currently unavailable in many states in the United States. In recognition of the Tenth Amendment to the U.S. Constitution and federalism principles, Chapter 9 is only available in states whose legislatures have expressly allowed its municipalities to file for Chapter 9. In other words, state law exclusively governs the ability of a municipality to file for Chapter 9. Local governments are instrumentalities and extensions of the state sovereign and cannot appear before a federal bankruptcy judge without the state sovereign's express consent, which is most often given by legislative action.

The Oregon legislature has not made Chapter 9 available to Oregon's cities and counties. In Oregon, only irrigation and drainage districts can file for Chapter 9.[5] This decision–or potential oversight–is unfortunate. Local governments lose a powerful restructuring

4. Chapter 9 allows a municipality to radically readjust the liability side of its balance sheet, but the process is no panacea. Federal bankruptcy law does not directly resolve the revenue challenges of a municipality, including the loss in property values during the 2008 Great Recession. And the process is resource draining and protracted.

5. Irrigation and drainage districts are expressly authorized to file for Chapter 9 under Oregon law. OR. REV. STAT. § 548.707 (2013). Over the past hundred years, there are only two Chapter 9 cases of record in Oregon. *See In re* Summer Lake Irrigation Dist., 33 F. Supp. 504 (D. Or. 1940); *In re* Grants Pass Irrigation Dist., 33 F. Supp. 507 (D. Or. 1940). In both cases, the Oregon District Court addressed the constitutionality of a debt adjustment plan under Oregon law. In *Grants Pass*, the court considered whether the Oregon statute was void for authorizing the impairment of contracts in contravention of article I, section 10, clause 1 of the U.S. Constitution, whether the federal statute (Chapter IX) violated the sovereignty of Oregon, and whether Chapter IX violated the Fifth Amendment. 33 F. Supp. at 507–08. In *Summer Lake*, the court addressed the same questions and ruled that Chapter IX was constitutional and that Oregon had consented to Chapter IX jurisdiction and adjudication for its irrigation and drainage districts. 33 F. Supp. at 505–06. These arguments ring a familiar bell in that they were made seventy-five years later in the city of Detroit during its eligibility hearing. *In re* City of Detroit, 504 B.R. 97 (Bankr. E.D. Mich. 2013). In the case of the city of Detroit, Judge Rhodes' ruling did not deviate from the rulings in Grants Pass and Summer Lake. Judge Rhodes held that (i) state law authorizing municipalities to file for Chapter 9 protection is constitutional, notwithstanding constitutional prohibitions on impairment of contract and pension obligations, and (ii) Chapter 9 did not violate a state's sovereignty. *Id.*

option and significant bargaining leverage in their negotiations with bondholders, current employees and retirees, and other creditors. We believe that Chapter 9 should be one component of a state process that enables Oregon's cities and counties to modify their financial obligations and reorganize their operations in the face of financial distress. Failure to do so is a failure of preparedness.

In Part II, we discuss the problems currently facing subnational governments. Part III delineates the surprisingly limited and ineffectual debt restructuring options under Oregon state law. Part IV is an exploration of the history and nuances of Chapter 9 of the federal bankruptcy code. Chapter 9 is a complicated and perilous process, but it offers meaningful relief. This part explains Chapter 9's key provisions and benefits. In Part V, we outline the framework for a state process by which distressed municipalities can receive authorization to file for Chapter 9 protection.

Ultimately, this article seeks to encourage the Oregon state legislature to implement a mechanism that allows a municipality to seek protection under federal bankruptcy law as an option of last resort. In the event that out-of-court creditor concessions prove elusive, a municipality must have the ability to seek unilateral debt adjustment. Without this threat, municipalities face creditors who are disincentivized to entertain consensual, out-of-court debt adjustment. We believe that allowing Oregon municipalities to file for Chapter 9 will give local government the leverage necessary to achieve meaningful consensus and effect significant reform.

II. Municipalities and the Current Landscape in Oregon

The Great Recession's fiscal ramifications did not immediately affect municipalities. Municipalities were initially able to rely on intergovernmental aid–comprised of grants, transfers, and other funds a municipality receives from federal, state, county, or other local governments through ongoing revenue-sharing agreements and one-time infusions.[6] The American Recovery and Reinvestment Act ("ARRA") was signed in 2009 as a short-term stimulus bill seeking to infuse $787 billion into the economy; a significant portion of these funds represented direct aid to states, funds that often times went to

6. *See* The Pew Charitable Trusts, America's Big Cities in Volatile Times: Meeting Fiscal Challenges and Preparing for the Future 2–3 (2013) [hereinafter Meeting Fiscal Challenges], *available at* http://www.pewtrusts.org/~/media/Assets/2013/11/11/AmericasBigCitiesinVolatileTimes.pdf.

localities.[7] In fact, states have historically funded on average close to one-third of local budgets.[8] Funding through the ARRA helped stabilize localities for a brief period of time, but the ARRA and other measures have merely served to delay the day of reckoning. By 2010, state aid to municipalities decreased by $12.6 billion from the previous year and decreased again in 2011, and 2012.[9] Specifically in Oregon, state aid to municipalities has steadily decreased since 2007.[10]

The cessation of federal timber payments further complicates this dynamic for Oregon municipalities. The federal government owns more than 50% of the land in Oregon.[11] In 2000, the federal government began limiting logging on its Oregon land.[12] In order to compensate counties that lost revenue due to this policy shift, the government agreed to pay affected counties a subsidy. The federal government provided timber payments to eligible Oregon counties to account for the (i) "loss of property tax revenue, which results from an inability to impose taxes on federally owned forest lands," and (ii) "reduction in the amount of logging allowed on federal forest lands."[13] These funds were typically earmarked for schools or road maintenance, but some portion was available for general operating

7. *See* WHITE HOUSE ADMINISTRATION, ANNUAL REPORT TO THE PRESIDENT ON PROGRESS IMPLEMENTING THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, 1ST ANNUAL REPORT, CHAPTER 1: THE YEAR IN REVIEW, ECONOMIC REVIEW OF THE RECOVERY ACT, ¶ 11 (2010), http://www.whitehouse.gov/recovery/anniversary/Chapter1.

8. THE PEW CHARITABLE TRUST, THE LOCAL SQUEEZE: FALLING REVENUES AND GROWING DEMAND FOR SERVICES CHALLENGE CITIES, COUNTIES, AND SCHOOL DISTRICTS, at 5–6 (2012), [hereinaftert THE LOCAL SQUEEZE] *available at* http://www.pewtrusts .org/~/media/Assets/2012/06/Pew_Cities_Loc al-Squeeze_report.pdf ("Many states provide grants [to localities] for general operations; in other cases, money is set aside for certain uses, such as road repair. States also sometimes share a portion of tax revenue with cities, counties, and school districts based on factors like population, need, and the community's existing tax burden.").

9. *See id.* at 4, 7 (In 2011, Nebraska cancelled all funding to cities and counties. And in Maryland, state aid to counties and municipalities dropped 60% from 2007 to 2012).

10. *Fiscal Challenges for Oregon's Cities*, ECONORTHWEST, Sept. 2011, at 5, *available at* (2011). http://www.orcities.org/Portals/17/Publications/SpecialPubs/Fiscal_Challenges _fo r_Oregon_Cities_FINAL.pdf.

11. CONGRESSIONAL RESEARCH SERVICE, FEDERAL LAND OWNERSHIP: OVERVIEW AND DATA 5 (2012), http://www.fas.org/sgp/crs/misc/R42346.pdf.

12. *See* STATE OF OREGON, SECRETARY OF STATE AUDITS DIVISION, OREGON'S COUNTIES: 2012 FINANCIAL CONDITION REVIEW 9 (2012) [hereinafter FINANCIAL CONDITION REVIEW].

13. *Id.*

expenditures.[14] Eighteen Oregon counties have received federal timber payments.[15] The subsidies approximated $250 million per year from 2000 to 2007, but have been diminishing every year since.[16] The subsidies ended in 2013.[17] The loss of these payments has put additional pressure on these counties–especially those that relied heavily on the payments, including Josephine, Douglas, Curry, Coos, and Jackson counties.[18]

Declining intergovernmental aid has been coupled with declining property tax collections. Property tax revenue had been a stalwart for municipalities during previous economic downturns.[19] But the imploding housing market precipitated the Great Recession and an unprecedented fall in home prices decimated county coffers. Between 2007 and 2011, home prices fell almost 20% nationally, with states like Arizona and Nevada harder hit.[20]

Unfortunately, at a time where revenues are declining, costs are rising. In 2009, municipalities spent more than 35% of their budget expenditures on salaries and wages.[21] City and municipal budgets face rising labor costs in the form of salaries and wages, as well as pensions and daunting employee-related costs for long-term health care for retired employees. In fact, health benefit costs and pension costs have steadily increased for the vast majority of municipalities.[22] Meaningful reductions in these expenditures are elusive. In addition, as the Great Recession unfolded, demand for the free services that municipalities provide spiked, particularly health and human services and public safety. Indeed, municipalities fund public welfare programs that provide "cash or food assistance, healthcare, low-

14. *Id.*

15. These counties are Josephine, Douglas, Curry, Coos, Jackson, Lane, Polk, Benton, Columbia, Klamath, Linn, Clackamas, Tillamook, Yamhill, Marion, Lincoln, Washington, and Multnomah. *Id.*

16. *See id.*

17. Richard Lardner, *Forest Service to States: Give Timber Subsidies Back,* ASSOCIATED PRESS, May 3, 2013, *available at* http://news.yahoo.com/forest-states-subsidies-back-073739062.html.

18. *See* 2012 FINANCIAL CONDITION REVIEW, *supra* note 12, at 21–26, 31–36, 41. The numbers show that 24.2% of Josephine County's, 22.4% of Douglas County's, 17.7% of Curry County's, 15.1% of Coos County's, and 10.6% of Jackson County's 2011 budget was comprised of federal timber payments. *Id.* at 9.

19. *See* THE LOCAL SQUEEZE, *supra* note 8, at 8–9.

20. *See id.* at 9.

21. *Id.* at 13.

22. *See* MICHAEL A. PAGANO & CHRISTIANA MCFARLAND, NAT'L LEAGUE OF CITIES, RESEARCH BRIEF ON AMERICA'S CITIES: CITY FISCAL CONDITIONS IN 2013, at 5–6 (2013).

income housing, and workforce development."[23] From 2007 to 2010, the number of Americans in poverty increased 14%, increasing the demands for municipality-provided services.[24]

Municipalities have tried a number of ways to strengthen their balance sheets but have found limited success. Municipalities are ill-equipped to create new revenue streams to combat these shifts. Forty-six states severely limit a municipality's ability to increase taxes.[25] There are also political obstacles. Elected officials are prone to eschew tax increases in favor of less controversial revenue-generating measures, such as raising fees that are applied to city services.[26] But these fee increases often fail to generate significant funds. Even in states that have the option of increasing taxes, the imposition of higher taxes may only serve to decimate the tax base. Indeed, macro migration trends demonstrate that the U.S. population is shifting out of large, northeast city centers, and migrating to southern and western areas.[27] These trends shrink tax bases in affected areas. Further, tax increases arguably accelerate these trends and eviscerate the benefit of a tax increase.

