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IS CHAPTER 9 BANKRUPTCY THE ULTIMATE REMEDY FOR FINANCIALLY DISTRESSED MUNICIPALITIES: ARE THERE BETTER RESOLUTION MECHANISMS?

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INTRODUCTION

The Illinois legislature, in considering how best to assist local governments facing financial challenges or economic distress, may find instructive how other states have addressed these problems and the alternatives and opportunities available in the form of legislation including authorization to file for Chapter 9, municipal bankruptcy, under Federal Bankruptcy Law 11 U.S.C. § 901, *et seq*. Dealing with the financial distress of a local government requires not merely short-term actions to increase tax revenues and lower costs, but also the long-term reinvestment in the local government. The goal of the long-term reinvestment is to improve and expand governmental services and infrastructure and stimulate business opportunities and growth for creation of new businesses and new jobs resulting in new taxpayers to increase tax revenues that brings about the recovery for the health, safety and welfare of citizens. Such an approach is likely in the best interests of not only the local government but also its citizens and taxpayers, and its creditors, including employees and retirees. It is only through a robust recovery plan that creditors, including employees and retirees, will be paid to the fullest extent possible.

As will be discussed, the consideration of a bill to permit Illinois municipalities to file for Chapter 9 should not preclude the state or its local governments from taking action short of Chapter 9 to assist in times of financial crisis. Moreover, as will be examined, some states have devised a procedure whereby there is an independent, second look at the wisdom of a municipal bankruptcy filing before it is finalized. Such a system could also be considered by Illinois. The Illinois Local Government Protection Authority developed by the Civic Federation is such an approach as will be discussed below. As used throughout this presentation, "municipality" is not used as defined in the Illinois Constitution to mean only cities, villages and incorporated towns, but is used in the broader sense contemplated by the Federal Bankruptcy Law to include units of local government and school districts generally.[1]

In connection with any analysis of the advisability of permitting Illinois municipalities to file for Chapter 9, consideration should be given to an unexpected consequence of the availability of such a remedy. As will be discussed further, Chapter 9 typically is recognized as a last resort, a step to be taken if all else fails in attempts to rescue the financially troubled municipality. Certainly, given historic costs, expense and disruption resulting from Chapter 9, Chapter 9 is not a step to be undertaken lightly. However, the very existence of the availability of Chapter 9 may have a salutary effect on efforts to resolve municipal difficulties outside of a Chapter 9 proceeding. This was recognized in hearings before the United States House of Representatives Committee on the Judiciary as early as 1942.[2] The legislative history for hearings on the extension of the Municipal Debt Composition Act reported that the passage of the Municipal Bankruptcy Act in 1934 permitted the City of Detroit to restructure its outstanding municipal debt outside of bankruptcy through a composition of creditors requiring 100% approval of affected creditors. Since 8% of bondholders were holdouts with 92% approval of creditors, the Mayor and Civic Leaders of Detroit were major supporters of municipal bankruptcy in the passage of 1930's Chapter IX not because they were clairvoyant that in 2013 they would use it. Rather, they supported the bankruptcy option realizing that a more drastic alternative would convince the holdouts to accept the plan approved by the 92% given the fear of alternative municipal bankruptcy treatment was perceived to be far worse. The legislative history also refers to the refunding and refinancing of the significant amount of outstanding

indebtedness of the City of Chicago at that time because of the favorable psychology of having the provisions of the Bankruptcy Act available. Thus, any exploration of the advisability of the passage of authorizing legislation in Illinois ought not be viewed as necessarily leading to a rush to file Chapter 9.

THE MUNICIPAL BANKRUPTCY EXPERIENCE

As you may be aware, there have been only 662 municipal bankruptcies (*see* Charts, Appendix 1 and 2) filed in the United States since the adoption of the authorizing legislation in 1937. Few debtors have been major municipalities. Orange County, California in 1994, Bridgeport, Connecticut in 1991, Jefferson County, Alabama in 2011, Stockton, California and San Bernardino, California in 2012 and Detroit in 2013 are recent notable exceptions. For the most part, the 662 Chapter 9 filings have been small municipalities or special tax districts or utilities (about 60%). In fact, since 1954, less than 20% of all Chapter 9 filings have been cities, towns, villages and counties (63 of 318). Further, in the municipal bankruptcy, even determining eligibility can take significant time and delay such as in Vallejo, California, which was filed in 2008. Disputes with municipal unions over pensions and benefits bogged down the proceeding and delayed that City's emergence from bankruptcy. The issue of the relative treatment of pension and debt payments took center stage in Chapter 9 cases of Detroit, Stockton and San Bernardino. The decision on the eligibility of Stockton alone took almost ten months. After more than a year in bankruptcy, the issue of the eligibility of San Bernardino was finally determined, paving the way for a battle between the competing interests. The Detroit bankruptcy was long and expensive. It is safe to say that the availability of a bankruptcy option has not proven to be a "quick or easy fix" to municipalities.[3] This is particularly true where there has been contention between the major players in the case. Historically and practically, Chapter 9 debt adjustments should be the last resort after all other alternatives have been unsuccessful. Many states have provided assistance, refinancing, oversight and other mechanisms to help local government avoid Chapter 9 if it is at all possible. The authorization of municipalities to file should not be interpreted as precluding such efforts by a state.

THE LESSONS LEARNED FROM CONSTITUTIONAL CHALLENGES MUNICIPAL BANKRUPTCY PROVISIONS

The Tenth Amendment to the Constitution explicitly articulates the Constitution's principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the Constitution of the United States are reserved to the States respectively or to the people. Accordingly, while Article I, Section 8 of the Constitution gives Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States," that power may not interfere with the power reserved to the States by the Tenth Amendment. While there may be precedent for the Federal preemption of bankruptcy law for corporations and individuals, there was, at our Nation's founding, no precedent for a dual sovereign passing a law regulating the bankruptcy of the other. This remains the case today. The earliest iterations of statutes providing for municipal debt adjustment (Chapter IX) not unexpectedly resulted in a review of the constitutionality of municipal bankruptcy by the U.S. Supreme Court.

As you know, the current version of Chapter 9 of the Bankruptcy Code attempts to embrace the concept of sovereignty of States and the limitations imposed by the Tenth Amendment. Section 903 of the Bankruptcy Code specifically reserves a State's power to control municipalities.[4] In addition, § 904 of the Bankruptcy Code specifically limits the jurisdiction and powers of the Court over the municipality.[5] As a result, the power of a Bankruptcy Court presiding over a Chapter 9 case is limited and cannot interfere with the property, revenue, politics, government and affairs of the municipality. The jurisdiction of the Bankruptcy Court over the municipality flows from the specific authorization of the State in question to allow the municipality to file. Most States have chosen not to specifically authorize their municipalities to file.[6]

Earlier versions of municipal bankruptcy legislation attempted to deal with these concepts as well. Prior to 1934, Federal bankruptcy legislation did not provide a mechanism for municipal bankruptcy, insolvency, or debt adjustment.[7] During the period 1929 through 1937, there were 4,700 defaults by governmental bodies in the payment of their obligations.[8] In 1934, the House and Senate Judiciary Committees estimated that there were over 1,000 municipalities in default on their bonds.[9] That was obviously a different stage of financial distress than presently exists today with no State in default of any its general obligation bonds.

Until World War II, units of local government were very heavily dependent upon property tax. During the Depression, there was widespread nonpayment of such taxes. Bondholders brought suits for accountings, secured judgments and obtained writs of mandamus for levies of further taxes. The first municipal debt provisions of the Bankruptcy Act of 1898 as amended from time to time (hereinafter the "*Bankruptcy Act*") were enacted as emergency legislation for the relief of such municipalities. The municipal provisions became effective on January 24, 1934.[10] These provisions were to be operative for a two-year period from that date, but this period was later extended to January 1, 1940.[11] This legislation reflected a recognition that municipalities required a mechanism that would stay the annihilating litigation arising from defaults and provide a fresh start through the allowance of municipal debt adjustment to what is sustainable and affordable. In this way, creditors of the distressed municipality could be paid as much as possible without crowding out essential governmental services.

The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934 thus reflected an attempt to protect municipalities from debilitating disputes with creditors.[12] The 1934 legislation provided a procedure whereby a local governmental unit, if it could obtain acceptances from two-thirds of its creditors, could have a plan of readjustment enforced by the Federal courts. The 1934 legislation contained language similar to the policy expressed in the current § 904:

> The Judge … shall not by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district or (b) any of the property or revenues of the taxing district necessary in the opinion of the Judge for essential governmental purposes or (c) any income producing property, unless the plan of adjustment so provides.

Nevertheless, the Supreme Court determined that, under the 1934 legislation, the court, and to some extent, the creditors through the court, had certain control over the municipality's revenues and governmental affairs. In 1936, the Supreme Court of the United States held, in the case of *Ashton v. Cameron County Water Improvement Dist., No. 1*,[13] that the 1934 municipal bankruptcy legislation was unconstitutional because it infringed upon the sovereign powers of the States and potentially permitted too much control by a Federal court and by Federal legislation over municipalities, sub-sovereigns of the sovereign States.

In 1937, new legislation was passed attempting to cure the defects outlined by the Court in *Ashton* and to protect municipalities from the injurious protracted litigation that some were enduring. The 1937 municipal bankruptcy legislation, enacted in response to the *Ashton* decision, required:

(l) no interference with the fiscal or governmental affairs of political subdivisions;

(2) a restriction on the protection of bankruptcy to the taxing agency itself;

(3) no involuntary proceedings;

(4) no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and

(5) no impairment of contractual obligations by the States.

This legislation was upheld by the Supreme Court in *United States v. Bekins*,[14] where the Supreme Court noted that the statute was carefully drawn so as not to impinge upon the sovereignty of the States. Like the 1934 legislation, language similar to the § 904 concept was included, although references to "the opinion of the Judge" were deleted.

Chapter IX then, while part of the Bankruptcy Act, provided a forum in which a municipality could *voluntarily* seek an adjustment of indebtedness if authorized by the State to file. A Chapter IX proceeding was not a proceeding to adjudge the city a bankrupt. The court's jurisdiction did not extend to declaring the city bankrupt or to administering its affairs as a bankrupt. The court was limited to approving as a matter of law or carrying out a proposed plan for reorganization of a municipality's debt.[15]

The principles enumerated in *Ashton* and the 1937 legislation are important in understanding the role of a Bankruptcy Court in a Chapter 9 proceeding today.[16] The Court cannot constitutionally interfere with the revenue, politics, or day-to-day operations of the municipality. The Bankruptcy Court cannot replace, by its rulings or appointments, the City Council or any other elected or appointed official. The limited, but vital, role of the Bankruptcy Court is to supervise the effective and appropriate adjustment of municipal debt in accordance with applicable law. (Obviously, the special limitations on the power of the Bankruptcy Court in a Chapter 9 case would not be applicable if the city *consented* to the stay or order of the court which affected its political or governmental powers.)[17] Historically, Chapter IX and its

successor Chapter 9 were intended to facilitate rather than mandate voluntary municipal debt adjustment, not municipal debt elimination. States have in their legislation provided mechanisms to assist local governments in distress ranging from needed technical assistance to an emergency manager or receiver who takes charge of governmental operations and financing under state law.

LEGISLATION BY THE STATE TO AUTHORIZE CHAPTER 9

Only a municipality may be a debtor under Chapter 9 of the Bankruptcy Code.[18] Only a municipality can initiate a Chapter 9 proceeding. There can be no involuntary Chapter 9 proceeding. Not only are involuntary proceedings constitutionally prohibited, as set forth in *Ashton*, but also there is no statutory basis for such an involuntary action. Only § 301 of the Bankruptcy Code, providing for voluntary cases, is incorporated into Chapter 9. A municipality is a political subdivision, or public agency, or instrumentality of a state.[19] A municipality is not eligible to be a debtor pursuant to any other Chapter of the Bankruptcy Code.[20]

Moreover, under the 1994 Act, in order to proceed under Chapter 9, state law must have specifically authorized the entity to be a debtor under Chapter 9.[21] As noted, twelve states have specifically authorized a municipality to so proceed.[22] Two states have specifically prohibited municipalities from filing for relief under the Bankruptcy Code.[23] Another twelve states authorize a filing under certain conditions such as approval of the Governor, Treasurer, some legislative committee or authority or use of an additional review process such as the neutral evaluator in California. Three states authorize only a specific municipality or type of municipality to file. (Illinois currently only authorizes the Illinois Power Authority to file Chapter 9.) The remaining twenty-one states have no specific authorization so their municipalities cannot file Chapter 9 in California. *See* Charts, Appendix 3 and 4.