Access to debt markets is also restricted. Like most states, Oregon caps the amount of bonded indebtedness a municipality can incur at any given time. A county may not issue general obligation bonds exceeding 2% of the real market value of taxable property in the county.[28] A county may not issue revenue bonds exceeding 1% of the real market value of all taxable property in the county.[29] To finance pension obligations, a county may issue revenue bonds so long as they do not exceed 5% of the real market value of the county's taxable property.[30] Cities likewise have bond borrowing limits. Cities cannot issue general obligation bonds exceeding 3% of the real market value of taxable property in the city.[31] In addition, municipalities must have a statutory or home rule charter grant of

23. *See* THE LOCAL SQUEEZE, *supra* note 8, at 14.

24. *Id.*

25. *See id.* at 11.

26. *See* MICHAEL A. PAGANO & CHRISTIANA MCFARLAND, *supra* note 22, at 5–6.

27. *See* Karen Weise, *Austin is the New Brooklyn*, BLOOMBERG BUSINESSWEEK (Apr.10, 2014), http://www.businessweek.com/articles/2014-04-10/asutin-tex-dot-gains-from-urban-flight-to-second-tier-metro-areas.

28. OR. REV. STAT. § 287A.100(2) (2013).

29. *Id.* § 287A.105(1).

30. *Id.* § 238.694(4).

31. *Id.* § 287A.050(2).

power to borrow money.[32]

Attempts to reduce labor costs have generally been ineffective. Collective bargaining agreements severely limit attempts at reducing headcount or benefits. Municipalities invariably wind up instituting hiring freezes and then making minor reductions in headcount.[33] But these cuts offer marginal relief, accounting for only a 3.4% reduction in workforce between September 2008 and December 2011.[34] Collective bargaining agreements also limit attempts to reduce health care and pension benefits. Further, as detailed below, state law compels many municipalities to make pension contributions to general funds regardless of constrained budgets.

Municipalities that had cash reserves in 2007 invariably accessed these funds as the Great Recession unfolded and now face depleted buffers. For example, Sacramento tapped cash reserves beginning in 2007.[35] At that time, the reserve balance was 31% of general revenue. By 2011, the reserve was down to just 6% of general revenue.[36] Sacramento, as well as the vast majority of other municipalities, cannot rely on its cash reserve to address future fiscal challenges.

Confronted with this brave new world, municipalities have taken desperate measures. Some municipalities have decided to sell government assets and privatize government functions, including parking enforcement, park maintenance, graffiti removal, collection of delinquent taxes, and operation of public venues, including zoos.[37] In March 2010, New Jersey appointed a Privatization Task Force that sought to evaluate the viability of privatization.[38] Unfortunately, the vast majority of these transactions are characterized by short-term cash infusions that produce either excessive future expenses or a disproportionate loss of future revenue. For example, in late 2010, Newark opted to sell and then lease back sixteen of the city's buildings, including its police and fire headquarters and symphony

32. *See id.* § 287A.

33. *See* PAGANO & MCFARLAND, *supra* note 22, at 6.

34. *See* MEETING FISCAL CHALLENGES, *supra* note 6, at 13.

35. *Id.* at 16.

36. *Id.*

37. *See* Ianthe Jeanne Dugan, *Facing Budget Gaps, Cities Sell Parking, Airports, Zoo*, WALL ST. J., Aug. 23, 2010, http://online.wsj.com/news/articles/SB20001424052748703960004575427150960867176.

38. 42 N.J.R. 690(a) (2010).

hall.[39] The sale yielded $74 million for the city, but leasing the buildings back will cost the city $125 million over the next twenty years.[40] Chicago leased its parking meter system to a consortium led by Morgan Stanley in order to balance its budget.[41] Chicago received $1.16 billion from its parking meter lease, but the consortium is now expected to make more than ten times that amount over the course of the seventy-five year deal.[42] Further, these one-time sales temporarily fill budgetary gaps but fail to produce any structural reform that improves the municipality's viability.

Against this backdrop, Oregon municipalities, as well as municipalities in other states, are forced to seek some mechanism that will allow for systemic debt restructuring. Unfortunately, state law offers few options.

III. MUNICIPAL DEBT ADJUSTMENT AND REORGANIZATION UNDER OREGON LAW

An Oregon municipality that cannot service its existing debt load has few meaningful options under state law. The municipality can (i) borrow its way out of its liquidity crisis, assuming it remains below debt caps under state law and has access to the capital markets, (ii) negotiate consensual concessions and compromises from its bondholders, trade vendors, current employees and retirees, among other creditors, which, in the absence of a binding mechanism, may be impossible, (iii) cut municipal operating expenses, which may compromise the municipality's mandate and impair its ability to function on behalf of the public's interest, and (iv) raise taxes. None of these options are necessarily easy to implement, and depending on a municipality's challenges, a number of them may need to be simultaneously employed. Increasing taxes may be politically impossible or prohibited by state law, and even where a tax increase is accomplished, revenues may continue to decline as the increase accelerates tax-payer flight to other localities. The obstacles to a consensual write-down of debts are self-evident. And borrowing

39. Michele Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1167–68 (2014).

40. *Id.*

41. *See* Darrell Preston, *Morgan Stanley Group's $11 Billion Makes Chicago Taxpayers Cry*, BLOOMBERG, Aug 8, 2010, http://www.bloomberg.com/news/2010-08-09/morgan-stanley-group-s-11-billion-from-chicago-meters-makes-taxpayers-cry.html.

42. *See id.*

money to fill budgetary gaps fails to address structural deficiencies.

And then there is the constitutional problem. Article 1, § 10 of the U.S. Constitution provides that "[n]o State shall . . . pass any . . . Law impairing the Obligation of Contracts . . . ."[43] Referred to as the "Contracts Clause," this prohibition limits a state's ability to impair existing contractual obligations.[44] Some state constitutions contain the state's own version of the contracts clause. But all state provisions invariably mirror the federal Contracts Clause, and the standard of review is similar for both.[45] Indeed, Oregon's constitution prohibits the impairment of contractual obligations. Article I, Section 21, of the Oregon Constitution ("Oregon Contracts Clause") states that "[n]o . . . law impairing the obligation of contracts shall ever be passed."[46] Oregon state courts have supported the clause's fidelity. State courts have ruled that the clause applies to both statutory and private contracts.[47] Consequently, Oregon municipalities have few meaningful state law restructuring options, and attempts to achieve sustainable viability have been frustrated.[48]

43. U.S. CONST. art. I, § 10, cl. 1. The full clause reads:

> No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

The Contracts Clause originally read: "No State shall . . . pass any . . . laws altering or impairing the obligation of contracts . . . " The words "altering or" were removed without comment. *See* Robert C. Palmer, *Obligations of Contracts: Intent and Distortion*, 37 CASE W. RES. L. REV. 631, 644 (1987).

44. The Contracts Clause is frequently interpreted to be an absolute bar on a state's ability to pursue unilateral contract modification. But this interpretation is incorrect. The judiciary has recognized myriad exceptions to the Contracts Clause. *See, e.g.*, Home Building & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934); *see also* Allied Structural Steel Co. v. Spannus, 438 U.S. 234 (1978); U.S. Trust Co. v. New Jersey, 431 U.S. 1 (1977); UAW v. Fortuno, 633 F.3d 37 (1st Cir. 2011); Buffalo Teachers Federation v. Tobe, 464 F.3d 362 (2d Cir. 2006); Baltimore Teachers Union v. Mayor of Baltimore, 6 F.3d 1012 (4th Cir. 1993).

45. *See* Amy B. Monahan, *Statutes As Contracts? The "California Rule" And Its Impact On Public Pension Reform*, 97 IOWA L. REV. 1029, 1040 (2012); 16B Am. Jur. 2d Constitutional Law § 753 (2012) ("Generally, the federal and state constitutional guarantees against the impairment of contractual obligations are interpreted essentially identically and given the same effect.").

46. U.S. CONST. art. I, § 10, cl. 1. Unlike the constitutional prohibition under the U.S. Constitution, Oregon's courts have not adopted a balancing test to determine whether a law that impairs contractual obligations is constitutional.

47. Eckles v. State, 760 P.2d 846 (Or. 1988); Hughes v. State, 838 P.2d 1018, 1024 (Or. 1992) (PERS contact is statutorily-based, and cannot be impaired without breaching it).

48. For example, in *City of Enterprise v. State*, 69 P.2d 953 (Or. 1937), the Oregon

Further complicating this problem is the fact that, as noted above, the state has not allowed its municipalities to seek protection in the federal bankruptcy courts.

A. Pension Obligations in Oregon

1. Public Pensions are Contracts Under Oregon Law

Since 1945, Oregon has provided its public employees with a host of retirement benefits.[49] And state courts have attempted to insulate these benefits from unilateral modification.[50] For unionized employees, pension benefits will generally be offered pursuant to collective bargaining agreements. For non-union employees, if an employer offers benefits to an at-will employee and the employee accepts, a unilateral contract exists, and if the offer contains a promise of a future benefit, the employee's right to the benefit accrues upon acceptance.[51]

Oregon courts have consistently recognized the obstacles to unilateral modification of employment contracts by the state or one of its municipalities.[52] In fact, absent employee consent to adjust these

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Supreme Court struck down a 1933 statute that authorized the circuit court to appoint an administrator for a municipality that had defaulted on contractual debt. The statute, known as the Municipal Administration Act provided that "[a]ny county, city, school district, port or water district having a population of less than 100,000 inhabitants that has defaulted for a period of six months in payment of a judgment or any contractual indebtedness is subject to the act." *Id.* at 954. The Act empowered the administrator to liquidate and modify contractual obligations of the municipality with state court approval. The City of Enterprise filed a petition under the Act. Holders of city notes, including the State of Oregon, the State Bond Commission, and State Treasurer all appealed the city's petition to the Oregon Supreme Court, which held that the Act violated the separation of powers provision in section 1 of Article III of the Oregon Constitution. *Id.* at 958.

49. Strunk v. Public Employees Retirement Board, 108 P.3d 1058, 1068 (Or. 2005).

50. "'[Employee] pension plans, whether established by law or contract, create a contractually based vested property interest which may not be terminated by the employer, except prospectively.'" James v. Clackamas Cnty., 259 P.3d 995, 999 (Or. Ct. App. 2011) (brackets in original; citation omitted).

51. *See* Taylor v. Multnomah Cnty. Deputy Sheriff's Ret. Bd., 510 P.2d 339, 342 (Or. 1973) (by tendering part performance under the pension plan, the employee established contractual rights under the plan that could not be taken away, provided she completed performance); *see also* Watkins v. Josephine Cnty., 259 P.3d 79, 82 (Or. Ct. App. 2011).

52. Oregon courts have found no exception to the prohibition, even where the impairment is in the public interest or is not substantial. *See* Strunk v. PERB*,* 108 P.3d 1058, 1094 (Or. 2005) ("this court has yet to determine whether substantiality of an impairment of a contractual obligation is required to show a violation of *Article I, section 21*"). However, the Oregon Supreme Court is unlikely to apply such a rigid test if faced with a challenge to an out-of-court debt adjustment plan consented to by a substantial majority of a municipality's

liabilities, a municipal employer in Oregon may bear the burden of these obligations even if it lacks the resources to pay them.

The majority of Oregon municipalities participate in PERS. For these municipal employers, the PERS contract is statutory and runs between the municipality as employer and its respective employees. As with local governments managing their own pension systems, governments that participate in PERS are obligated to fund PERS retirement benefits.[53] Oregon state law does not contemplate any exception to this obligation.[54] In fact, there is no mechanism under Oregon state law that allows a PERS-participating municipality to terminate its participation in PERS.[55]

Furthermore, Oregon law supports the premise that an employee's contract right to pension benefits becomes vested at the time of his or her acceptance of employment.[56] Under Oregon state law, the public employees of PERS-participating employers become PERS members upon completing six months of uninterrupted service.[57] At that time of vesting, the promise of a state-law defined public pension is binding on the municipal employer.[58] Public employers who, pursuant to collective bargaining agreements or otherwise, have agreed to undertake the employee contribution obligation to the Public Employees Retirement Fund ("PERF") are thereby contractually bound. "Participating PERS employers provide and fund the benefits; PERF and PERB act as a conduit through which those benefits pass."[59] A covered employee or Public Employees Retirement Board ("PERB") may bring an action against the employer for failure by the municipal employer to meet its attendant obligations—including the employer contribution to the

creditors if (i) the plan is arguably fair and equitable and (ii) the objecting hold-outs would receive much less if the plan is not fully implemented by the municipality or essential services will not be provided to residents. In the face of a public emergency, it is hard to see how the Oregon Supreme Court would not allow for an exception to the prohibition on contractual impairment. That said, to date, none has ever been granted.

53. *See* Stovall v. State, 922 P.2d 646, 663 (Or. 1996).

54. In *Stovall*, the Oregon Supreme Court ruled that the local governments participating in PERS provide and fund the benefits and that the Public Employee Retirement Fund ("PERF") acts merely as a conduit through which those benefits pass. *Id.* The local government employers are liable for any breach of those benefits. *Id.* at 664.

55. The Oregon legislature does not appear to have authorized municipalities to withdraw from PERS.

56. Hughes v. State, 838 P.2d 1018, 1029 (Or. 1992).

57. OR. REV. STAT. § 238.015(1) (2013).

58. Or. State Police Officers' Ass'n v. State, 918 P.2d 765, 771 (Or. 1996).

59. *See Stovall*, 922 P.2d at 663.

PERF.[60]

Ultimately, the promise of a public pension is binding at the time of the employee's acceptance, thereby imposing significant future and unliquidated, and most likely, unfunded, obligations on the state and its cities and municipalities.[61]

2. Legislative Reform Has Been Drawn-Out and Difficult

Oregon political leaders have been able to circumvent the Oregon Contracts Clause by making prospective adjustments to the PERS contract.[62] These changes have been largely limited to modifications affecting new employees.[63] In 2003, the state legislature passed the PERS Reform and Stabilization Act of 2003 ("2003 Reform Act"). The 2003 Reform Act made significant changes to PERS by: (i) directing all employee-member salary contributions after January 1, 2004, to an individual account program, (ii) altering how PERS credited earnings to Tier 1 members, (iii) prohibiting members from making further contributions to the variable annuity account program, (iv) temporarily suspending COLAs for Tier 1 members, and (v) permitting erroneously paid benefits to be recouped from future PERS earnings as administrative expenses. But the Oregon Supreme Court voided the provision in the 2003 Reform Act that eliminated the annual assumed earnings rate credit to Tier 1 members' regular accounts on the grounds that the change reflected an impairment of the obligations of the statutory

60. OR. REV. STAT. §§ 238.655, 238.705, 238.710.

61. The fact that there is no separate pension clause in the Oregon Constitution that protects the impairment of municipal pension obligations should not, in and of itself, entitle retirees to any less protection under the Oregon Contracts Clause than if there was a separate pension clause. The Bankruptcy Court for the Eastern District of Michigan recently opined on the effect of the Michigan Constitution's pension clause in *In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich. 2013). The Court stated that the separate pension clause in the Michigan Constitution offered employees no additional protections from those protections already provided by the Michigan Constitution's contracts clause. *Id.* at 118–27. The pension obligations of Michigan's municipalities were constitutionally protected by the contracts clause in the Michigan Constitution, and the existence of a separate pension clause did not entitle pension benefits to heightened protections from contract benefits. *Id.*

62. Most recently, the Oregon legislature passed Senate Bill 861, which modified cost-of-living adjustments (COLAs) for retirees under PERS, and Senate Bill 862, which modified the calculation of the final average salary for PERS members and removed future legislators from PERS.

63. The Oregon Supreme Court has, in fact, invalidated parts of passed legislation that modified existing benefits for employees.

PERS contract in violation of the Oregon Contracts Clause.[64] Furthermore, in *Strunk*, the Oregon Supreme Court ruled that the suspension of the COLAs to retirees' fixed serviced retirement allowances violated the PERS statutory contract.[65]

The existing case law on the 2003 Reform Act demonstrates that any meaningful reform analysis requires a comprehensive understanding of the contours of the PERS contract and contractual impairment.[66] But the scope and force of the PERS contract is not entirely clear. The legal analysis is nuanced and further complicated by temporal issues such as when certain benefits accrue and the permanence of the statutory promises that comprise PERS.[67] We believe that any discussion of contractual impairment must distinguish not only between future promises with respect to new employees and existing obligations relating to retirees and existing employees that may extend into the future, but also between future liabilities that have been funded and future liabilities that remain unfunded.[68] The executive and legislative bodies cannot be certain

64. Strunk v. PERB, 108 P.3d 1058 (Or. 2005).

65. *Id.* at 1064. At the same time, in 2006, the Ninth Circuit Court of Appeals rejected an argument that other provisions of the 2003 Reform Act violated the Contracts Clause in Article I, Section 10, of the United States Constitution. *See* Robertson v. Kulongoski, 466 F.3d 1114, 1119 (9th Cir. 2006) (ruling that state legislature did not promise that PERS would be maintained so that the Money Match remains the primary calculator of member service retirement allowances). And more recently, in *White v. PERB*, 268 P.3d 600, 608 (Or. 2011), the Oregon Supreme Court ruled that there is no statutory obligation on the part of PERB to credit accounts with more than the assumed earnings rate.

66. *See* Or. State Police Officers' Ass'n, 918 P.2d 765 (Or. 1996) (ruling that ballot measure 8 is void because the employer 6% pick up, the guaranteed assumed earnings rate and the inclusion of unused sick leave in the pension benefit are constitutionally protected terms of the PERS contract).

67. *See*, *e.g.*, Adams v. Schrunk, 488 P.2d 831 (Or. Ct. App. 1971) (contractual right established prior to completion of service).

68. There is an important distinction between pension liabilities that have been funded by the local government and pension liabilities that are unfunded, due either to the future maturity of the liability or an inability of the municipality to fund. In Oregon, government employers have no right to the funds in employees' and retirees' accounts that were contributed by employers on behalf of pension obligations. These funds are seen as property of the employees and retirees. In other words, a property right is coupled with the contractual right. The employee or retiree holds this property right and it cannot be taken by the employer without due process and fair consideration. *See, e.g.*, Amy B. Monahan, *Public Pension Plan Reform: The Legal Framework*, 5 Educ. Fin. & Pol'y 617 (2010). Employees and retirees are presumed to have a property interest in unfunded benefits as well, though that interest appears to be contingent on the municipality's ability to fund. Asset valuation is an art, not a science, thus the funded versus unfunded distinction will almost always be the subject of litigation as it involves speculative exercises of valuation. Property rights arguably attach to obligations that have been funded, and thus any impairment of already-funded obligations may require

that proposed legislative reform is constitutional without further guidance from the courts. This dynamic engenders paralysis that complicates reform efforts and delays the comfort that comes with finality and outcome certainty.

B. Impairment of Bonded Indebtedness in Oregon

Municipalities predominantly issue general obligation bonds and special revenue bonds. General obligation bonds are backed by a commitment of the municipality to levy ad valorem taxes to satisfy the bonds, and the bonds can be issued by Oregon's municipalities to finance capital construction or capital improvements upon the approval of the municipality's governing authority.[69] The municipality's full faith and credit back these bonds, but they are not supported by a pledge of property. Consequently, general bondholders are unsecured creditors who do not have a security interest in property owned by the municipal issuer.

Historically, general bondholders have not been deterred by the prospect of being unsecured creditors. Bonds are contracts that create municipal obligations that cannot be easily modified under state law. Further, there have been few bond defaults in Oregon's history that have not been consensually resolved. However, as discussed in more detail below, the unsecured nature of general obligation debt can place bondholders in a compromised position if a municipality defaults and the municipal borrower files for Chapter 9 protection. Under federal bankruptcy law, holders of general obligation bonds are on par with other unsecured debt holders, including trade creditors, employees, and retirees. This gives the municipality significant leverage over general bondholders that it does not otherwise have under state law.

Oregon's cities and counties can also issue special revenue bonds to finance special projects.[70] Unlike general obligation bonds, revenue bonds are secured by a pledge of a specific stream of income, most often a particular tax or fee generated by the project financed by the bonds themselves.[71] Typically, special revenue bonds are nonrecourse debt secured by pledges of income such as (i) receipts from the operation of water, sewage, waste, or electric systems, (ii)

consideration. *See id.*

69. OR. REV. STAT. §§ 287A.140, 287A.050 (2013).

70. *Id.* § 287A.150.

71. *See id.*

highway or bridge tolls, (iii) user fees, (iv) special excise taxes, including hotel/motel taxes, alcoholic beverage taxes, meal taxes and license fees, and (v) proceeds from other project financing. As discussed in further detail below, special revenue bondholders are secured creditors in a Chapter 9 bankruptcy case and are entitled to continue receiving payments on their bonds from the pledge of income during the postpetition period. In other words, the income constitutes the collateral of the bondholders notwithstanding the filing of the Chapter 9 case.

In addition to general obligation and revenue bonds, Oregon's municipalities are authorized to issue refunding bonds, which pay off existing bonded indebtedness.[72] The issuance of these bonds gives municipalities the ability to refinance existing bonded indebtedness.[73] Along with the statutory caps on permitted bonded indebtedness, which ensure that municipalities do not overleverage their balance sheets and tie up significant amounts of taxing and other revenues servicing bonded debt, refunding bonds give the municipality the ability to ensure sufficient liquidity to rollover existing indebtedness.