Prior to 1994, a number of states had been silent on the issue of whether local governmental bodies were authorized to file under Chapter 9. The power of a municipality "to do all acts necessary, proper or convenient" including the right to sue and be sued had been held sufficient to authorize a municipality to file.[24] Given the judicial and legislative history surrounding municipal debt adjustments and state authorization to file a Chapter 9, it was important to note there could have been an overlooked problem in this regard. Commentators cited the reported decisions in North and South Shenango Joint Municipal Authority as a statement of law.[25] This case as reported could stand for the proposition that home rule power granted to a municipality is sufficient authority for it to be eligible to institute a Chapter 9 proceeding even though there is no expressed statutory power to file. However, such was not the final result in North and South Shenango, in which the Bankruptcy Court was reversed by the district court in an unreported decision.

In a decision arising out of the filing by a Colorado special purpose district before the 1994 legislation, the bankruptcy court revisited the same issue. The special purpose district had, under applicable statute, the ability to be a party to suits, actions and proceedings, to borrow money, incur indebtedness and issue bonds, to refund any bond indebtedness, to manage, control and supervise all of the business and affairs of the district and to exercise all rights and powers necessary or incidental to or implied from the special powers granted by the statute. The statute further provided that the specific powers granted should not be considered as limitations upon

any power necessary or appropriate to carry out the purposes and intent of the statute. The court found that the express and specific authorization to file a Chapter 9 is not required by 11 U.S.C. § 109(c)(2) and the aforementioned general powers were sufficient to constitute a general authorization for a Chapter 9 filing. The court held that the ability to file a Chapter 9 was necessary or incidental to the power to refund bond indebtedness and the District's ability to manage, control or supervise its business and affairs.[26] However, a Philadelphia bankruptcy court decision,[27] citing the North and South Shenango case, held that the right to sue and be sued did not constitute the requisite affirmative action required by the Bankruptcy Code. In the bankruptcy of the City of Bridgeport, the court also concluded that specific authorization to file a Chapter 9 petition was not required.[28] The legislative history behind the 1994 Act specifically noted the controversy and the purpose of the amendment to clarify the matter. The state law must specifically authorize the filing.[29] The court in the Orange County bankruptcy ruled that the Orange County Investment Pool was not specifically authorized to file a Chapter 9 petition by a statute which referenced a laundry list of public entities that are authorized to file but which did not refer to an investment fund.[30]

Given the requirement that the state specifically authorize its municipalities to be debtors under Chapter 9, the issue is whether it is advisable to give Illinois municipalities this ultimate remedy. A further question is whether the ability to file should be part of a procedure whereby there is a second look by knowledgeable parties before the remedy is exercised. This consideration may be informed by the tradition of states providing assistance or oversight to their municipalities where appropriate.

THE TRADITIONAL ROLE OF STATES IN ASSISTING FINANCIALLY TROUBLED MUNICIPALITIES

States typically play an important role in assisting municipalities in times of financial distress. It is unusual that the largest city in the State of Michigan, Detroit, has chosen bankruptcy as its best option. States traditionally have enacted legislation designed to protect their cities from financial distress or to aid cities should financial distress befall them.

Traditionally, states have attempted to supervise local government financing and limit volatility through the enactment of debt limitations and laws that permit the refunding of municipal obligations. Over time, states have developed more sophisticated mechanisms of assisting and providing oversight to their municipalities through the use of receivers, financial managers, and oversight and refinance authorities. Each state has its own, unique approach to these mechanisms. Various states have adopted different vehicles to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. At their most basic, these methods, which may be found in legislation or constitutional provisions, include limitations on debt and taxes and on the authority to refinance outstanding debt. More hands-on involvement by the states arises in the event of financial distress. Procedures devised for such situations generally start with the requirement to balance the budget and progress to review, assistance and oversight by the states of municipal budgets and financial issues.

In addition, states have developed unique approaches to the oversight, supervision, and assistance of local governments in times of emergency. These include advisory commissions that review the financials, the budgeting and financing done by municipalities, receiverships, financial managers, financial control boards, refinance authorities, oversight commissions, and others. These mechanisms will be briefly reviewed in this material and are discussed in more detail in Municipalities in Distress? referenced in endnote 3.

FINANCIAL CYCLES REQUIRE THAT STATE AND LOCAL GOVERNMENTS PREPARE FOR ECONOMIC DOWNTURNS

The impact of economic cycles has been demonstrated throughout the history of state and local government debt financing.[31] Unfortunately, we all recognize an adverse effect of downturns, namely, lower state and local government revenues. Nevertheless, economic downturns provide no holiday from the threat of higher state and local government expenses, which are highlighted by the ever-increasing need for improvement in infrastructure, education, health care, and public safety. Over time, various new mechanisms have been introduced to provide supervision and assistance to those local governments that are experiencing financial distress. There does not appear to be a reason any local government should have to endure, without supervision or assistance, the devastating effects of a financial meltdown and possibly to resort to the filing of municipal bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. Traditionally, States have worked with their local governments to avoid financial meltdowns and bankruptcy, and there is no reason to believe that tradition will not continue.

HOW STATES HAVE ATTEMPTED TO SUPERVISE STATE AND LOCAL GOVERNMENT FINANCING AND VOLATILITY IN TIMES OF ECONOMIC DISTRESS

Historically, States have adopted various mechanisms to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. In the past, these mechanisms primarily have started with basic limitations on debt and taxes and authorization to issue refunding bonds.

At the front lines of protecting the financial status of local government are constitutional and statutory limitations on the debt municipalities may have outstanding at any time. In addition to debt limitations, all States include provisions in their statutory law for the issuance of refunding bonds.

DEBT LIMITATIONS

One of the most important protections for municipalities and their creditors is the limitation that the various States have imposed on the amount of debt a municipality may issue and hold at any one time—in fact, all States with the exceptions of Alaska, Florida, and Tennessee impose some sort of limit.[32] Municipalities in 28 States are restricted by limits imposed by their respective constitutions. Twenty-one States that impose debt limitations on their municipalities do so via statutory provisions. These municipal debt limits range from a

percentage of a valuation of assessed property in the local unit of government to a set monetary amount.[33] Some states like Illinois provide that home rule units have no debt limits, tax caps or referendum for debt imposed by the state. Instead, these states rely on a home rule unit to deal with financial and governmental matters as responsible home rule units.

REFUNDING BONDS

The most common way that municipalities restructure their debt is through the issuance of refunding bonds. Refunding bonds, as the name implies, are bonds that are issued to redeem the principal of outstanding bonds. Every state provides some sort of refunding bond provision for its municipalities. By issuing refunding bonds, a municipality may be able to refinance its debt at a more favorable interest rate or restructure its outstanding obligations to mature at a time when the municipality believes it will be more flush with money. Refunding bonds also may help a municipality to push off its debt troubles for another day. In most cases, the issuance of refunding bonds does not result in an increase in outstanding debt, because the refunded bonds no longer count toward the legal limits. By setting debt limits and taxing limits and allowing for the issuance of refunding bonds some states have attempted to curb the number of municipal financial crises and defaults. As you know, the largest cities in Illinois do not have these limits. In addition to these provisions, some steps have gone a step further to help beleaguered municipalities resolve their financial issues at the initial signs of a problem.

THE USE OF VARIOUS MECHANISMS BY STATES TO PROVIDE FINANCIAL OVERSIGHT AND ASSISTANCE TO MUNICIPALITIES IN DISTRESS TO AVOID THE USE OF CHAPTER 9

The limitation on indebtedness and authorization to issue refunding bonds are the basic tools in the States' arsenal to assist municipalities. However, in times of financial distress, these basic approaches have been enhanced by additional mechanisms. These methods have started with reaffirming statutory requirements to balance budgets and progressed to greater state assistance and oversight of municipal budgets and finances in times of financial emergency as well as the use of refinance authorities, receivers, financial managers and financial oversight authorities. States have approached the task of supervising and assisting their municipalities in a variety of ways. Although these mechanisms vary by type and degree of supervision and assistance, the widespread development of these mechanisms indicates the growing trend of more active oversight and supervision of municipalities by States in order to build better credibility with citizens and creditors, including the municipal bond market.

There appears to be statistical and practical support for the proposition that states that authorize their municipalities to file Chapter 9 bankruptcy but also have mechanisms for assistance, oversight or at least a "second look" before being able to file for Chapter 9 have reduced the use of Chapter 9 by their municipalities and have provided for the most effective relief to bridge the financial crisis. As you know, only 12 states[34] allow a municipality solely on its own decision to file a Chapter 9 bankruptcy without a "second look," either the approval of the governor, treasurer, some state agency or authority or a last effort at negotiation like the neutral evaluator in California (adopted in 2011) and 12 more require a second look.

Since 1980, those municipalities with no second look are more than six times more likely to file Chapter 9 than in the state where a second look is required (200 versus 32). Accordingly, a review of mechanism and procedure for a second look or oversight and assistance used by states in connection with consideration of the authorization of use of Chapter 9 municipalities seems prudent.

STATE-IMPLEMENTED PROGRAMS TO ASSIST IN TIME OF FINANCIAL CRISIS

As discussed below, over half of states, including Illinois, have implemented municipal debt supervision or restructuring mechanisms to aid municipalities. These programs, many of which are identified in the Table below and which are described in detail in Municipalities in Distress?, range from the California Debt and Investment Advisory Commission and the Florida Local Government Financial Technical Assistance Program, which provide guidance for and keep records of the issuance of municipal bonds in those States, to the layered approach of Rhode Island to aid municipalities depending on a municipality's level of financial instability. Other States with these provisions have effectively used these mechanisms to control the restructuring of their municipalities.

Table: State-Implemented Programs to Aid Municipalities

State	**Intervention Provision**
Arizona	School District Receivership
California	Debt and Investment Advisory Commission
Connecticut	Ad hoc State Intervention
District of Columbia	Financial Responsibility and Management Assistance Authority
Florida	Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program
Georgia	Government Monitoring
Idaho	Debt Readjustment Plans
Illinois	Local Government Financial Planning and Supervision Act and Illinois Financially Distressed City Law
Indiana	Distressed Political Subdivision Protections and Township Assistance and Emergency Manager
Kentucky	County Restructuring Provisions
Maine	Board of Emergency Municipal Finance
Massachusetts	Ad hoc State Intervention

Table:	**State-Implemented Programs to Aid Municipalities**
State	**Intervention Provision**
Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act and Local Financial Stability and Choice Act
Minnesota	Back-Up Payment Procedures for Municipalities and School Districts
Nevada	Local Government Financial Assistance and Audit Enforcement Act
New Hampshire	Emergency Financial Assistance
New Jersey	Local Government Supervision Act and Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act
New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board
North Carolina	Local Government Finance Act
Ohio	Fiscal Watch; Fiscal Emergency; and the Fiscal Emergencies and Financial Planning and Supervision Commission
Oregon	County Public Safety Emergency and Fiscal Control Board and Municipal Debt Advisory Commission
Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act
Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission
Tennessee	Emergency Financial Aid to Local Government Financially Distressed Municipal Procedures
Texas	Municipal Receivership
Wisconsin	Deficiency Protection for Public Improvement Bonds

Illinois has several statutory provisions which, while relevant to assisting municipalities in distress, have certain limitations. Under the Local Government Financial Planning and Supervision Act[35] a local government with a population of less than 25,000 and suffering a fiscal emergency in certain instances may, upon two-thirds vote of the members of its governing body, petition the governor for the establishment of a financial planning and supervision commission in order to remove the fiscal emergency. Fiscal emergency includes the existence of

any one or more of the following conditions: (1) the existence of a continuing default in the payment of principal and interest on any debt obligation for more than 180 days; (2) the failure to make payment of over 20% of all payroll to employees of the unit of local government in the amounts and at times required by law where the failure has continued for more than 30 days after such time for payment, unless two-thirds of such employees agree in writing to such extension; and (3) the insolvency of the unit of local government being a financial condition that the unit is (a) generally not paying its debt as it becomes due unless such debt is the subject of a bona fide dispute or (b) unable to pay its debts as they become due. In 1980, the Chicago Board of Education was placed under the supervision of the state and in 1989 East St. Louis was placed under state supervision.

Another relevant Illinois statute is the Illinois Financially Distressed City Law.[36] This statute applies to a home rule unit which is designated by the Department of Revenue to be (a) in the highest 5% of all home rule municipalities in terms of aggregate of tax rate percentage of all property taxes levied and (b) is in the lowest 5% of all home rule municipalities in terms of per capita tax yield. Such home rule unit is then designated by a joint resolution of the General Assembly as a financially distressed city. A financially distressed city so designated has a financial advisory authority for the city appointed by the Governor as an agency of state government. The Financial Advisory Authority is to provide assistance to and a financial basis for the financially distressed city to request funding through securities issued by the Illinois Finance Authority to provide financial aid to the city so that it can provide municipal services to its residents while attempting to pay creditors and bondholders. The city must submit a budget and an initial financial plan to the Authority for approval. The Authority can issue recommendations, directives or make material changes to revenue or expenditure estimates or to the budget and financial plan. The Financial Advisory Authority has no power to impair contracts or obligations of the city. Issues with the Illinois Financially Distressed City Law include whether the highest and lowest 5% categories work, whether obtaining a joint resolution of the General Assembly is practical and efficient, what professional advisors and qualified persons are available to serve as uncompensated directors of the Financial Advisory Board, what are the criteria for state aid and how available is it, are financial plans the same as recovery plans and does the city have the ability to develop such, is the city the best party to develop a budget and financial plan and, if the Authority really cannot impair contracts, how effective is any recovery? Another question is whether the Financial Advisory Authority can take control of the city even though the Authority is prohibited from active management and, most importantly, why so few cities ever use the Financially Distressed City Law.

STATES RECOGNIZING MUNICIPAL RECEIVERS: RHODE ISLAND AND TEXAS

Some States provide for the appointment of a receiver for troubled municipalities. For example, in June 2010, Rhode Island enacted a law providing a process of progressive state intervention for municipalities in financial distress. The new law created a three-step process for distressed government, in what was possibly an attempt by Rhode Island to prevent ad hoc efforts by municipalities to restructure with tactics that could be unfriendly to the municipal markets.[37]

In addition to the recent Rhode Island law and a law in Texas allowing for a judicially appointed municipal receiver, other States have chosen to allow for a financial control board, emergency managers, coordinators, overseers, or a financial commission to aid troubled municipalities.

FINANCIAL CONTROL BOARDS AND THEIR PROGENY

Today, the laws of Florida, Indiana, Michigan, Nevada, New Jersey, New York, North Carolina, Pennsylvania, and Rhode Island include a variation on a provision allowing for the appointment of a financial control board or commission, emergency managers, receivers, coordinators, or overseers over a troubled unit of local government. The intent of many of these provisions is to identify early signs of financial distress for a city or municipality so that the state may intervene before the city or municipality reaches the level of a municipal crisis. Importantly, such provisions are not just a web of buried state laws never to be used but, rather, are applied where situations call for intervention.

The New York Experience. Perhaps the most well-known appointment of a financial commission was the implementation of the New York City Financial Control Board in 1975. In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that, for more than ten years, New York City had been using questionable accounting and borrowing practices to eliminate its annual budget deficits.[38] Banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could be resolved only by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York City nearly defaulted on the payment of its notes in October 1975, and it was predicted that a default was likely in December absent federal aid.[39] In response, the State Municipal Assistance Corporation issued a series of securities on behalf of the city and a financial control board was appointed.

The New York City Financial Control Board was given the power and responsibility to review and provide oversight with respect to the financial management of New York City's government. Among other things, the act establishing the board required the city to prepare and submit a "rolling" four-year financial plan to the Financial Control Board prior to the beginning of each city fiscal year.

The Pennsylvania Experience. Similar to the New York experience, Pennsylvania has implemented a series of provisions to aid ailing cities. Pennsylvania law contains the Financially Distressed Municipalities Act, which applies to any county, borough, incorporated town, township, or home-rule municipality (Act 47).[40] Under these provisions, if the state's Department of Community Affairs determines that a municipality is financially distressed based on certain triggering events, the department may appoint a coordinator to guide the municipality in getting its financial affairs in order. Since 1987, there have been only 28 municipalities that have chosen to involve the Act 47 declaration of and determination of financial distress and only 9 so far have had the determination rescinded.

In addition to the Financially Distressed Municipalities Act, Pennsylvania law contains the Intergovernmental Cooperation Authority Act, which was created in 1991 to deal with insolvency issues faced by Philadelphia. The act created a five-member authority with authorization to enter into intergovernmental cooperation agreements with cities, and these agreements were preconditions to the issuance of any obligations by the authority. Among other things, the authority could issue bonds and the city and the authority were required to work together to develop a five-year recovery financial plan.

The Michigan Experience. Likewise, the State of Michigan, under its former Local Government Fiscal Responsibility Act, has taken over the Detroit Public Schools, the City of Pontiac, the City of Ecorse, the Village of Three Oaks, the City of Hamtramck, the City of Highland Park, and the City of Flint.[41] These provisions were subsequently replaced by the Local Government and School District Fiscal Accountability Act.[42] Under this act, if a school district or municipality was in a perilous financial situation, the governor of Michigan could declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager be appointed, the emergency manager had broad powers to operate and restructure the municipality, including the ability to reject, modify, or renegotiate contractual obligations.[43] As a last resort, this emergency manager could file a Chapter 9 municipal bankruptcy petition on behalf of the municipality.[44] This Public Act 4 of 2011 provided for a Michigan emergency manager with extraordinary power. The act was very controversial, especially to local government bodies and elected officials. A referendum placed on the November 6, 2012, ballot defeated Public Act 4 of 2011, the Michigan Emergency Manager Law.

On December 27, 2012, the governor of Michigan signed into law the Local Financial Stability and Choice Act,[45] which replaced the defeated Public Act 4. Also, in 2012, Indiana passed legislation allowing its Distressed Political Subdivisions Appeal Board to appoint an emergency manager for its distressed subdivisions on grounds and with powers similar to the Michigan emergency manager.[46]

The Massachusetts Ad Hoc Experience. Similar to the laws of states establishing specific authority for financial control boards or similar commissions, Massachusetts has typically employed a system of implementing legislation on an ad hoc basis to create a financial control board or overseers for municipalities in severe financial distress.

The California Experience: Neutral Evaluator. California also has experimented with the concept of introducing a third party to assist in the resolution of municipal financial difficulties. California recently enacted a provision restricting the ability of its municipalities to file petitions to institute Chapter 9 proceedings.[47] The thrust of the legislation is to provide a period of objective and dedicated negotiation and resolution of issues affecting major creditors or financial problems. The legislation provides for a neutral evaluation process, otherwise known as mediation, for major creditors and parties to the financial problems. The neutral evaluator process provides a professional, independent, neutral advisor to serve as the supervising adult, which is the essence of a neutral evaluator. The neutral evaluator can foster negotiations among the municipality and representatives of major creditor constituencies, including workers and union representatives, vendors, contract suppliers, holders of major claims including

bondholders, judgment creditors, or others whose interests could affect the financial fate of the municipality. The neutral evaluator process may not last more than 60 days from the date the evaluator is chosen unless the municipality or a majority of participating interested parties elect to extend the process up to an additional 30 days. The neutral evaluator procedure is intended to be an expedited process and cannot last more than 90 days from the date of the selection of the neutral evaluator.

North Carolina Experience. Due to a significant number of local government defaults during the Great Depression, North Carolina created the Local Government Finance Commission as part of the North Carolina Department of the State Treasurer. The Commission provides oversight and assistance to North Carolina local governments. No debt can be incurred by any local government in North Carolina without the supervision and assistance of that Commission and the oversight continues as to annual financial reporting and accounting of the fiscal health of the local governmental offering broad assistance in financial administration. This is supervision of debt incurrence from cradle to payment in full.

The passage of a bill permitting a Chapter 9 filing should not preclude Illinois from taking the action other states have chosen short of a Chapter 9 filing to rescue their financially challenged municipalities.[48] These alternatives to Chapter 9 that certain states have provided to avoid the cost and stigma of Chapter 9 have been well-accepted and appreciated by the municipal market. For this reason, every state provides for some form of refinancing of municipal obligations and some states provide various forms of oversight, supervision and financial support to the distressed municipality. The ability to file Chapter 9 does not prevent as an alternative the oversight, supervision and refinancing of the debt of a financially challenged municipality as was done with New York City in 1975 and the formation by New York State legislation of a Municipal Assistance Corporation that helped supervise the financial recovery of the City and refinance its debt or similar assistance by Ohio to Cleveland in 1978 or by Pennsylvania to Philadelphia in 1991 with the passage of the Pennsylvania Inter-Governmental Cooperation Act. Further, the passage of the Bill would not preclude the oversight and supervision of overseer, budget commission or receiver such as authorized by recent legislation in Rhode Island or the use of an emergency manager as permitted by legislation in Michigan and Indiana or financial control boards in New York State or Act 47 used in Pennsylvania.

DEVELOPMENT OF THE LOCAL GOVERNMENT PROTECTION AUTHORITY: A PROPOSAL OF THE CIVIC FEDERATION

The experience of the New York Financial Control Board, Detroit with the emergency manager, the Rhode Island receiver approach, and the mediator of the California statutory scheme have coalesced in the concept of a local government protection authority. (The draft of the Illinois Senate legislation and the Civic Federation's description illustrating how such an authority would function has already been submitted to the Committee by the Civic Federation.) Under consideration by some states is the use of a local government protection authority utilizing some of the best aspects from the mediation process of the neutral evaluator and the oversight and supervision of financial control boards and a receiver. Under this municipal debt resolution mechanism, the state would establish an entity that would have a quasi-judicial function and

power similar to a commission or special master appointed by a state supreme court or other objective nonpolitical process. The members of the authority would be independent, experienced experts in governmental operation or finance as well as in mediation and debt resolution techniques, including bankruptcy. The authority would start with those municipalities that petition for help or those municipalities that have triggered certain established criteria where the jurisdiction of the authority may be mandated by state law. The first phase is mediation and consensual agreement by the municipality and the affected creditor constituencies similar to the neutral evaluator process. However, participation by the authority may be voluntary by petition of the municipality or other affected constituencies asserting that a financial emergency exists or, under the most dire circumstance could be required, and negotiation and discussion of positions are strictly confidential. The state law establishing the authority may have an exception to its open meetings law and its freedom of information law to allow for open discussion of any sensitive and confidential topics. If additional tax revenues or loans or grants from the state are needed, recommendations to the state by the authority may be made. The authority may be empowered to likewise call for a referendum on a local basis for increased taxes or other actions. Specified time periods for resolution will be set forth and, if the voluntary process is not successful, the second phase may be requested or may be mandatory if the authority so requires.

In the second phase, the authority and its designated members turn into a quasi-judicial panel, and the municipality is required to set forth the steps to be taken to address its specific financial problem (recovery plan). Creditors, workers, and taxpayers will have the ability to comment and to attempt, through negotiation, to modify the recovery plan within a set period of time. Then, the recovery plan is presented to the panel members of the authority for determination of the plan's feasibility and whether it is reasonably fair to creditors' interests in relation to the requirement that, under all circumstances, essential governmental services, at least at an established necessary level, must be maintained for the reasonable future. One of the triggers for the authority's jurisdiction is the petition by the municipality, its workers, or taxpayers that a governmental function emergency exists. The municipality or petition must state that essential services as to the health, safety, and welfare of its residents are being threatened and that the forced reduction in services, given the municipality's financial condition and its revenues, impairs the health, safety, and general welfare of its residents. The authority, after hearing all sides (municipality, workers, taxpayers, affected creditors), will determine:

- What is sustainable and affordable;

- What the municipality can afford; and

- What adjustments must be made to the recovery plan to allow the municipality to continue to provide essential governmental services to its residents at established mandated levels to preserve the health, safety, and welfare of its residents and to pay what is feasible to its creditors, including workers' wages and pensions.