As with pension obligations, the Oregon Contracts Clause protects bonds and other types of debt instruments. Bonded indebtedness cannot be written down under state law without the express consent of the holders in accordance with the terms of the loan documents. As described below, this is not true in bankruptcy. If a municipal borrower filed for Chapter 9 protection, that municipality would be able to compromise existing unsecured bond debt on new payment terms. Further, a municipal debtor would only be required to pay holders of secured bond debt the value of their lien (rather than the face amount of the debt) on new payment and performance terms approved by the bankruptcy court.[74]

C. Absence of Debt Adjustment Mechanism Under Oregon Law

Oregon law does not provide a collective mechanism that enables cities and counties to adjust their existing debt load. Instead of focusing on debt deleveraging and operational reorganization, Oregon law has created a system of public borrowing caps and limitations on creditor attempts to enforce judgments.[75] These

72. *Id.* § 287A.360.

73. *See id.*

74. 11 U.S.C. § 1129(b)(2)(A).

75. OR. REV. STAT. §§ 30.260–300 (2013).

provisions ideally afford a distressed municipality additional time to address its financial difficulties. To that end, Oregon law exempts public property from execution to pay a debt or judgment.[76] A judgment creditor cannot execute on public property in Oregon. Consequently, judgment creditors' primary option is to file a mandamus action seeking to compel municipal officers to levy sufficient taxes to satisfy the judgment.[77] In the event the levy fails, the municipality can petition a court for an order requiring installment payments for a period of up to ten years, depending on the ability of the municipality to pay its debt and still carry out its essential governmental responsibilities.[78] If the municipality cannot pay within the ten-year period, there is no provision for extension or for forgiveness of the debt. In other words, a county facing a significant judgment may evade full satisfaction of the judgment by pleading insolvency. But the judgment cannot be written off.

In 2012, the Oregon legislature enacted legislation that addressed financial distress among its counties.[79] The legislature sought to assist troubled counties impacted by the recent loss of federal timber revenue. In particular, the law authorizes counties to declare a public safety services emergency by requesting in writing that the Oregon Criminal Justice Commission review and analyze the public safety services provided in the county.[80] If the Governor issues a public safety emergency, he or she must then establish a Fiscal Assistance

76. *See id.* § 18.345(1)(g); Eldredge v. Mill Ditch Co., 177 P. 939, 940 (Or. 1919); First Nat'l Bank of Idaho v. Malheur Cnty., 45 P. 781 (Or. 1896); Portland Lumbering & Mfg. Co. v. Sch. Dist. No. 1, 10 P. 350 (Or. 1886). Public property is generally not lienable.

77. Under Oregon law, to the extent a creditor obtains a judgment against or settlement with a municipality, payment must be made by the municipality and can be funded through a tax levy if the following conditions exist: (i) the judgment exceeds the funds available in the municipality's budget; (ii) the judgment exceeds 10% of the total unrestricted revenues in the municipal budget for the coming year; (iii) payment would impair the municipality; and (iv) the municipality has called an election to submit a special levy. OR. REV. STAT. § 30.295. The problem with an action in mandamus is a collection problem. Ultimately, a municipality will not be able to service its bondholder debt if it does not have the funds available to satisfy the indebtedness or even to cure the default and is unable to raises taxes or raise sufficient revenue from a tax increase to satisfy the indebtedness. Oregon state law does allow holders of special revenue bonds issued by county pollution control facility and public housing projects to seek the appointment of a receiver and to foreclose upon default. However, it appears that foreclosure is strictly limited under Oregon law to these issuers. *See id.* §§ 468.268, 456.210.

78. *Id.* § 30.295.

79. *See id.* §§ 203.095, 203.100.

80. *Id.* § 203.095(1).

Board ("FAB") for the distressed county.[81] The board must devise a recovery plan.[82] The plan may, among other things, recommend that the county renegotiate payment terms of the county's legal and moral indebtedness, as well as cut services, lay off employees, reduce costs, and sell or lease real or personal county property.[83]

This law is limited in two material respects. First, the ability for the county to renegotiate payment terms of existing indebtedness is wholly dependent on achieving a consensual agreement with its creditors. While forbearance is certainly possible, creditors maintain a disproportionate amount of leverage. Indeed, the municipality does not have a meaningful threat of unilateral contract modification because access to federal bankruptcy court is restricted. Second, implementing the FAB's actions requires a majority vote of both the Governor-appointed board members and the county's governing board. Thus, county governments can block the Governor-appointed board.

More troubling, the law does not necessarily incentivize local governments to maintain a solvent and fully operational government. In the event of municipal distress, the county can ask the state to get involved. At the same time, the law does not authorize the state to override local government in fashioning a solution. The law brings more parties to the table, but fails to define a process that could produce a viable solution for the local government, its taxpayers, and the state.[84]

81. *Id.* §§ 203.095(4), 203.100.

82. *Id.* § 203.095(5);

83. *See id.* §§ 203.095(4), 203.100.

84. It is important to note that Oregon state law does allow for the substantive consolidation of the state's instrumentalities. More specifically, state law provides statutory mechanisms for dissolution, merger, and consolidation of municipalities. *See id.* §§ 222.210–310 (consolidation of cities); *id.* §§ 222.610-710 (surrender and merger of city into adjoining city); *id.* §§ 222.510-580 (annexation of public service districts). Generally, any city may surrender its charter and be merged into an adjoining city in the same or another county, with the majority support of both of its electors. Surrender and merger does not affect existing suits, actions or proceedings, which must be defended by the surviving city. Likewise, debts and liabilities of the city surrendering its charter will become the liabilities of the city into which it is merged. Unfunded PERS liabilities must be addressed by the cities engaged in surrender and merger. Furthermore, state law provides that a city that is not liable for any debt or other obligation can surrender its charter, disincorporate and cease to exist if a majority of its electors authorize the disincorporation. *See id.* § 222.610. Within thirty days after the authorization to surrender and disincorporate, the city must convey all its real and personal property to the county in which the city is located for the benefit and use of the county. *See id.* § 221.650. In this scenario, all of the city's property rights and interests will vest in the county.

Ultimately, many Oregon municipalities face a Hobson's choice: utilize a more aggressive debt adjustment mechanism than currently offered under state law or face ruin.

IV. CHAPTER 9—THE FEDERAL DEBT ADJUSTMENT AND REORGANIZATION OPTION[85]

A. Overview of Federal Municipal Bankruptcy Laws

Prior to 1934, municipalities were expressly excluded from seeking protection under federal bankruptcy law.[86] But the Great Depression precipitated a wave of small town defaults. The prospect of widespread municipal financial collapse gained attention within the national consciousness. Distressed municipalities had few options and faced the prospect that spurned bondholders would attempt to seize government property or force the locality to adopt new taxes, which could only serve to further decimate struggling citizens and their respective communities. These troubled times prompted federal action. Congress sought "'to provide a forum where distressed cities, counties, and minor political subdivisions, . . . of their own volition, free from all coercion, [could] meet with their creditors under the necessary judicial control and assistance in an effort to effect an adjustment of their financial matters upon a plan deemed mutually advantageous.'"[87] The very first municipal bankruptcy act was enacted in 1934 ("1934 Municipal Bankruptcy Act").[88] This new law sought to address the holdout phenomenon that arises when a few recalcitrant creditors threaten to block consummation of a negotiated debt readjustment plan reached between the municipality and its creditors.[89] The law had the support of a variety of municipal officials and creditors, including trust estates, insurance companies,

85. Chapter 9 refers to the Chapter of Title 11 of the United States Code (the "Bankruptcy Code" or "Code") that deals with municipal borrowers in financial distress. A municipality that seeks bankruptcy protection will file a Chapter 9 petition. This is in contrast to corporate debtors, who file petitions under Chapter 11 of the Bankruptcy Code if they intend to reorganize or sell assets as a going concern, or who file petitions under Chapter 7 if they intend to liquidate their assets for the benefit of their creditors. In some instances, an operating company will file a petition under Chapter 7.

86. *See* Joseph Patchan & Susan B. Collins, *The 1976 Municipal Bankruptcy Law*, 31 U. MIAMI L. REV. 287, 288 (1977).

87. H.R. REP. NO. 94-686, at 4 (1975) (ellipsis in original; citation omitted).

88. *See id.* at 5.

89. *See* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 450 (1993).

endowment funds, pension funds, and other major holders of municipal bonds.[90]

The constitutionality of the new law was immediately contested. In *Ashton v. Cameron County Water Improvement District*,[91] the Supreme Court struck down the 1934 Municipal Bankruptcy Act. By a 5-4 vote, the Court held that the new law allowed for an unconstitutional level of federal interference with states' rights to manage their own affairs.[92] Undeterred, Congress promptly enacted another municipal bankruptcy law in 1937, which ultimately became Chapter IX under the Chandler Act of 1938 ("Original Chapter IX"). Original Chapter IX was only nominally different than its predecessor.[93] Nevertheless, the Court upheld the new law in *United States v. Bekins*.[94]

Original Chapter IX proved to be quite durable, but it became ineffective as the size and complexity of municipal distress grew over time. The law had a number of idiosyncratic provisions, including the requirement that the municipality had to formulate a plan of adjustment and have that plan approved by 51% of its creditors *prior to the filing of a bankruptcy petition*.[95] Further, the law did not provide for an automatic stay of all creditor collection actions or a mechanism for raising funds to pay ongoing expenses during the bankruptcy case.[96] By 1975, Congress recognized that Original Chapter IX was "hopelessly archaic and unworkable for all but the smallest entities."[97] At that time, a number of municipalities were experiencing financial distress on a scale that the nation had not seen since the Great Depression. Most notably, New York City was facing financial demise, and state officials were aggressively lobbying Congress to pass a new municipal bankruptcy law to accommodate a

90. *See id.* at 451.

91. Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513 (1936).

92. *See id.* at 530–31.

93. *See* McConnell & Picker, *supra* note 89, at 453 ("The only changes of constitutional interest between the [1934 Municipal Bankruptcy] Act and the [new Chapter IX] were that the [new law] (1) omitted the express provision of [its predecessor] requiring the approval of the bankruptcy petition by the State, replacing it with the requirement that a petitioning municipality show that it 'is authorized by law to take all action necessary to be taken by it to carry out the plan,' and (2) excluded counties from the Act." (footnote omitted)).

94. United States v. Bekins, 304 U.S. 27 (1938).

95. *See* Kenneth W. Ellison, *The Recent Revision of the Federal Municipal Bankruptcy Statute: A Potential Reprieve for Insolvent Cities?* 13 HARV. J. ON LEGIS. 549, 556–57 (1976).

96. *See id.*

97. H.R. REP. NO. 94-686, at 4 (1975).

filing by a municipality of its size.[98] New York City ultimately resolved its financial crisis without resorting to a bankruptcy filing, but the result of the city's near calamity was a new municipal bankruptcy law.[99] Original Chapter IX was amended "to provide a workable procedure so that a municipality of any size that . . . encountered financial difficulty [could] work with its creditors to adjust its debts."[100] The amendments allowed for a federal court to supervise a consensual settlement between a municipality and a majority of its creditors.[101] The primary purpose of the new law ("Chapter 9") was to "allow the municipal unit to continue operating while it adjust[ed] or refinance[d] creditor claims with minimum (and in many cases, no) loss to its creditors."[102] Aside from some relatively minor subsequent amendments, the federal bankruptcy laws today bear a striking resemblance to those passed in 1976 with respect to municipal bankruptcy.

B. Chapter 9's Dimensions

Municipal debtor cases generally implicate a handful of discrete issues. The most frequently reoccurring issues in municipal cases are (i) the debtor's eligibility to file a bankruptcy petition; (ii) the scope of federal judicial involvement vis-à-vis state sovereignty; (iii) rejection of collective bargaining agreements and adjustment of pensions and health care benefits; and (iv) guidelines for formulating and confirming a plan for adjustment.

1. Eligibility

Section 109(c) delineates the requirements that an entity must satisfy before it may file a petition under Chapter 9. Unfortunately, the criteria are invariably subjective and fact-specific, leading to contentious litigation and a depletion of the municipal debtor's scarce financial resources.

Primarily, the entity must qualify as a "municipality"[103]—

98. *See* SEYMOUR P. LACHMAN & ROBERT POLNER, THE MAN WHO SAVED NEW YORK: HUGH CAREY AND THE GREAT FISCAL CRISIS OF 1975, at 147–66 (2010).

99. *See* H.R. REP. NO. 94-686, at 61 ("[I]n further view of the fact that the legislation which we have before us was created and tailored for the one purpose of protecting the City of New York . . . .").

100. *Id.* at 6.

101. *See id.*

102. *Id.*

103. 11 U.S.C. § 109(c)(1) (2012).

defined by 11 U.S.C. § 101(40) as a "political subdivision or public agency or instrumentality of a State."[104] This broad definition captures counties and cities, as well as special district governments with narrow responsibilities such as health care services, fire protection, irrigation and water.[105]

Section 109(c)(2) is derived from section 84 of the Original Chapter IX. Under section 84, a municipality was allowed to file a petition under Original Chapter IX if the act was "*generally* authorized by state law."[106] (emphasis added.) Section 109(c)(2) originally adopted this language. The subsection's language was vague, and attempts to determine if the standard had been satisfied led to rulings that arguably undermined state sovereignty.[107] Section 109(c)(2)'s language was amended in 1994 so that a municipality could file a Chapter 9 petition only if the municipality was "*specifically* authorized . . . by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor."[108] (emphasis added.)

Currently, twenty-seven states allow some or all local governments to file for Chapter 9.[109] But of this group, only twelve allow a municipality to file without any material prerequisites.[110] The remaining fifteen states allow municipalities to file but condition the exercise of this option. For example, Connecticut requires that municipalities obtain the express prior written consent of the governor prior to filing a petition.[111] California recently modified state law so that a municipality may not file a Chapter 9 petition unless it is facing a fiscal emergency or has participated in an evaluation process with interested parties presided over by a neutral evaluator.[112] Oregon,

104. 11 U.S.C. 109(c)(1) (2012).

105. *See* H.R. Rep. No. 94-686, at 19–20.

106. Lawrence P. King, *Municipal Insolvency: The New Chapter IX of the Bankruptcy Act*, 1976 DUKE L.J. 1157, 1158 (1976).

107. *See* McConnell & Picker, *supra* note 88, at 458–60; *see also In re* City of Bridgeport, 129 B.R. 332, 336–37 (Bankr. D. Conn. 1991); H.R. REP. NO. 103-835, at 59 (1994).

108. 11 U.S.C. § 109(c)(2).

109. GEORGE MASON UNIVERSITY CENTER FOR STATE AND LOCAL GOVERNMENT LEADERSHIP, LOCAL GOVERNMENT FISCAL CRISES: THE CRISIS FACING LOCAL GOVERNMENTS AND WHY IT MATTERS 11 (2013) (emphasis added), http://s3.amazonaws.com/chssweb/ documents/12810/original/GMU_Fiscal_Lit_Review.pdf?1379616883.

110. These states are Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas and Washington. *Id.*

111. *Id.*

112. *See* William Brandt & Patrick Darby, Municipal Debt and The Prospects of

Colorado, and Illinois allow only certain types of localities to file a Chapter 9 petition.[113] In Oregon, only irrigation and drainage districts are allowed to file a Chapter 9 petition.[114]

Section 109(c)(3) requires that the municipality be "insolvent"—a requirement not imposed on debtors who file under other Code Chapters. The solvency determination must consider a municipality's condition at the time the bankruptcy petition was filed. However, a municipality is not required to be delinquent in paying its bills in order to seek bankruptcy protection. Section 101(32)(C) defines the term "insolvent" to mean a "financial condition such that the municipality is – (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due."

The definition of "insolvent" affords a municipality two means to satisfy section 109(c)(3). Under section 101(32)(C)(i), the municipality can demonstrate that on the petition date it was not paying its debts as they became due. In the alternative, under section 101(32)(C)(ii), the municipality may prove insolvency prospectively by showing that it will be unable to pay debts as they become due in the current or future fiscal year. In evaluating these criteria, courts have generally relied on the insolvency standard developed in involuntary bankruptcy cases under section 303.[115] Courts have considered the totality of the circumstances in determining insolvency. Consequently, generally not paying debts under section 109 could mean (i) missing a significant number of payments or (ii) missing a few payments that are significant in relation to the debtor's business or operations.[116] In fact, the failure to pay a single debt may qualify a municipality as "insolvent."[117]

The vast majority of municipal debtors do not delay a bankruptcy filing to the point where the municipality is unable to timely pay its debts.[118] Therefore, municipal debtors tend to rely on

Chapter 9, Presentation at 30th Annual Jay L. Westbrook Bankruptcy Conference (2011).

113. George Mason University Center, *supra* note 109, at 11.

114. *See* Or. Rev. Stat. § 548.705 (2013).

115. *See, e.g.*, Gen. Trading, Inc. v. Yale Materials Handling Corp., 119 F.3d 1485, 1504 (11th Cir. 1997).

116. *See, e.g.*, *In re* All Media Props., Inc., 5 B.R. 126, 143 (Bankr. S.D. Tex. 1980).

117. *See In re* Food Gallery at Valleybrook, 222 B.R. 480, 487–88 (Bankr. W.D. Pa. 1998) (collecting cases).

118. *See, e.g.*, *In re* Pierce Cnty. Housing Auth., 414 B.R. 702 (Bankr. W.D. Wash. 2009); *In re* City of Vallejo, No. 08-26813, 2008 WL 4180008, at *22 (Bankr. E.D. Cal. Sept.

section 101(32)(C)(ii) to establish insolvency. Courts have analyzed this requirement on a cash-flow basis, evaluating a debtor's obligations as of the petition date and "as those obligations actually exist, not as they could exist under hypothetical circumstances."[119] At the same time, in relying on section 101(32)(C)(ii), a debtor must be able to demonstrate that its inability to meet its debts in the future is "'imminent and certain, not merely a possibility or speculation.'"[120] Naturally, any evidentiary showing in this context will be premised on projections, and accuracy is severely compromised the longer the projection. For municipalities, projections beyond two years are generally unreliable—the aggregate effect of unknown variables multiplies exponentially.[121] Consequently, a municipality relying on section 101(32)(C)(ii) is generally expected to demonstrate insolvency within the fiscal year in which the bankruptcy filing occurs or the subsequent fiscal year.[122] Projecting insolvency beyond this period is perhaps too speculative to satisfy section 109(c)(3).

Section 109(c)(4) requires that the municipality "desires to effect a plan to adjust [its] debts." In evaluating this requirement, courts tend to focus on the municipality's prepetition efforts to address its fiscal crises and whether the debtor is acting in good faith to resolve the issues that could not be resolved outside of bankruptcy.[123] A municipality is not acting in "good faith" if it seeks bankruptcy protection merely to delay or evade payment to creditors.[124] In order to satisfy this subjective requirement, a municipal debtor must present evidence that it seeks to utilize Chapter 9 in order to confirm a plan of debt adjustment. A debtor can accomplish this by (i) filing a plan of adjustment with the bankruptcy petition, (ii) submitting an affidavit detailing extensive prepetition and possibly postpetition efforts to resolve claims and reduce debts, or (iii) providing some other form of evidence that establishes the requisite intent.[125]

5, 2008); *In re* McCurtain Mun. Auth., No. 07-80363, 2007 WL 4287604, at *3 (Bankr. E.D. Okla. Dec. 4, 2007); *In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn. 1991).

119. *In re* City of Vallejo, 2008 WL 4180008, at *22 (noting that potential settlements that could reduce the city's debt obligations could not be considered under a section 109(c)(3) analysis).

120. *In re* City of Bridgeport, 129 B.R. at 337–38 (quoting *In re* U.S.A. Motel Corp., 450 F.2d 499, 503 (9th Cir. 1971)).

121. *See id.* at 338.

122. *See id.*

123. *See In re* City of Vallejo, 2008 WL 4180008, at *22.

124. *See In re* City of Vallejo, 408 B.R. 280, 295 (B.A.P. 9th Cir. 2009).

125. *See, e.g.*, *id.*

The final requirement under section 109 involves the viability and necessity of the bankruptcy filing. Section 109(c)(5) ensures that a municipality has engaged its creditors in seeking to obtain a consensual work-out prior to accessing the bankruptcy process. This subsection requires that the debtor either:

> (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such [debtor] intends to impair under a plan in a case under such Chapter;
> (B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such [debtor] intends to impair under a plan in a case under such Chapter;
> (C) is unable to negotiate with creditors because such negotiation is impracticable; or
> (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547.[126]

The municipality must meet at least one of these requirements under section 109(c)(5).Section 109(c)(5)(A) is a remnant from Original Chapter IX and inquires whether the debtor has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such municipality intends to impair under its plan of adjustment (the "Majority Creditor Requirement"). Municipal debtors could file a petition under Original Chapter IX only if they satisfied this requirement. Ultimately, legislators realized that this requirement was unduly onerous and effectively precluded the vast majority of municipalities from gaining desperately needed bankruptcy court protection. In 1976, the amendments allwoed municpal debtors to file a bankruptcy petition even if they could statisfy the Majority Creditor Requirment.[127]

A municipal debtor that cannot satisfy section 109(c)(5)(A) can still file a petition under Chapter 9 if it can show that it either (i) negotiated in good faith with creditors but could not obtain an agreement;[128] or (ii) could not negotiate with creditors because such negotiations were impracticable.[129] The former showing will

126. 11 U.S.C. § 109(c)(5) (2012).
127. *Id.* § 109(c).
128. *Id.* § 109(c)(5)(B).
129. *Id.* § 109(c)(5)(C).

invariably demand some proof of negotiations that include a good faith effort to compromise and avoid bankruptcy.[130] Multiple rounds of negotiations may be necessary. However, the Code recognizes the potential futility in forcing a municipality to negotiate with creditors to the point of impasse in all instances.[131] Creditors may be hostile to any attempt to adjust obligations. Further, the sheer number of creditors may preclude negotiations. In some instances, the need to act quickly to preserve assets or prevent public harm may be sufficient to justify a hasty filing.[132] Therefore, section 109(c)(5)(C) offers an alternative basis for eligibility, exemplified by *In re City of Vallejo*.[133] In that case, the debtor failed to negotiate with creditors prior to the filing of its bankruptcy petition.[134] The court ruled that this fact did not preclude the debtor from establishing its eligibility.[135] Negotiations were impracticable for a number of reasons, including (i) the debtor could not engage in meaningful negotiations with the indenture trustee for bondholders because the debtor was not able to submit a viable long-term financial plan without first adjusting its labor costs; (ii) the debtor could not identify a number of its creditors, including retired employees, and even if it could, it would have been futile to include them in complex, ongoing negotiations with the unions; and (iii) a hasty filing was necessary in order to continue providing the community with essential services.[136]

Finally, under section 109(c)(5)(D), a debtor can seek bankruptcy protection if it reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547, which addresses transfers of municipal monies or assets made at some point during the 90-day period prior to the bankruptcy filing.