The authority will act as an "honest broker" to mandate increases in taxes, where necessary; increases in contributions by the municipality or workers for pension or other benefits, if necessary; or reduction, delay, or stretching out of payments to creditors. Further, if

necessary to preserve the public health, safety, and welfare of the municipality's residents, the authority will have the power to reduce workers' wages, pensions, or other benefits.

A municipality that underestimates in its recovery plan its ability to pay creditors and workers will have necessary increases recommended and found by the authority to be required for the benefits of the workers and the creditors. A municipality that overestimates its ability to pay or makes promises that are not sustainable and affordable will be subject to the recommendation of the authority that payments available to creditors be reduced and taxes possibly increased. The findings of the authority will specify if they are final and enforceable by the parties or if further negotiations or proceedings are necessary. The authority will be charged to make sure that the municipality and the state maintain access to the financial markets, and the ability to borrow will be protected if possible. This authority process should help protect all parties, workers, vendors, and creditors and the taxpayers and the municipality so they will have needed means of continued financing credibility that can be accomplished on the local level based upon maintaining market credibility. The authority can authorize the municipality to enforce its findings. The findings, determinations, and rulings of the authority can have the force of law by providing that, if the legislature does not act within a short, specified period and overturn the act of the authority, it is the law. Such means of enforcement can include having the recovery plan approved or revised by the commission as the basis for a pre-negotiated or "pre-packaged" Chapter 9 plan. The authority can authorize the municipality to file a Chapter 9 proceeding based on the recovery plan as a pre-packaged Chapter 9 plan. Such a pre-packaged Chapter 9 plan can significantly reduce costs, expenses, uncertainty, and financial market risk of a free-fall Chapter 9 proceeding. In the corporate world, for instance, pre-packaged Chapter 11 plans (corporate plans of reorganization) have been confirmed in weeks rather than months or years with reduced costs, risks, and uncertainties.

This municipal protection authority concept could be the means of providing state and local government cooperation and oversight while allowing the municipality, its elected officials, workers and unions, creditors and bondholders to have a means of participation with a definitive end result. Further, the resolution for affected workers and creditors can be hard-wired for a payment source of dedicated taxes for assured payment of wages, benefits, and creditor claims rather than the speculative hope of future payment at the willingness of future legislative actions.

THE STRUCTURE FOR OVERSIGHT AND EMERGENCY FINANCING

Local governments that have encountered financial distress have resorted to financing and oversight authorities (such as New York City and Philadelphia). This approach can involve various degrees of formal oversight and control. In the beginning, it can be as simple and benign as a "commission" that reviews the city budget and makes recommendations based on new revenue sources. If necessary, the authority can develop into a refinancing authority with full power to refinance existing debt of the local government and to authorize collection of new revenue sources or withdraw use of new revenue sources if budget recommendations are not followed or met. There are two basic advantages to this approach:

- The new independent issuer can have financial credibility and, therefore, access to borrowing in the capital marketplace if it has an assured source of revenue to pay debt service that is isolated from the bankruptcy and other legal risks; and

- An independent authority can use various tools to enforce fiscal discipline on the local government because it can be removed from political pressures.

The basic idea is that the authority is given a revenue source. It then borrows and assigns the revenue source to pay debt service on the bonds, payments to creditors and to provide funds for necessary infrastructure enhancement to foster improved economic growth. The authority makes the bond proceeds available to the local government to pay its expenses and retire the deficit. A basic legislative choice is whether the local government levies the new taxes and pledges the proceeds to the authority or the authority is the taxing body authorized to levy taxes. In addition, the sub-sovereign's ability to levy new taxes may be conditioned on a balanced budget or approval of the authority. *The New York Times* has favorably reported on this concept of an authority as a structure to assist troubled cities deal with their problems, including issues of pension and debt obligations. *See* Walsh, Mary Williams. "Stepping Up with a Plan to Save American Cities." *New York Times*, 12 Nov. 2013, NY ed: F16.

Financing through the authority can be used both for a long-term amortization of the cumulative deficit and, if necessary, for an interim period, to accomplish the annual revenue anticipation note borrowings that are necessary for the sub-sovereign to operate. Different revenue sources might be used for each type of borrowing. The disciplinary tools are important and a wide range of tools can be constructed, including the following:

Grants from the Federal, State or Regional Governmental Bodies. Obviously, a source of funds has to exist from which to make grants. The grant becomes a tool if the federal, state, or regional governmental body[49] imposes performance conditions as a precondition to any grant. The federal, state, or regional governmental body can make the process more politically palatable by freely making a grant to the authority while requiring either in the legislation or in the grant documents that the authority impose performance requirements.

Loans from the Federal, State or Regional Governmental Bodies. Instead of a grant, the federal, state, or local governmental body can make loans that require ultimate repayment. The repayment terms can be varied depending upon the local government's compliance with an approved financial plan and the achievement of goals over time. That is, interest rates can be increased or decreased as needed; in a worst-case scenario, principal payment can be accelerated for a default. There can also be in certain states the assumption of the obligations by the state.

Intercepts. Part of the discussion in structuring grants and loans should consider "intercepting" the payments to the local government. Legislation can be written that permits the state or regional governmental body to withhold these payments if the local government acts inappropriately or fails to act, or that permits those revenues to be pledged (*e.g.*, paid directly) to lenders or bondholders. In the implementation stage, there is an issue of whether special interest groups, such as unions, local financial institutions, or pension funds might have the ability and

willingness to invest in such financing. New York City had support from unions in purchasing significant positions of its refinancing debt.

Budget Process Involvement. Having a financial plan to work out of the deficit, following that plan, and changing the plan as experience dictates are the keys to a successful workout. The first step is to identify the problems and to stop the financial bleeding to the degree possible.

Required Financial Performance. The authority can legislatively be given powers to participate in and monitor the local government's budget process across a broad spectrum. Ultimately, the teeth in the program are that bond proceeds or new tax revenue sources are not made available to the local government until it complies with the plan, and that continued compliance is required for a continuing revenue flow. The legislation itself can contain the requirements, or it can authorize the authority to develop and establish the requirements.

Legislative Assistance. A financially distressed local government comes as a somewhat recalcitrant beggar to the legislature. An authority that is monitoring (and actively participating in) the local government's recovery can give it credibility with the legislature or, alternatively, if the local government fails to make progress, can assist the legislature in developing new criteria and programs.

Moral Obligations of the State. Some states may be constitutionally able to assume debt of a local government. In such states an "extra-legal" state guaranty called a "moral obligation" is sometimes used to credit enhance bonds.

Appointment of Authority Members. The makeup of the governing body of the authority is critical to its success. Payment of its staff is important. It is conceivable that some community leaders may be willing to serve without compensation if they believe the authority and its tools are capable of success. Whether or not the local government is able to appoint or be represented on the authority is a question for the drafters of the legislation.

Acceleration of Loans. If the authority makes loans to the local government, the loan could include the right to accelerate repayment of the obligations if the local government fails to comply with the recovery plan.

Publicity. By participating in the local government recovery process, the authority can become a mechanism for disseminating both good and bad information about the progress of the local government's recovery efforts. Such information flow and disclosure will be helpful in building credibility with the investment community. The experiences of New York City, Cleveland, and Philadelphia stress the importance of accurate and clear communication with the financial market.

Powers. The authority can have as many or as few powers as the legislature may require, including but not limited to:

1. Authorizing filing of a judicial action for municipal debt adjustment by the local government;

2. Granting, after hearing and notice, a stay against litigation and debt enforcement;

3. Approving or withdrawing future use of increased tax revenues;

4. Rejecting or approving budget, financial plans, and future financing;

5. Determining financial emergency or recovery;

6. Approving, expediting, or withholding state aid and entitlement to taxes distributed to the local government;

7. Approving or issuing bonds for refinancing or paying local government deficit or extraordinary operating expenses;

8. Reporting to the state regarding the need for further legislative or disciplinary tools; and

9. Transferring certain governmental services to other governmental bodies or consolidating governmental services on a regional basis or with other municipalities.

Consolidation of Regional Essential Governmental Services. One interesting proposition for States is whether certain essential governmental services such as public safety (police and fire) or public health or education should be consolidated and combined on a regional basis to gain the benefits of the efficiencies and elimination of duplicative and overlapping services and administration.

Legislation can be written so that some or all of the above-described tools are available to the authority. These tools can be designed and enacted so that they are mandatory or discretionary. The choices and variations can be further delineated. A variation of the intercept and periodic financial reporting has been used in connection with troubled debt securities issued by local government as a mechanism to ensure the flow of payments from taxes or fees to the bondholders.

Any state municipal refinancing or restructuring board should have sufficient power and authority under state law to effectively supervise a distressed local government. Accordingly, any such municipal oversight and reference authority should be authorized to be able to:

1. Require balanced budgets and provide economic discipline and reporting;

2. Issue debt in the state's name or as a separate entity to obtain market credibility and access;

3. Have the power to negotiate debt restructuring and quasi-judicial jurisdiction;

4. Review services or costs that can be transferred to other governmental bodies;

5. Have the right to intercept tax revenue and ensure payment for essential services and necessary operating costs;

6. Have the power to authorize a Chapter 9 filing if needed;

7. Obtain bridge financing of, or refinance, troubled debt;

8. Transfer certain services to other governmental agencies to reduce expenditures;

9. Grant funds to the municipality to bridge the financial crisis;

10. Provide funds to the municipality by means of a loan with terms that are realistic or payable from out-of-state tax sources that can be offset;

11. Use an intercept of state tax payable to the municipality to ensure essential municipal service;

12. Create private-public partnerships to lease and sell municipal properties to provide bridge financing and cash-flow relief;

13. Develop a vendor assistance program to provide vendor payments through financing by purchase of vendor claims at a discount (fixed discount) and secured by payment from dedicated tax revenues over time or provide current cash flow relief from current or future vendor payments;

14. Explore the consolidation on a regional basis of certain governmental services; and

15. Monitor compliance with any restructuring plan to ensure compliance and prevent financial erosion.

THE COMPETING FORCES IN A CHAPTER 9

Chapter 9 is generally viewed as the remedy of last resort for troubled municipalities. If permitted by its state law, a municipality typically does not seek Chapter 9 relief unless it is in extreme financial distress with no obvious solution. Among the factors that can lead to such serious financial distress include the decline of urban areas, the decline of industry and related shrinking of the tax base, unaffordable and unsustainable personnel costs and large debt obligations in excess of the ability to pay. Chapter 9, however, is a vehicle not for elimination of

debt, but for debt adjustment. (*See* Appendix 5 for Charts regarding the differences between Chapter 9 and Chapter 11 of the Bankruptcy Code.) The primary purpose of Chapter 9 is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims. Faced with the necessity to adjust debt, cities who recently have filed for Chapter 9 have been faced with heated battles between creditors including public employees and representatives of public debt with respect to the conduct of the case and the plan of adjustment to be confirmed. Accordingly, a brief discussion of the provisions in Chapter 9 governing the rights of creditors is instructive.

The following chart summarizes the priorities of creditor payments in Chapter 9.

SUMMARY OF CHAPTER 9 PRIORITIES

	TYPE OF CLAIM	**EXPLANATION**
1.	Obligations secured by a statutory lien to the extent of the value of the collateral.[ab]	Debt (bonds, tax anticipation notes, revenue anticipation notes) issued pursuant to statute that itself imposes a pledge. (There may be delay in payments due to automatic stay – unless stay is lifted – but ultimately will be paid.) One may expect the bondholders secured by a state statutory lien to argue that the municipality must pay on time the pledged revenues since to do otherwise is contrary to state law and §§ 903 and 904 of the Bankruptcy Code.
2.	Obligations secured by special revenues (subject to necessary operating expenses of such project or system) to the extent of the value of the collateral.[ab] These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.	Special revenue bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are used primarily or intended to be used primarily to provide transportation, utility or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specially levied to finance one or more projects or systems, excluding receipts from general property, sales or income taxes (other than tax increment financing) levied to finance the general purposes of the debtor.[c] There should be no delay in payment since automatic stay is lifted under § 922(d).

	TYPE OF CLAIM	EXPLANATION
3.	Secured lien based on bond resolution or contractual provisions that does not meet test of statutory lien or special revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof.[c]	Under the language of §§ 522 and 928, liens on such collateral would not continue post-petition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or debtor. One may expect the creditor to argue that pursuant to §§ 903 and 904, the court cannot interfere with the power of a State to control a municipality in exercise of political or governmental powers with the property or revenues of the debtor, and that includes the grant of security to such secured creditor, priority of payment, mandatory set aside or mandatory appropriation required by state statute or constitution.
4.	Obligations secured by a municipal facility lease financing.	Under § 929 of the Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5.	Administrative expenses (which would include expenses incurred in connection with the Chapter 9 case itself).[d] Chapter 9 incorporates § 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under § 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to § 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.
6.	Unsecured debt includes:	
	A. Senior unsecured claims with benefit of subordination paid to the extent of available funds (without any obligation to raise taxes) which include any of B, C, D or E below.	

	TYPE OF CLAIM	EXPLANATION
	B. General obligation bonds.	Secured by the "full faith and credit" of the issuing municipality. Post-petition, a court may treat general obligation bonds without a statutory lien or special revenues pledge as unsecured debt and order a restructuring of the bonds subject to state statute and constitutional provisions as to security interests lien, priority of payment, mandatory appropriation or set aside. Payment on the bonds during the bankruptcy proceeding likely will cease.
	C. Trade.	Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services.[e]
	D. Obligations for accrued but unpaid prepetition wages and pensions and other employee benefits.	These do not enjoy any priority, unlike in a Chapter 11.[f]
	E. Unsecured portion of secured indebtedness.	
	F. Subordinated unsecured claims.	Any debt subordinated by statute or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive *pro rata* distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

a Chapter 9 incorporates § 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. *But see* numbers 3 and 4.

b Chapter 9 incorporates § 364(d) of the Bankruptcy Code, which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.

c A pledge of revenues that is not a Statutory Lien or Special Revenue Pledge may be attacked as not being a valid continuing Post-Petition Lien under § 552 of the Bankruptcy Code.

d These expenses strictly relate to the costs of the bankruptcy. Because the bankruptcy court cannot interfere with the government and affairs of the municipality, general operating expenses of the municipality are not within the control of the court, are not

discharged and will remain liabilities of the municipality after the confirmation of a plan or dismissal of the case.

e Section 503(b)(9) provides for a priority claim to be paid on confirmation of a plan for the value of goods provided prepetition within 20 days of the petition date.

f Chapter 9 does not incorporate § 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collative bargaining agreements (making the standard less restrictive, *i.e.,* "impairs ability to rehabilitate") or §§ 507(a)(4) and (5), which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacation, severance, sick leave or contribution to pension plans of currently $12,475 per employee.

MUNICIPAL OPERATIONS AND CREDITOR PROTECTIONS

While in a Chapter 9 proceeding, the municipality will still have to function as a municipality. Depending upon the statutory mission of the municipality, there are certain necessary and basic municipal services that must be provided, such as public safety (police and fire), public health and welfare (education and health, transportation, building and zoning and, under certain instances, sewer, water and electrical services). History has shown that municipalities in financial distress need a recovery plan that stimulates economic activity in the municipality and encourages business to locate or expand there. This business expansion typically creates new, good jobs that increase tax revenues that lead to the recovery and the solution of financial distress. Also, in order to effectuate a recovery plan, which is necessary for a turnaround, and to prevent future financial distress, there must be funding of essential government services. This will produce a stimulation of the economy and encourage growth of the municipality which will attract new businesses and new citizens. This economic growth will create needed jobs, especially for younger workers who will in turn become taxpayers and which will result in increased tax revenues. In order to accomplish the recovery plan, improved infrastructure is required in order to ensure the required movement of goods, services and workers. In addition, enhanced education programs are important to train young workers for the specific jobs created. Further, improved public safety and welfare programs that will lead to a constructive environment fostering economic growth and recovery.

Defining these necessary municipal services is a question of state law and local choice and may by itself be a complex issue. A bankruptcy court and creditors will not be able to successfully interfere with such service. Section 904 of the Bankruptcy Code recognizes this reality. Accordingly, certain revenues and activities of the municipal body that may be the cause of the "insolvency" may not be able to be restrained, curtailed or modified without a compelling reason. Even municipal debt secured by "special revenues," which pledge is preserved by reason of § 928 of the Bankruptcy Code, is subject to the payment of necessary operating expenses.

"SPECIAL REVENUES" PLEDGED TO BONDHOLDERS

Many municipal bonds are revenue bonds secured by a pledge of revenues derived from a specific project or a special tax levy. In fact, all states recognize some form of a revenue bond. As background, in a corporate bankruptcy context, § 552 of the Bankruptcy Code provides that

property acquired by the estate or the debtor after commencement of a case is not subject to any lien resulting from a security agreement entered into by the debtor before the commencement of the case. Thus, in a corporate bankruptcy, if a revenue pledge were to exist, such as a lien on inventory or accounts receivable, the pledge likely would not survive the filing of a bankruptcy petition (namely any property or revenue created post-petition, such as inventory manufactured or accounts receivable received from sales of inventory after the filing of the case). In a municipal bankruptcy, however, this is not the case. Specifically, § 928 of the Bankruptcy Code provides that in the case of "special revenues," the security interest in "special revenues" remains valid and enforceable even though such revenues are received after a Chapter 9 filing. Subsection (b) of § 928 provides that in the case of project or system financing, the bondholders' lien on "special revenues" is subject to necessary operating expenses of the project or system. Thus, subject to the payment of operating expenses, holders of special revenue bonds would continue to receive payment on those bonds, regardless of the bankruptcy filing.[50]

Section 928 was incorporated into the Bankruptcy Code by the Municipal Bankruptcy Amendments, which were adopted in 1988, as part of an Act to Amend the Bankruptcy Law to Provide for Special Revenue Bonds, and for Other Purposes, Pub. L. No. 100-597 (1988) (*"1988 Amendments"*). As noted by the Bankruptcy Court in the *Jefferson County, Alabama* Chapter 9 bankruptcy proceeding, the 1988 Amendments became necessary because at the time the 1988 Amendments were adopted, there was great concern in the municipal bond market that the application of general commercial finance concepts rendered the extension of credit to a troubled municipality fraught with risk.[51] In fact, "[a] major purpose was to change from using corporate debt principles in the municipal financing context when their application would be at odds with how municipal financing has evolved. This was and remains especially apt for revenue based municipal financing transactions."[52] As is clearly set forth not only in the specific provisions added to Chapter 9 by the 1988 Amendments but also in the legislative history for the 1988 Amendments, Congress concluded that, without the 1988 Amendments, the uncertainty of the effect of Chapter 9 as it then existed on municipal debt could have dire effects. This was especially true with respect to concerns regarding the continuation of a lien on revenues in a Chapter 9 proceeding.[53] The Senate Report for the 1988 Amendments, Senate Report No. 100-506, 100th Cong., 2d Session (1988) (the *"Senate Report"*), made it clear that the intention of the 1988 Amendments was to address the real worry in the marketplace that revenues dedicated to the repayment of municipal revenue obligations would be diverted to other purposes once a local government entered bankruptcy; that this worry rendered clarification of the law a necessity; and that revenue debt could not be impaired in a Chapter 9.[54] The same concern was reflected in the House Report for the 1988 Amendments, which noted that the bill "remedies the inconsistencies between bankruptcy law and principles of municipal finance to remove the potential for problems that now exist."[55] As noted by the *Jefferson County* Bankruptcy Court, "[i]f nothing more is evident from … the legislative history, it is that Congress intended that certain of the corporate finance principles be modified including changing how the automatic stay applies to revenue based financing for municipalities."[56]

In fact, the Bankruptcy Court in *Jefferson County* found that it was clear from the legislative history accompanying the 1988 Amendments that the elimination of the potential loss of a municipal creditor's lien on special revenues was critical to Congress.[57] Indeed, the 1988 Amendments were enacted, in part, to protect the municipal bond market from the uncertainty

common in other commercial credit markets, provide for readily available inexpensive financing for municipalities and municipal projects and ensure that municipal revenue bondholders receive the benefit of their bargain without the uncertainty typical in non-government financing. In enacting the 1988 Amendments, Congress specifically recognized that "the proposed amendments reflected the principles that have long been the premise for municipal finance but have not been expressly stated in the Bankruptcy Code."[58] The Senate Report stated:

> The problems created by the incorporation of general commercial finance concepts into municipal bankruptcy provisions first came to light as a result of the financial crisis confronting the City of Cleveland, Ohio in 1979. Cleveland needed additional financing but lenders were unwilling to lend for a variety of reasons, including the incorporation into Chapter 9 of the general bankruptcy concepts of Section 552 of the Code.… Thus lenders who contemplated providing financing during financial troubles of the City were discouraged given the concern that their security interest might terminate upon a Chapter 9 filing of the city. … Such uncertainty may have dire effects in the future ….

Thus, § 928 provides that special revenues acquired by the debtor after the commencement of a bankruptcy case are subject to any lien granted on special revenues prior to the bankruptcy filing. Section 928 is intended to ensure that revenue bonds do not become transformed into general obligation bonds with a call against all the assets of the municipality upon the filing of bankruptcy petition.[59] The Bankruptcy Court in *Jefferson County* explains:

> The bigger picture of what was to be accomplished by the 1988 Amendments comes from knowing that the post-bankruptcy loss of a security interest in pledged special revenues via § 552(a) or the § 547 avoidance of a payment to a bond or warrant holder pursuant to a special revenue financing could have made the obligation or avoided transfer unsecured. As an unsecured indebtedness, it was then potentially repayable from the general revenues of the municipal entity. Under this scenario, it might have been changed by the pre-1988 version of the Bankruptcy Code from an obligation repayable solely from the revenues of the system or project or a specified tax into one repayable from the general revenues of the municipality. Essentially, it may have been turned from a nonrecourse into a recourse obligation of the municipal government.[60]

As background, prior to the addition of § 928 to the Bankruptcy Code, § 552(a) of the Bankruptcy Code was applicable to revenue debt in a Chapter 9. That section provides that property acquired by a debtor after the commencement of the bankruptcy case is not subject to a lien created prior to the bankruptcy filing unless the acquired property constituted proceeds of the property pledged prior to the bankruptcy filing. The result of the application of § 552(a) in the municipal context generally was to strip the lien of revenue bondholders. Therefore, the revenue bondholders would become unsecured creditors with a claim against the post-petition revenues that had previously secured the revenue bonds and their claims would become part of the general obligations of the municipality. The general funds would then be used to pay all creditors including the revenue bondholders. As a result, rather than taking the risk that a specific revenue stream would be sufficient to pay debt service on their bonds, revenue

bondholders were, in fact, taking the risk that the general fund of the municipality would not be sufficient to repay all debts of the municipality. Section 928 resolved this problem by providing that revenue bondholders continue to have a lien on special revenues generated after the bankruptcy case. As the legislative history makes clear, the addition of § 928 was motivated by the desire to make it easier for municipalities to obtain needed financing for public projects.

In addition to providing that the lien on special revenues continues after a Chapter 9 filing, the 1988 Amendments also dealt with the problem of timely payment. In order to avoid the delay in payment caused by the automatic stay of § 362, the 1988 Amendments added a new subsection to § 922 of the Bankruptcy Code that makes the automatic stay provision inapplicable to the payment of pledged special revenues to the holders of municipal indebtedness.[61]

The Senate Report observed that the payment of the net revenues, after payment of operation and expenses of the income producing property, should be paid to the holders of secured bonds without the application of the automatic stay, which is the derivation of § 922(d) in the Code, as the Senate Report states:

> This provision [362] is overly broad in Chapter 9, requiring the delay and expense arising from a request for relief from automatic stay to accomplish what many state statutes mandate: the application of pledged revenues after the payment of operating expenses to the payment of secured bonds. The automatic stay should specifically be inapplicable to application of such revenues.[62]

In fact, as the Senate Report noted at page 21,

> Reasonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal finance.