2. Limited Judicial Involvement

Concerns regarding unconstitutional federal interference with states' rights to manage their own affairs have circumscribed judicial

130. *See, e.g.*, *In re* Ellicott Sch. Bldg. Auth., 150 B.R. 261, 266 (Bankr. D. Colo. 1992).

131. *See* 11 U.S.C. § 109(c)(5)(C).

132. *See In re* City of Vallejo, 408 B.R. 280, 298 (B.A.P. 9th Cir. 2009); *In re* Boise Cnty., 465 B.R. 156, 168–69 (Bankr. D. Idaho 2011); *In re* N.Y.C. Off-Track Betting Corp., 427 B.R. 256, 277–78 (Bankr. S.D.N.Y. 2010); *In re* Valley Health Sys., 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008).

133. *In re* City of Vallejo, 408 B.R. 280 (B.A.P. 9th Cir. 2009).

134. *Id.* at 296–97.

135. *See id.*

136. *See id.*

powers in Chapter 9 cases. Unlike judges overseeing cases filed under other bankruptcy Chapters, Chapter 9 judges are unable to exert control over a debtor's operations, assets, or management. The bankruptcy court's power is limited to four broad case matters: (i) eligibility determinations; (ii) case dismissal; (iii) assumption and rejection of executory contracts and unexpired leases; and (iv) confirmation or denial of the plan of adjustment. Ultimately, a municipality can file a Chapter 9 petition and proceed to run the debtor in bankruptcy in the same fashion as if the bankruptcy had not been filed. This lack of oversight may be attractive to Chapter 9 debtors but can undermine the effectiveness of the bankruptcy process. In Chapter 11, a bankruptcy judge has myriad levers available to incentivize the debtor and case constituencies to negotiate and resolve key disputes. Chapter 9 lacks this type of neutral driver.

3. Automatic Stay

The automatic stay in section 362 of the Bankruptcy Code prevents creditors and counterparties from pursuing any claim against the municipality. This moratorium on collection efforts allows a municipality to focus on a comprehensive debt restructuring. Furthermore, the automatic stay and the claim allowance process force creditors to file claims against the debtor in bankruptcy court, enabling the debtor to address all creditor claims in one court.

4. Collective Bargaining Agreements and Pension and Health Care Benefits

Chapter 9 enables municipal debtors to reject collective bargaining agreements and impose new terms on current employees.[137] This is one of a municipality's greatest powers in bankruptcy, but may be the product of congressional oversight.

a. NLRB v. Bildisco & Bildisco and the Rejection of Collective Bargaining Agreements

Prior to 1984, circuit courts of appeal had split as to whether a corporate debtor under Chapter 11 had the power to reject collective bargaining agreements in the same manner it could reject other, less significant contracts. The Supreme Court sought to resolve this

137. *See* 11 U.S.C. § 365 (2012); *In re* City of Vallejo, 408 B.R. 280.

circuit split in *NLRB v. Bildisco & Bildisco.*[138] In that case, the debtor sought bankruptcy protection under Chapter 11.[139] At the time, approximately 40% to 45% of the debtor's labor force was represented by Local 408 of the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America ("Union").[140] Union members who were employed by the debtor were working pursuant to a collective bargaining agreement. The debtor sought to reject this agreement once in bankruptcy, arguing that rejection would save the company approximately $100,000.[141] At that time, the Code did not contain a provision that specifically addressed the rejection of a collective bargaining agreement, but section 365 provides for the rejection of executory contracts.[142] The bankruptcy court allowed the debtor to reject the collective bargaining agreement.[143] The Union appealed the ruling, but the district court upheld the order.[144] The Union then appealed to the Court of Appeals for the Third Circuit.[145]

The court of appeals affirmed the bankruptcy court's ruling, holding that a collective bargaining agreement was an executory contract subject to rejection under section 365.[146] To effectuate a rejection, the debtor needed to demonstrate that under the debtor's business judgment, the collective bargaining agreement was burdensome to the estate and that the equities balanced in favor of rejection.[147] The Union appealed the circuit court's ruling to the Supreme Court where it argued that the standard for rejection should be stricter than that advocated by the court of appeals, i.e., in light of the special nature of rights created by labor contracts, the debtor should not be permitted to reject the collective bargaining agreement unless it could demonstrate that its reorganization would otherwise

138. NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984).

139. *Id.*

140. *Id.* at 517.

141. *Id.* at 517–18. Presumably, after the debtor rejected the collective bargaining agreement, it would be able to offer new terms on a take-it-or-leave-it basis. The debtor must still negotiate an employment contract with its employees.

142. 11 U.S.C. § 365 (2012).

143. *Bildisco*, 465 U.S. at 518.

144. *Id.*

145. *Id.*

146. *Id.* at 519.

147. *In re* Bildisco, 682 F.2d 72, 79 (3d Circ. 1982) *aff'd sub nom.* N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513.

fail.[148]

The Supreme Court affirmed the circuit court's ruling.[149] The Supreme Court explained that all collective bargaining agreements, except those subject to the Railway Labor Act, were subject to rejection under section 365.[150] However, the Court agreed that collective bargaining agreements are of a special nature and that "a somewhat stricter standard should govern the decision of the [b]ankruptcy [c]ourt to allow rejection of a collective-bargaining agreement."[151] Ultimately, the Court adopted the circuit court's proposed standard, but it provided additional guidance as well.[152] The Court explained that before determining whether to allow rejection of a collective bargaining agreement, "the [b]ankruptcy [c]ourt should be persuaded that reasonable efforts to negotiate a voluntary modification had been made and [were] not likely to produce a prompt and satisfactory solution."[153] Once the bankruptcy court made such a determination, it was obligated to balance the equities and consider the interests of the affected parties, including the debtor, creditors and employees.[154] Further,

> [t]he bankruptcy court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them, and the impact of rejection on the employees. In striking the balance, the bankruptcy court must consider not only the degree of hardship faced by each party, but also any qualitative differences between the types of hardship each may face.
>
> . . . [T]he bankruptcy court must focus on the ultimate goal of Chapter 11 when considering these equities. The Bankruptcy Code does not authorize free-wheeling consideration of every conceivable equity, but rather only how the equities relate to the success of the

148. *Bildisco*, 465 U.S. at 523.
149. *Id.* at 534
150. *Id.* at 522–23.
151. *Id.* at 524.
152. *See id.*
153. *Id.* at 526.
154. *See id.* at 527.

reorganization.[155]

In response to the *Bildisco* ruling, union leaders called upon Congress to pass legislation addressing the ruling's perceived inequities.[156] They argued that "unless [the] disgraceful and unfair situation [the ruling created was] corrected, unscrupulous employers [would] increasingly begin to use the threat of bankruptcy to force workers to accept rewriting of their contracts to incorporate concessions in their wage levels and working conditions."[157]

Congress addressed this issue by drafting a new section, 1113, as part of the 1984 amendments to the Bankruptcy Code.[158] The new section established a detailed three-stage process that directs the debtor and any union affected by a labor contract that the debtor seeks to reject to engage in collective bargaining. Section 1113's main purpose is to encourage a solution of the employer's labor problems through collective bargaining rather than by means of the debtor's unilateral action and recourse to the bankruptcy court.[159]

Chapter 9 does not incorporate section 1113.[160] Consequently, bankruptcy courts have reasoned that the approach propounded in *Bildisco* applies in Chapter 9 cases. Arguably, Chapter 9 debtors face fewer obstacles in rejecting a collective bargaining agreement because the negotiation procedures found in section 1113 are inapplicable. However, municipal debtors face a different challenge in rejecting collective bargaining agreements. In many states, pension and related labor benefits are controlled and protected by contract, state statutes

155. *Id.*

156. *See* Rosalind Rosenberg, *Bankruptcy and the Collective Bargaining Agreement–A Brief Lesson in the Use of the Constitutional System of Checks and Balances*, 58 AM. BANKR. L.J. 293, 312 (1984).

157. *Id.* at 313 (quoting Letter from Legislative Director of the United Automobile, Aerospace & Agricultural Implement Workers of America to Members of Congress (Mar. 9, 1984)).

158. *See* 130 CONG. REC. H7489 (daily ed. June 29, 1984) (statement by the Hon. Peter W. Rodino Jr., Chairman of the House Committee on the Judiciary, upon the consideration of the Conference Report on H.R. 5174) ("[Drafting section 1113] was the most serious matter that the conference had to deal with and we dealt with it over a long period of time and it was only after much deliberation and much exchange that we finally came to what we believe to be a very balanced provision . . . .").

159. *See, e.g.*, *In re* K & B Mounting, Inc., 50 B.R. 460, 464–65 (Bankr. N.D. Ind. 1985).

160. Chapter 9 was amended in 1994, and Congress considered a proposal to add to Chapter 9 a provision similar to section 1113. But the proposal was never enacted into law. *See In re* Cnty. of Orange, 179 B.R. 177, 183 n.15 (Bankr. C.D. Cal. 1995).

and the state constitution. Significant constitutional issues are implicated when federal law grants a municipal debtor the ability to take action that is prohibited by a governing state constitution or statute. Though a detailed discussion of these constitutional issues is beyond the scope of this paper, a general discussion is necessary in order to understand the nature of this issue in Chapter 9.

b. Rejection of Collective Bargaining Agreements Under Chapter 9: Analysis and Implcations.

Chapter 9 enables municipal debtors to unilaterally reject collective bargaining agreements and other employment contracts. Rejection constitutes breach of the contract or lease, thereby entitling the counterparty to damages. The Bankruptcy Code categorizes these damage claims as prepetition, unsecured non-priority claims subject to significant write-down. The ability to write-down existing liabilities extends to pension liabilities, but probably only to the unfunded portion of the liability. The funded obligation is most likely property of employee accounts belonging to employees and retirees, and thus not subject to material adjustment in Chapter 9.[161] The law notwithstanding, the ability to reject contracts with employee unions will likely be limited by the practical need to retain certain skilled employees in order to ensure the local government's continued operation.