The clear intent of Congress in enacting the 1988 Amendments was to provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing. "[T]he amendments insure that revenue bondholders receive the benefit of their bargain with the municipal issuer, namely, they will have *unimpaired rights to the project revenue pledged to them*."[63]

New Section 927 [928] along with the definition of Special Revenues in Section 902(3) protect the lien on revenues.[64]

In sum, Congress made clear that revenue bondholders are entitled to receive the revenues pledged to them without any interference and on a timely basis.

Particular attention should be directed to the definition of "special revenues," the pledge of which survives bankruptcy.[65] "Special revenues" are defined as:

> (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to

provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;

(B) special excise taxes imposed on particular activities or transactions;

(C) incremental tax receipts from the benefited area in the case of tax-increment financing;

(D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or

(E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purpose of the debtor…[66]

Examples of the "special revenues" mentioned in clause (A) include receipts derived from or received in connection with the ownership, financing, operation or disposition of a municipal water, electric or transportation system. An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (B). "Special excise taxes" are taxes specifically identified and pledged in the bond financing documents and are not generally available to all creditors under state law. General state sales, general income or general property taxes would not be special excise taxes without specific language deemed levied to finance a specific project or system. In a typical tax increment financing referred to in clause (C), public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts may be part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the preexisting tax base of the community. Examples of revenues from particular functions under clause (D) would include regulatory fees and stamp taxes imposed for the recording of deeds or any identified function and related revenues identified in the municipality's financing documents, such as tolls or fees related to a particular service or benefit. Under clause (E), an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered "special revenues." Likewise, any special tax or portion of a general tax specifically levied to pay for a municipal financing should be treated as "special revenues."[67]

STATUTORY LIENS PROTECT BONDHOLDERS

In certain situations, even if holding general obligation bonds for which the contractual pledge of a municipality's taxes or revenues generally would terminate on the filing of a municipal bankruptcy petition, a bondholder may continue to receive payment in the wake of a Chapter 9 filing if the underlying statute authorizing the issuance contains a statutory lien, which lien comes into existence by virtue of the statute and arises by force of the statute on specific circumstances or conditions and not requiring further action by the municipality.[68] A statutory lien cannot be canceled on the filing of a bankruptcy petition or by the bankruptcy court. This approach was recognized by the district court on appeal in the Orange County bankruptcy.

There, the court found that the lien securing tax and revenue anticipation notes pursuant to a California statute authorizing the county to pledge assets to secure notes was a statutory lien. Since the statute imposed the pledge, not a security agreement, it survived the filing of a Chapter 9 petition.[69] At least thirty-two States recognize some form of a statutory lien in relation to their bond obligations.[70]

In 2011, the State of Rhode Island was faced with issues of financial distress of its municipalities and, in particular, the City of Central Falls, an old manufacturing town of 19,000, which that had lost its industrial base and had fallen on hard times. The bond rating agencies had reacted to efforts of Central Falls to have a court appointed receiver placed as new management of the City. The state adopted a new law in 2010 that provided that with state supervision, depending on the degree of distress, there could be use of a state appointed overseer, a budget commission of state and local appointed members to approve budgets going forward or a receiver who would replace local government with the power to file Chapter 9. The governor and others had fears that the new law that allowed Chapter 9 filings might cause a restriction in access to the financial market or increase in borrowing costs by all municipalities in Rhode Island as a contagion of a municipal bankruptcy filing. Accordingly, Rhode Island passed a law granting a first statutory lien on all ad valorem taxes and general funds assessments for payment of all public debt (bonds and notes). This was well received by rating agencies and the municipal market so that, when Central Falls filed a Chapter 9 bankruptcy later in 2011, there was no real contagion to other Rhode Island municipalities as to restriction of access to or increase in the cost of borrowing. This is unlike the experience in Michigan where other municipalities claimed as much as 100 basis points or more (1% or more per annum) increase in borrowing costs for unlimited ad valorem tax general obligation bonds (*"ULTGOs"*) due to Detroit's filing in 2013 and the emergency manager's unfounded claim they were unsecured. Even though ultimately, the ULTGOs bondholders were to receive 100% recovery under Detroit Plan of Debt Adjustment the contagion and cloud on ULTGOs continues. After confirmation of Detroit's Plan of Debt Adjustment last year, there was proposed in Michigan (MI HB5650) to confirm a "statutory lien" being provided on ULTGOs in Michigan for the same reasons as Rhode Island, reduction in the borrowing costs to municipalities in the state. Also, Nebraska has introduced similar legislation to Rhode Island providing a first statutory lien on revenues to assure and secure the payment of bonds and notes (NE LB67). In fact the State of California complained its school districts were paying 50 to 100 basis points (.5% to 1% per annum) more because of the Michigan ULTGO issue, and a bill in the senate has been introduced to provide a statutory lien to reduce the cost of borrowing by its schools. (CA SB222)

The statutory language creating a statutory lien is exemplified by California Senate Bill 222 relating to school bonds.[71] The bill provides:

> (a) When collected, all taxes levied shall be paid into the county treasury of the county whose superintendent of schools has jurisdiction over the school district on behalf of which the tax was levied, to the credit of the interest and sinking fund of the school district, or community college district as designated by the California Community Colleges Budget and Account Manual, and shall be used for the payment of the principal and interest of the bonds and for no other purpose.

(b) Bonds issued and sold pursuant to this chapter shall be secured by a statutory lien on all revenues received pursuant to the levy and collection o the tax. The lien shall automatically attach without further action or authorization by the governing board of the school district or community college district. The lien shall be valid and binding from the time the bonds are executed and delivered. The revenues received pursuant to the levy and collection of the tax shall be immediately subject to the line, and the line shall automatically attach to the revenues and be effective, binding, and enforceable against the school district or community college district, its successors, transferees, and creditors, and all other asserting rights therein, irrespective of whether those parties have notice of the lien and without the need for any physical delivery, recordation, filing, or further act.

Some municipal analysts have noted the language of 30 ILCS 350 Local Government Reform Act and related laws (including ordinances authorizing Bonds issued under Home Rule Powers) may be read to create a statutory lien on all revenues received by the governmental body pursuant to the levy and collection of tax or the collection or deposit of money, funds or revenues so pledged to the payment of the Bonds. Historically, municipal markets and analysts have raised the question for states as to whether there should be confirmed that there are statutory liens on general obligation bonds and that the rights of revenue bonds are consistent with the 1988 Amendments under that state's law.

The significance of special revenues and statutory liens was illustrated recently by the case of *Sierra Kings Health Care District,* in which a court order reaffirmed the fact that a Chapter 9 proceeding and any order or Plan of Debt Adjustment cannot interfere with notes, bonds or municipal obligations that are paid from the pledge of taxes or revenues that are special revenues or subject to a statutory lien.[72] Of special significance is the fact that the *Sierra Kings* court confirmed, for the first time, the post-petition effectiveness of a municipality's pledge of *ad valorem* taxes which qualified as both a special revenue pledge and a statutory lien. The Chapter 9 proceeding, orders and plan would not affect the timely payment on these bonds according to their terms. Bankruptcy courts in the confirmed Plans for Detroit and Stockton respected statutory liens and special revenues.

The following chart summarizes the intended treatment of bonds and notes, depending on how they are secured, in a Chapter 9 proceeding.

Summary of Basic Treatment of Bonds and Notes in Chapter 9

Type of Bonds/Notes	Bankruptcy Effects
General Obligation Bonds	Post-petition, a court may treat general obligation bonds as unsecured debt absent a statutory lien or a pledge of revenues that classifies as special revenues or a statutory lien, priority mandatory appropriation or set aside for payment arising out of state statute or constitution "statutory or constitutional provision as to payment." Payment on the bonds during the bankruptcy proceeding likely will cease including payments subject to state statutory or constitutional provisions as to payment as noted above.
General Obligation Bonds plus Pledged Revenues	Assuming that the general obligation pledge is an actual pledge of revenue and to the extent that it may be classified as a statutory lien or special revenues, or subject to state statutory or constitutional provisions as to payment as noted above this secured, statutory or constitutional requirement of the state issuance should be respected to the degree it is consistent and authorized under state law. A pledge of revenues that is not a statutory lien or special revenues may be attacked as not being a valid continuing Post-Petition Lien under § 552 of the Bankruptcy Code. This position may be questioned under §§ 903 and 904 of the Bankruptcy Code given the prohibition that the court not interfere with the power of a State to control a municipality in exercise of political or governmental powers the government affairs or revenues of the municipality including payments subject to state statutory or constitutional provisions as to payment as noted above.
Special Revenue Bonds	A pledge on special revenue bonds will survive a bankruptcy filing. Pre-petition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of operations and maintenance costs) that are pledged to bondholders. The contemplated remedy for default often focuses on a covenant to charge rates sufficient to amortize the debt. Defaulted bondholders are expected to seek mandamus in court to require the municipal borrower to raise its rates.
Revenues Subject to Statutory Lien	Assuming the pledge is authorized under state law through a statutory lien, the bankruptcy court should respect that statutory lien. Thus, as long as the revenues are subject to a statutory lien, payments to the bondholders should be protected post-petition.

General obligation bonds without any pledge of revenue or special statutory or constitutional priority mandated set aside or mandated appropriation can be treated like any other unsecured claim of vendors, workers or pension; however, in Medley, Florida, in 1968, there was a distinction made to pay bond indebtedness on schedule and stretch out the payments to other unsecured creditors over a 10-year period since failure to make payment on the bonds might cause the municipality to lose access to the market or to pay a significantly higher price for access that would justify a better treatment for bond indebtedness for the benefit of all.

As noted in *Faitoute Iron & Steel Co., et al. v. City of Asbury Park, N.J.*, 316 U.S. 502 (1942), discretion must be exercised in dealing with secured claims. While the court recognized that New Jersey's Depression-era Municipal Finance Commission Act of 1931 could impair municipal debt, there was recognition that secured claims and tax anticipation and revenue notes stand on an entirely different footing from other municipal obligations and, in relation to them, no claim is affected by the Municipal Finance Commission Act of New Jersey. The plan adopted by Asbury Park paid general obligation bondholders a compromise payment (less in amount and a delay in payment).

PAYMENTS TO BONDHOLDERS ARE NOT PREFERENCES

The Bankruptcy Code also provides assurance to holders of all municipal bond or note obligations that payments received within 90 days of the commencement of a municipal bankruptcy petition are not preferences that may be clawed back.[73] Specifically, § 926(b) of the Bankruptcy Code provides that a transfer of property of the debtor to or for the benefit of any holder of a bond or note on account of such bond or note may not be avoided under § 547. While this section refers to "bonds or notes," there is nothing in the legislative history to support the view that this provision is limited only to instruments bearing such titles. The intent appears to be that § 926(b) should be applicable to all forms of municipal debt and allow such holders to keep such payments where the Bankruptcy Code would otherwise require any payments made within 90 days of a bankruptcy filing to be returned to the estate. Special revenues and statutory liens are designed to provide a municipality experiencing financial distress with additional available sources of financing through various options of refinancing or refunding old debt or obtaining additional liquidity with the use of special revenues or statutory liens that are intended to continue to pay and have a continuing lien on taxes collected even if the municipality should authorize filing a Chapter 9 proceeding.

LENGTHY LITIGATION ON THE COMPETING RIGHTS OF CREDITORS MAY NOT BE IN THEIR BEST INTEREST

Municipalities cannot pay that which they have no revenues to fund. Further, when obligations become so overwhelming to a municipality as to crowd out necessary expenses for essential governmental services and infrastructure, the consequences can be devastating and can lead to the meltdown of the local government.

Without a successful recovery plan, there will not be enough funds to employ workers, provide essential services or pay pensions, impaired or unimpaired. In reality, the future of paying creditors including pension funding, workers continued employment and a recovery plan is dependent upon determining what costs and expenses are sustainable and affordable. This would include determining what amount of current expense can be paid that is reasonable, prudent and feasible. Such determination must take into account the necessity of sufficient funding for a recovery plan whereby essential governmental services can be raised to an acceptable level and infrastructure provided to encourage, stimulate and insure business growth and expansion with its accompanying creature of good new jobs, especially for the young citizens. This will insure not only short-term recovery, but long-term success.

The second look and oversight mechanism described herein would help the municipality and all concerned parties develop an effective recovery plan rather than litigate over payment issues which will not be efficient or cost effective.

Fortunately, the answer to all of this is simple. Rather than positioning and fighting as to what can be paid, what cannot be paid and what must be paid, it is in the best interests of all parties striving for the recovery and success of the municipality to recognize and determine what is sustainable and affordable acknowledging the resulting increase in the revenues or adjustments are simply a recognition of reality which through a consensual process prior to Chapter 9 or in a Chapter 9 proceeding. In the long term, this will pay more than the best litigation strategy.

Obligations of the municipality can be appropriately adjusted to what is sustainable and affordable, allowing the municipality to invest in that which will help it recover and grow. There would be the determined affordable fixed payments and contingent payments that would only be paid if there are increased revenues from the success of the recovery. If the municipality does better, there will be more funding. Obligations are not impaired or diminished because realistically all that can be paid is being paid. Creditors have improved expectations that the municipality operating under a realistic recovery plan will make future payments to fund their obligations based on anticipated recovery and success of the municipality. Also, there could be periodic adjustments to the fixed and contingent payments based on actual results of the recovery and what is affordable.

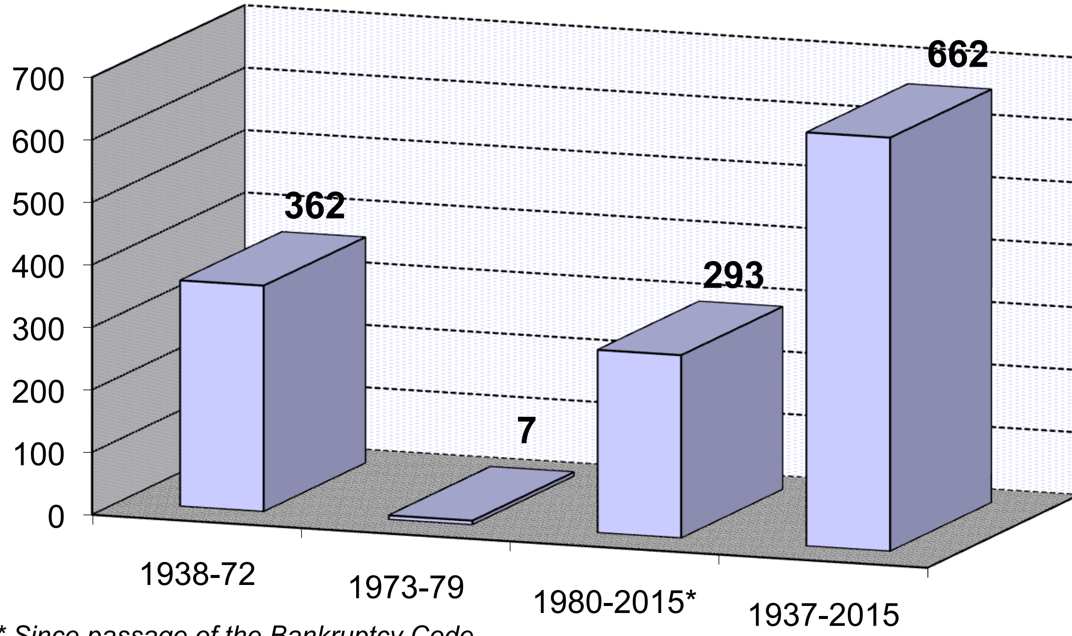
There should be a periodic review of the progress in the recovery plan. If there is a need to adjust available revenues or payment obligations so that what is paid is sustainable and affordable, those adjustments should be made.

CONCLUSION

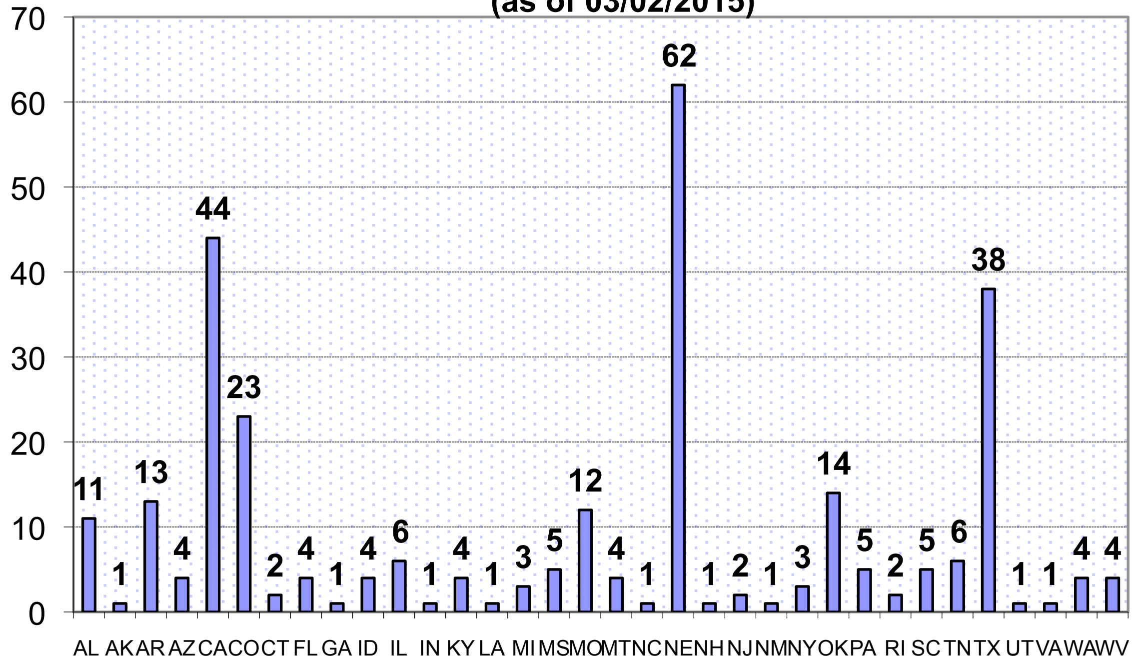
As discussed above, Chapter 9 is not a solution to the problems of a financially-troubled municipality. Rather, Chapter 9 is a process. As a result, debt adjustment without a recovery plan does not create an economic turnaround and raises the question of the futility of the process of not addressing the systemic cause of the problem. Essential governmental services must be funded. A recovery plan that stimulates the economy while providing adequate funds for the payment of essential governmental services will lead to economic opportunities and resulting job opportunities for the citizens of a financially distressed city, especially for the young workers. This recovery plan can only be accomplished by assuring participants that essential governmental services will be provided, including improved infrastructure and essential services so the blighted areas are transformed into areas where businesses and citizens will desire to reside and flourish and good jobs are available for all. Such a process will lead to new and expanded business and job opportunities, which result is in the best interest of all creditors. The recovery plan necessarily must be based upon the payment of what is sustainable and affordable. The increased revenues that flow from the creation of new jobs and new taxpayers under the recovery plan should permit the additional funds to ensure payment of these obligations that should be paid, including continued employment of public workers and appropriate funding of pensions. Without a successful recovery plan, the repayment of obligations will not only be difficult but practically impossible. However, restructuring of the obligations in a manner that

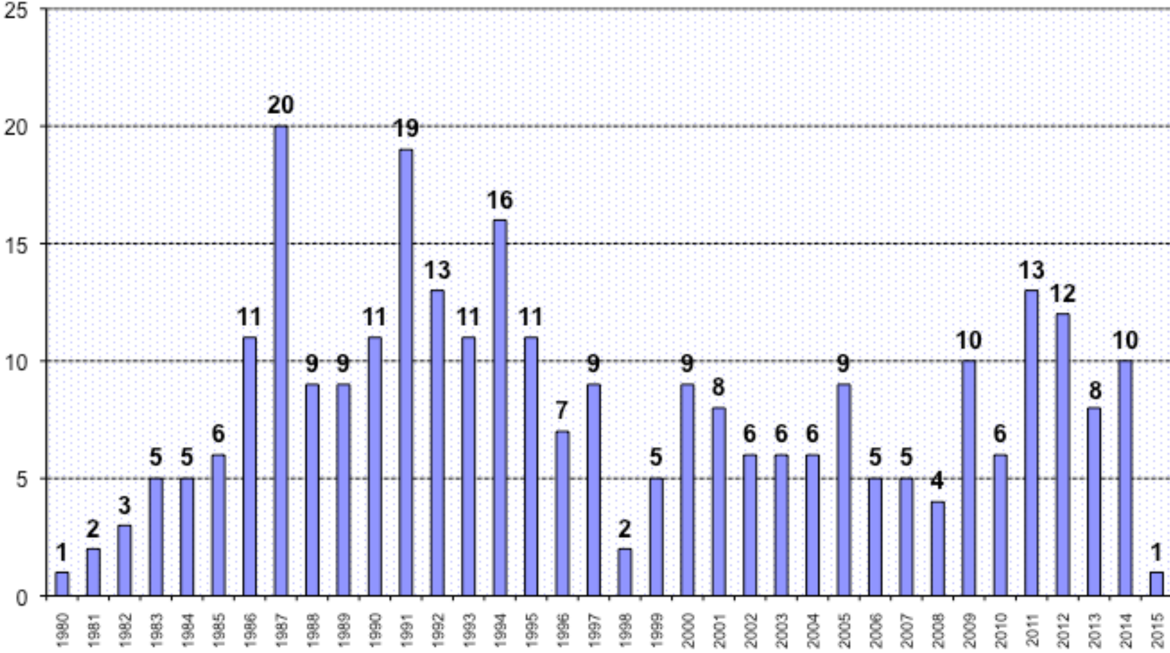
pays what is feasible is in the best interest of all. Chapter 9 has been and should continue to be used as a last resort when all other alternatives fail. Consideration of interim processes and procedures to encourage prompt and effective resolution of the causes of the financial distress should be considered such as the Local Government Protection Authority as developed by the Civic Federation. In the long run, we all are benefitted by effective laws and procedures to address and detect as early as possible the existence of municipal financial distress so that the governmental services provided to citizens of local government and the infrastructure are at a level that will allow both citizens and the local government to best assure the bright future of all.