Furthermore, to the extent a municipality's rejection of its contracts constitutes termination of the contractual agreements, including employment agreements, rejection may enable municipalities to halt employer contributions to PERF. In addition, the municipal debtor may be allowed to treat the PERS breach of contract claim as a pre-petition, unsecured non-priority claim subject to significant reduction.[162] There is an absence of legal guidance on the ability of a municipal debtor to discount or impair its obligations

161. *See* OR. REV. STAT. § 238.600(2) (2013). If PERS is terminated, each member of the system has a nonforfeitable right to the benefits that the member has accrued as of the date of the termination to the extent those benefits are funded. At least a colorable argument could be made that funds in PERS employees' accounts are not property of the debtor in Chapter 9, as they do not appear to be property of the municipality under existing state law. Thus, Chapter 9 would likely only allow a municipal debtor to compromise the unfunded portion of the pension liability.

162. For example, rejection of the collective bargaining agreement would enable municipalities to terminate the employer "pick-up" of employee contributions, and enable the municipality to negotiate a new contract with its employees.

to a *state-run* pension system. Historically, Chapter 9 municipal debtors have worked with their pension plans, including state-run pension plans to avoid an impairment.[163]

Complicating this analysis is the fact that PERS is codified by statute, and Chapter 9 does not allow a debtor to propose and confirm a plan of adjustment that violates state law prospectively.[164] So, while the rejection of an employee obligation could affect the municipality's obligations to PERS, it is unlikely that a Chapter 9 filing, in and of itself, automatically severs the municipal employer from its relationship as a PERS employer. For example, if the municipality is a school district, state law mandates that all public school districts participate in PERS, which means any plan of adjustment the municipal school district proposed would have to incorporate PERS prospectively. That does not mean that the school district cannot suspend pension contributions to PERS during the bankruptcy case, and thereby increase its leverage with the teachers' union, or reject the collective bargaining agreements. However, the school district could not retain a work force post-bankruptcy that does not provide its employees with the benefits of PERS. Likewise, if the municipality is a city or county, state law mandates that employers not participating in PERS provide a pension plan equal to or better than PERS for firefighters and police officers. This law would apply to debtors in Chapter 9, and thus any plan of adjustment proposed would need to comply with this state law.

Since 1956, Oregon has not authorized a public employer to withdraw from PERS. Without legislative authorization, it appears that no municipality can discontinue participation in PERS. Federal bankruptcy law may be of little help here because there does not appear to be a statutory contract between the state and local government employers with respect to the employers' obligations to fund PERS on behalf of their employees. Absent a municipality's ability to characterize its membership in PERS as an executory contractual relationship that can be rejected in bankruptcy, the central question is whether the municipality's rejection of its employment agreements in bankruptcy (including collective bargaining agreements) is sufficient to terminate the municipality's obligations to

163. There is a distinct lack of legal precedent on this issue. It is fair to recognize, however, that any attempt by a municipality to extricate itself from its PERS obligations would lead to protracted and expensive litigation.

164. 11 U.S.C. § 903 (2012).

PERS as a participating member. At the very least, we could imagine that a municipality seeking to terminate its relationship with PERS would seek a comfort order from the bankruptcy court that addresses its ongoing obligations under the PERS statutes. Again, this issue would be heavily litigated.

As a practical matter, contract rejection and the threat of terminating participation in PERS are not swords that should be freely wielded. While Chapter 9 debtors face fewer obstacles in rejecting a collective bargaining agreement because the negotiation procedures found in section 1113 are inapplicable, municipal governments are very much "going concerns," and they depend on their employees showing up for work every day and investing in their employment in good faith. Accordingly, rejection must be followed by good faith negotiations and fair treatment in order to ensure that a municipality can retain its skilled workforce and continue to provide necessary services to its taxpayers.[165]

State constitutions and statutes attempt to protect municipal labor obligations from unilateral adjustment by the state or its municipalities. However, Bankruptcy Code section 365 explicitly allows a municipal debtor to seek, and a bankruptcy court to allow, rejection of a collective bargaining agreement over the objection of employees and unions. In attempting to reconcile the tension between state law and federal bankruptcy law, bankruptcy courts initially deferred to state law, noting the historical concerns regarding state sovereignty.[166] Recent bankruptcy court and Supreme Court opinions have abandoned this deference on a variety of levels.[167] Primarily, the Tenth Amendment provides that powers not delegated to the federal government by the Constitution, "nor prohibited by it to the States, are reserved to the States . . . ." This Amendment acknowledges the role that two sovereigns can play in a variety of contexts. Sections 109, 903, and 904 of the Bankruptcy Code honor

165. In the case of retiree claims, they too would be treated as unsecured nonpriority claims subject to significant compromise even though they are not executory contracts subject to the rejection powers of section 365 of the Bankruptcy Code. These claims would likely be treated as unsecured nonpriority claims because they accrued prior to the petition date.

166. *See, e.g.*, *In re* Cnty. of Orange, 179 B.R. 177, 183 (Bankr. C.D. Cal. 1995) ("The history of Chapter 9 reflects concern on the part of Congress not to overstep the boundary between legislation necessary for municipalities to reorganize and the rights of states to control the functions of their municipalities.").

167. *See* Cent. Va. Cmty. Coll. v. Katz, 546 U.S. 356, 362 (2006); *In re* City of Stockton, 478 B.R. 8 (Bankr. E.D. Cal. 2012); *In re* City of Vallejo, 432 B.R. 262 (E.D. Cal. 2010).

this delicate state-federal relationship. Section 109(c) provides that a municipality cannot file a bankruptcy petition unless state law or an official granted authorization authority through state law specifically authorizes such action. Section 903 provides that the state's power to control a municipality is unaffected by a bankruptcy filing. Further, section 904 provides that the bankruptcy court may not interfere with a municipal debtor's political or governmental powers or its property or revenues.[168]

However, courts have recently found that once a state explicitly authorizes a municipality to file a Chapter 9 petition, the state cannot rely on section 903 and prevent the municipality from seeking relief explicitly authorized by the Bankruptcy Code. "[A] state's authorization that its municipalities may seek Chapter 9 relief is a declaration of state policy that the benefits of Chapter 9 take precedence over control of its municipalities."[169] Consequently, courts have rejected state attempts to "cherry-pick" which bankruptcy sections they wish to apply to municipal debtors. Section 904 makes clear that the bankruptcy court cannot forbid a municipality from seeking relief authorized under the Bankruptcy Code merely because the applicable state constitution or laws would be violated.

Furthermore, the Contracts Clause, whether in the U.S. Constitution or in the Oregon Constitution, does not restrict a municipality's ability to reject a collective bargaining agreement in Chapter 9 because that prohibition precludes *states* from passing legislation that impairs contractual obligations, but it does not preclude *Congress* through federal law from doing so. Relatedly, the Supremacy Clause would allow federal bankruptcy law to trump state law that restricts states from unilaterally impairing or modifying contractual labor obligations.

Recent case law has supported these conclusions, but they are by no means settled. The Supreme Court has not opined on these constitutional issues. This uncertainty incentivizes parties to bargain in bankruptcy to achieve a consensual outcome.

5. Plan for Adjustment of Debts

A Chapter 11 corporate debtor's bankruptcy case can take a number of routes. The case can be converted to one under Chapter 7,

168. For example, a bankruptcy court could not tax a municipality's citizens or require that the municipal debt impose a tax.

169. *In re* City of Vallejo, 432 B.R. at 268.

and a Chapter 7 trustee will manage the debtor's liquidation.[170] The debtor can also be liquidated in Chapter 11.[171] In the alternative, substantially all of the debtor's assets can be sold through section 363 or a plan of reorganization, and the remaining shell entity can be liquidated immediately or allowed to emerge from bankruptcy in order to carry out some ministerial tasks.[172] Finally, the Chapter 11 debtor can formulate and confirm a plan of reorganization that allows the company to emerge from bankruptcy as a viable going concern.[173] Unlike in Chapter 11, there are only two potential outcomes in Chapter 9. The court can dismiss the municipal debtor's case or the debtor can propose, and the court can confirm, a plan of debt adjustment. From the perspective of the municipal officials that sought the bankruptcy filing, there is only one positive result after a bankruptcy petition has been filed—confirmation of a debt adjustment plan.

Chapter 9 adopts key sections from Chapter 11 in establishing the requirements for confirmation of a plan of adjustment. Section 901 explicitly incorporates all applicable provisions of sections 1122, 1123 and 1129. The key components of the plan of adjustment involve dividing creditor claims into classes, specifying the treatment that each class is to receive, and seeking a vote from each class member. A class is deemed to have accepted the plan if (i) a majority of claimants in a class, and (ii) at least two-thirds in amount of the aggregate value of the claims in the class, vote in favor of the plan.[174] This structure addresses the holdout problem that frustrates many out-of-court restructuring efforts by allowing a municipal debtor to unilaterally rewrite debt terms over the objections of dissenting creditors if certain votes of acceptance are obtained from other creditors. In fact, an accepting majority of creditors can cram down new debt terms on a dissenting minority of creditors if the accepting majority hold two-thirds of the claims in any given class.[175] Furthermore, the municipal debtor controls the plan process. No other party may propose a plan.

But the requirements for plan confirmation and the process itself

170. 11 U.S.C. § 1112 (2012).
171. *Id.* §§ 1123, 1129.
172. *Id.* § 1129.
173. *Id.*
174. *See id.* § 1126(c).
175. *See id.*

is far more textured then just securing the necessary votes from each class of creditor. Indeed, the system is not characterized by consensual agreements; rather, "the critical question is what the debtor can do over the objection of creditors."[176]

In the plan confirmation process, municipal debtors hold many of the same powers and obligations held by Chapter 11 debtors. Most importantly, section 901 adopts key provisions from subsections 1129(a) and (b). Section 1129(a) delineates the requirements for plan confirmation, including the requirement under section 1129(a)(8) that each creditor class must vote to approve a proposed plan. However, section 901 also adopts the "cramdown" exception to 1129(a)(8). Pursuant to section 1129(b), a nonconsenting class of creditors (i.e., a class of creditors in which the majority in number vote to reject the plan or holders of claims that exceed one-third of the total amount of claims in that certain class of creditors vote to reject the plan) can be crammed down in certain instances. Primarily, at least one impaired class of claims must approve the plan, and the plan must be fair and equitable with respect to each impaired class that has not accepted the plan.[177] The definition of "fair and equitable" varies depending on whether the class is composed of secured or unsecured creditors.

Classes of secured creditors in Chapter 9 are frequently composed of bondholders secured by the revenues of a particular project or a pledge of special tax revenues.[178] A plan may be confirmed over the dissent of a secured creditor class if the plan provides that holders of secured claims retain the liens securing the claims and each creditor receive deferred cash payments with a present value equal to the value of the secured creditors' collateral as of the effective date of the plan. In the alternative, the plan can be deemed fair and equitable if it contemplates a sale of a secured creditor's collateral but (i) allows for the creditor to credit bid its claim and the creditor's lien to attach to the proceeds of the sale; and (ii) provides cash payments to the secured creditor with a present value equal to the value of the collateral.[179] The final way for a plan to be deemed fair and equitable is for the secured creditor to receive the "indubitable equivalent" of its secured position.[180] This

176. McConnell & Picker, *supra* note 89, at 464.

177. *See* 11 U.S.C. § 901(a) (incorporating § 1129(a)(10)).

178. *See* Brandt & Darby, *supra* note 112, at 28.

179. *See* 11 U.S.C. § 1129(b)(2).

180. *Id.* § 1129(b)(2)(A).

requirement is customarily satisfied by providing the creditor with a replacement lien on alternative collateral of equal value.[181]

Ultimately, the most realistic option in cramming down a secured creditor class is to allow a creditor to retain its liens and then to receive deferred cash payments over time. Various legal and market difficulties invariably eliminate the possibility of the municipal debtor selling its assets. Further, municipalities are generally unable to offer replacement collateral to a secured creditor in order to satisfy section 1129(b).

The vast majority of creditors in a Chapter 9 case will fall into unsecured creditor classes and face treatment that is decidedly different than that enjoyed by secured creditors. Generally, unsecured creditor classes in a Chapter 9 case include holders of general obligation bonds, current employees and retirees, and trade vendors. In a Chapter 11 case, in order for a plan to be "fair and equitable" as to an unsecured creditor class, the plan must provide that either (i) each unsecured creditor receive, on the effective date of the plan, property of a value equal to the allowed amount of its claim; or (ii) any claim or interest that is in a junior class does not receive or retain any property pursuant to the plan.[182] This last option is the absolute priority rule. In a Chapter 11 case, the rule often allows for the cramdown of an unsecured creditor class by excluding a junior equity class from participating in property distributions under the plan. However, there is no equity class in Chapter 9 and, in many cases, no junior creditor class. Consequently, the absolute priority rule has no meaningful role in most Chapter 9 cases. Fair and equitable treatment of unsecured creditor classes under Chapter 9 cannot follow the guidelines established by Chapter 11 case law. Rather, the requirement is more subjective under Chapter 9 and, as a result, easier to satisfy. The plan must "embod[y] a fair and equitable bargain openly arrived at and devoid of overreaching."[183] A fair and equitable bargain for unsecured creditors is one where the amount received by such creditors is "all that they 'can reasonably expect in the circumstances.'"[184]

181. This last provision is intended to allow the debtor flexibility in formulating a cramdown.

182. *See* 11 U.S.C. § 1129(b)(2)(B).

183. Town of Belleair, Fla. v. Groves, 132 F.2d 542, 543 (5th Cir. 1942).

184. Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942) (citation omitted).

Due to the uncertainty surrounding the fair and equitable nature of a cramdown, unsecured creditors will often resort to other Code provisions in attempting to ensure favorable treatment. More specifically, creditors have relied on section 943(b)(7)'s requirement that the plan be in the best interests of creditors and feasible. In Chapter 11, the best interests test requires that an impaired creditor receive or retain under the plan interests or property that is not less than the amount it would receive if the debtor were liquidated under Chapter 7.[185] A municipality cannot be liquidated, so courts have construed the test under Chapter 9 to require that the proposed plan treatment for an unsecured creditor is better than realistic alternatives, such as dismissal of the case.[186] A plan that fails to repay creditors an amount that even remotely approximates their claims may not necessarily be in the best interest of those creditors. However, a municipal debtor cannot devote a disproportionate amount of resources to creditor claims with the hope of satisfying this requirement because that allocation may cause the debtor to run afoul of section 943(b)(7)'s feasibility requirement. The feasibility analysis requires the bankruptcy court to determine that the debtor will be able to make plan payments and comply with other plan terms before confirming the plan. Customarily, courts will review the reasonableness of the debtor's projections for revenues and expenses to determine if the debtor can achieve going forward solvency.[187]

These principles create a framework that seeks to prevent one group of creditors, in many cases current and former employees, from "disproportionately bear[ing] the impact of the municipality's proposed restructuring" while ensuring the future viability of the municipality.[188]

6. Leverage Afforded to Municipal Debtors

As detailed above, Chapter 9 offers municipalities debt-adjustment options unavailable under state law. Naturally, the invocation of these options can be extremely helpful to a municipality seeking to restructure its debt. But the mere existence of Chapter 9 as

185. *See* 11 U.S.C. § 1129(a)(7).

186. *See, e.g.*, *In re* Sanitary & Improvement Dist. No. 7, 98 B.R. 970, 975 (Bankr. D. Neb. 1989).

187. *See In re* Mount Carbon Metro. Dist., 242 B.R. 18, 37–38 (Bankr. D. Colo. 1999); *In re* Corcoran Hosp. Dist., 233 B.R. 449, 459 (Bankr. E.D. Cal. 1999).

188. Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 410 (2011).

a possible option is valuable in facilitating out-of-court workouts with creditors and other counterparties. In many respects, Chapter 9's primary advantage is the increased negotiating leverage it affords a municipality *outside of bankruptcy court*.

The benefit of negotiating leverage cannot be overstated. Under Oregon state law, a municipality's creditors have almost no incentive to consider debt forgiveness. Aside from irrigation and drainage districts, Oregon municipalities are not authorized to file a Chapter 9 petition. But if Chapter 9 were a viable option for Oregon municipalities, creditors could not ignore settlement requests. The prospect of being crammed down in a Chapter 9 case will incentivize creditors to consider consensual adjustments to their debt claims. The specter of Chapter 9 should facilitate consensual out-of-court workouts between municipalities and their creditors, including public employees.

Chapter 9 provides municipalities with a viable option in the event political pressures are too great, the legislative process is too fragile, or state courts strike down legislative reform on the grounds that such reform violates the Contracts Clause. And the prospect of a municipality opting for Chapter 9 may compel rational actors to negotiate in a manner that will hopefully eliminate the need to exercise the option at all.

V. RESPONSIBLE REFORM IN THE STATE LEGISLATURE

The Oregon legislature should consider allowing cities, counties, and other political municipalities to seek Chapter 9 protection. However, a Chapter 9 filing should only be authorized after numerous rounds of meaningful out-of-course debt settlement negotiations. As discussed above, the threat of a Chapter 9 filing incentivizes parties to engage in consensual debt adjustment. State law should ensure that municipalities properly exhaust all settlement opportunities before resorting to federal bankruptcy court. Further, the process must impose checks and balances on a municipality's decision to file for Chapter 9. A municipality should be required to gain the approval of the Governor or some other high-ranking state official before filing for bankruptcy.

Ideally, state law would create a financial oversight commission composed of both elected officials and non-elected professionals tasked with ensuring that the decision-making process is collaborative and productive. By employing an administrative process that

leverages existing political and policy resources, the likelihood that a municipality is able to arrive at a consensual, and meaningful, out-of-court restructuring improves significantly.

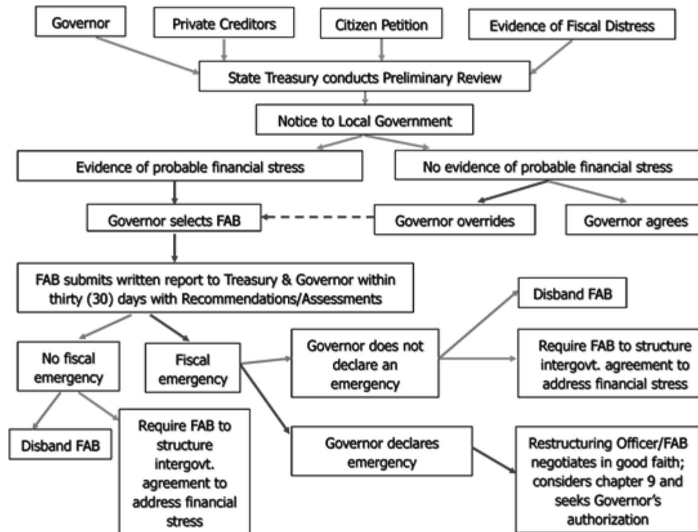
The proposed reform should be drafted around eight key concepts. First, a petitioning municipality should be allowed to engage in a financial restructuring or a municipal reorganization under Chapter 9 after completing the necessary negotiation prerequisites. Second, harm to the credit-worthiness of the state and its political subdivisions should be minimized. A financial death spiral could result if a municipality's bankruptcy filing raises the borrowing costs for the home state and all governmental entities within that state.

Third, the legislation must safeguard and ensure financial accountability of local units of government and school districts. Fourth, the municipality must be able to continue to provide necessary and essential services to its residents. Fifth, local elected officials should be allowed to participate in the restructuring process, though they may need to abdicate final decision-making authority to state officials. The key to an administrative process is continuous involvement and communication between state and local officials. Financial assistance boards should be comprised of some local officials.

Sixth, state officials should be authorized to declare the existence of a financial emergency within a local unit of government without the ability of the local unit to block such a declaration. The declaration of an emergency should be premised on a host of financial triggers. Seventh, once an emergency is declared and the state mandated out-of-court negotiations have been completed, the financial assistance board[189] should have the power to file a Chapter 9 petition once authorized by the appropriate state official. Once the municipality has filed its Chapter 9 petition, the board or emergency manager should be afforded a wide-array of powers in order to effectuate a meaningful recovery.

A proposed debt adjustment process is depicted on the next page as an example of the type of reform needed in Oregon.

189. In the alternative, the state legislature could provide for the appointment of an emergency manager–as opposed to an oversight board – to lead the restructuring efforts. The state must weigh the merits of an emergency manager led restructuring effort as opposed to one led by an oversight board. The authors do not take a position on whether a financial assistance board or an emergency manager should represent a municipal debtor in a Chapter 9 proceeding.



VI. CONCLUSION

Across the nation, subnational governments' financial distress has approached a crisis level. Currently, Oregon has cities and counties that are precariously close to service-level insolvency. But state law offers few restructuring options. This article encourages the Oregon legislature to create a framework that will facilitate negotiation among key constituencies and allow Oregon municipalities to file for Chapter 9 upon satisfaction of certain prerequisites. This process should give the municipality and its creditors every opportunity to reach consensual agreements that allow the municipality to enjoy sustainable viability. But there should be no illusions. The alternative to a consensual workout must be Chapter 9. Chapter 9 offers municipalities a host of measures to aggressively reduce debt obligations. A debtor's ability to file for bankruptcy incentivizes creditors to consider meaningful out-of-court concessions that can allow a municipality to avoid federal bankruptcy court altogether.

Oregon does not allow its cities and counties to file a Chapter 9 petition. This restriction is harmful in two significant ways. Primarily, a truly distressed municipality lacks a mechanism to address its financial troubles. Further, since Chapter 9 is not an

option, troubled municipalities lack bargaining leverage in out-of-court negotiations. By creating the framework advocated by this article, Oregon would give its municipalities meaningful restructuring options and the necessary leverage to explore them.

Ultimately, the process set forth herein is not one that mandates Chapter 9 bankruptcy as a one-size-fits-all solution. Rather, Chapter 9 is merely the last door at the end of a long hallway. Prior to arriving at this point, a distressed municipality should engage state and local leaders, and its residents, to determine whether a consensual collective adjustment plan is possible. If so, an out-of-court solution is always preferable to one that is mandated in court. We do believe, however, that a settlement process will be much more effective in extracting meaningful concessions from interested parties if all sides are forced to negotiate in Chapter 9's long shadow.