APPENDIX 1



APPENDIX 2




CHAPTER 9 FILINGS BY YEAR • 1980-2015
(as of 03/02/2015)
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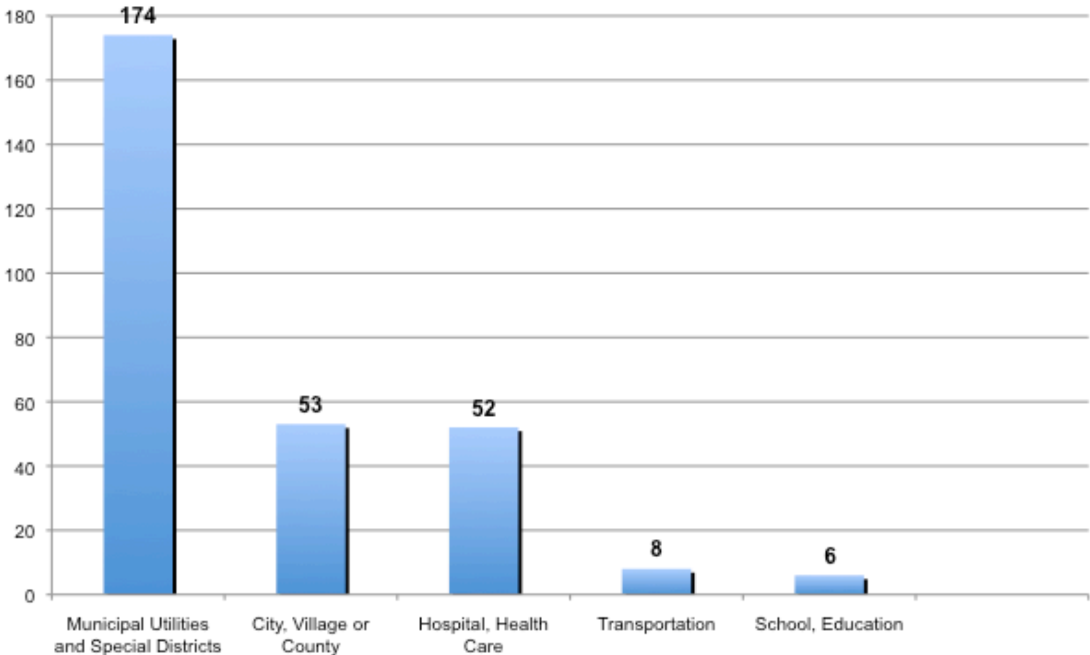
CHAPTER 9 FILINGS BY TYPE • 1980-2015
(as of 03/02/2015)
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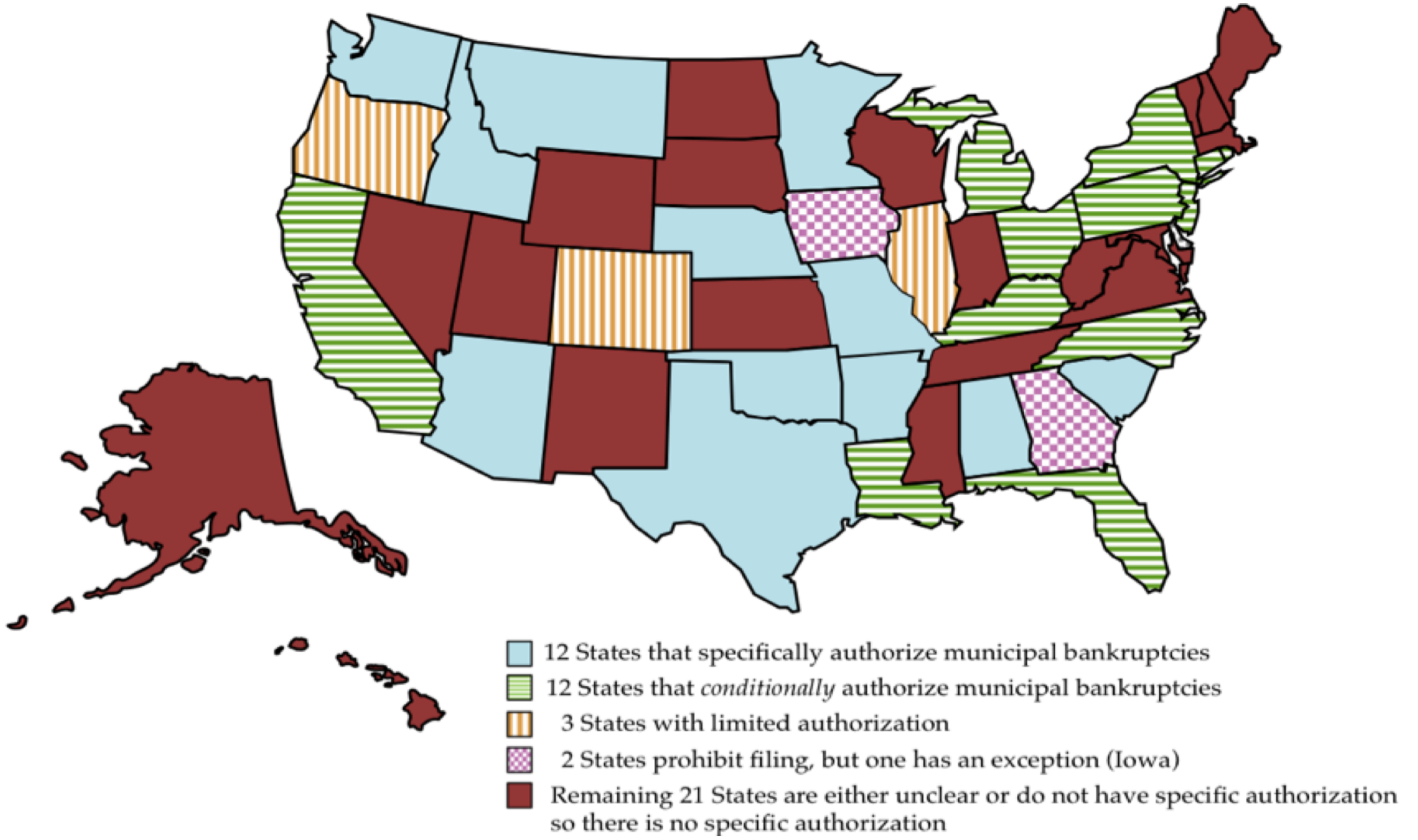
160
140
120
100
80
60
40
20
0
174
53
52
8
6
Municipal Utilities and Special Districts
City, Village or County
Hospital, Health Care
Transportation
School, Education

APPENDIX 3



Appendix 4

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities.

12 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3 (For Bonds Not Warrants)
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Idaho Code Ann. § 67-3903
Minn. Stat. Ann. § 471.831
Mo. Ann. Stat. § 427.100
Mont. Code Ann. § 7-7-132
Neb. Rev. St. § 13-402
Okla. Stat. Ann. tit. 62 §§ 281, 283
S.C. Code Ann. § 6-1-10
Tex. Loc. Gov't Code § 140.001
Wash. Rev. Code § 39.64.040

The 21 Remaining States are either unclear or do not have specific authorization. AK, DE, HI, IN, KS, ME, MD, MA, MS, NE, NH, NM, ND, SD, TN, UT, VA, VT, WV, WI, WY.

12 States that *conditionally* authorize municipal bankruptcies:

Cal. Gov't Code § 53760
Conn. Gen. Stat. Ann. § 7-566
Fla. Stat. Ann. § 218.01 and §218.503
Ky. Rev. Stat Ann. § 66.400
La. Rev. Stat. Ann. § 39-619
Mich. Comp. Laws § 141.1222
N.J. Stat. Ann. § 52:27-40
N.C. Gen. Stat. Ann. § 23-48
N.Y. Local Finance Law § 85.80
Ohio Rev. Code Ann. § 133.36
53 Pa. Cons. Stat. Ann. § 11701.261
R.I. Gen. Laws §45-9-7

3 States with limited authorization

- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition…" (CRS § 37-32-102 (Drainage & Irrigation District))
- Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 3855/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

2 States prohibit filing but one has an Exception

- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

APPENDIX 5

Key Differences Between Chapter 9 and Chapter 11

Chapter 9	Chapter 11
▪ Only the municipality can initiate a Chapter 9 if authorized by state law.	▪ The corporation (voluntary) or its creditors (involuntary) can initiate a Chapter 11 case if the corporation is a moneyed entity (not a non-for-profit) and insolvent.
▪ Only the municipality can file a Plan of Debt Adjustment.	▪ The corporate debtor (during the exclusive period) or any creditor (after the exclusive period) may file a Plan of Reorganization or Liquidation.
▪ The Plan of Debt Adjustment can only adjust debt. It cannot liquidate the municipality.	▪ A corporate plan can be for reorganization or liquidation.
▪ A Labor Agreement can be rejected in a Chapter 9 if the Labor Agreement burdens the municipality and the equities balance in favor of rejection. This is a lower standard than a Chapter 11.	▪ Section 1113 of the Bankruptcy Code sets forth the requirements for sharing information with employee representatives and workers and the process of information sharing, and the proposal by the debtor prior to the rejection of the Labor Agreement. It is a higher standard than Chapter 9.
▪ There is no limitation on damages on real estate leases held by a Trustee or Municipal Building Authority for a lease financing and the lease financing will be treated as a secured debt financing.	▪ There is a limitation of the greater of one year's rent or 15% of the remaining terms of the lease not to exceed three years for lease damages in a corporate Chapter 11. It is not treated as secured debt of the corporate debtor if it is a true lease.
▪ Payments to defease or pay current interest or principal on bonds or notes within the 90 day preference period before a Chapter 9 filing are not capable of being voided or deemed a preference.	▪ Payment of principal or interest not secured by collateral could be voided or deemed a preference during the 90 day period prior to filing a Chapter 11 if the holder would receive more than what it would be entitled to in a Chapter 7 liquidation.
▪ There are no priorities ahead of unsecured claims for prepetition claims due to employee wages, pensions, accrued vacations, healthcare and other employment benefits.	▪ There is a priority ahead of unsecured claims of up to $11,725 per employee for pre-petition wages, benefits, accrued vacation and healthcare benefits.
▪ "Special Revenues" and "Statutory Liens" are not limited or terminated by a Chapter 9 filing and are intended to continue to be paid to secured creditor and are unimpaired by the Chapter 9 filing (there is no Chapter 11 provisions comparable).	▪ Accounts receivable and inventory created post petition are not covered by the pre-petition lien of a secured lender and the pre-petition lien is terminated except for "proceeds" of the pre-petition lien.
▪ A Bankruptcy Court cannot interfere with any restrictions or requirements of state law regarding a municipality's exercise of its governmental powers (including payment of statutory liens). The Bankruptcy Court cannot interfere with the property, revenue and affairs of the municipality.	▪ The corporate debtor cannot take any action outside the ordinary course of business without Bankruptcy Court approval.
▪ The municipality can sell its assets, incur debt, borrow money and engage in governmental affairs without the necessity of having to obtain the approval of the Bankruptcy Court.	▪ The corporate debtor cannot borrow money, sell assets or expand or contract its business without Bankruptcy Court approval.

ENDNOTES

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1 Section 101(40) of the U.S. Bankruptcy Code defines municipality as "a political subdivision or public agency or instrumentality of a state."

2 Municipal Bankruptcy Composition Law: Hearing on H.R. 6912 Before the Special Subcommittee on Bankruptcy and Reorganization of the Committee on Judiciary, 77th Cong., 2d Sess. (1942).

3 In fact, not all fifty States permit their municipalities to file for Chapter 9. Only twelve States specifically authorize municipal bankruptcies. For more detail, see the book entitled Municipalities in Distress? published by Chapman and Cutler LLP, which is a 50 state survey of State laws dealing with financial emergencies of local governments, rights and remedies provided by States and State authorization of municipalities to file for Chapter 9 bankruptcy.

4 "This Chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise …" 11 U.S.C. § 903.

5 "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with - (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income producing property." 11 U.S.C. § 904.

6 *See* States listed in Note 22 for those that currently authorize municipalities to file.

7 *See* The Bankruptcy Act of 1800, 2 Stat. 19 (1800); The Bankruptcy Act of 1841, 5 Stat. 440 (1841); The Bankruptcy Act of 1867, 14 Stat. 517 (1867); The Bankruptcy Act of 1898, 30 Stat. 544 (1898). That is not to say that there were no defaults in government obligations in the nineteenth century. Indeed, the 1842 default by the State of Pennsylvania on its bonded debt inspired William Wordsworth to pen the sonnet "To the Pennsylvanians" in which he spoke of "won confidence, now ruthlessly betrayed." It was the defaults of local utility districts and municipalities in the 1800s that tarnished the integrity of the "new frontier's" obligations. George Peabody, an eminent financier, sought to be admitted to polite English Society only to be rebuffed, not due to his lack of social grace, but because his countrymen did not pay their debts. It was the defaults by State governments in the early nineteenth century and municipalities in the late nineteenth century that brought about the procedures which are now taken for granted, including debt limitations on municipal issues, bond counsel, and clearly defined bondholders' rights and State statutory provisions relating thereto.

8 *See* A Commission Report, City Financial Emergencies: The Intergovernmental Dimension (Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1973) (*"ACIR Report"*).

9 S. Rep. No. 407, 73rd Cong., 2d Sess. (1934).

10 48 Stat. 798 (1934).

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11 49 Stat. 1198 (1936).

12 *See* generally H.R. Rep. No. 207, 73rd Cong., 1st Sess. 103 (1933); H.R. Rep No. 517, 75th Cong., 1st Sess. 3-4 (1937); H.R. Rep. No. 686, 94th Cong., 1st Sess. 541, 542 (1975); H.R. Rep. No. 595, 95th Cong., 1st Sess. 397-398 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. 110 (1978), reprinted in 1978 U.S.C.C.A.N. 5787.

13 *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 80 L. Ed. 1309, 56 S. Ct. 892 (1936), *reh'g denied* 299 U.S. 619, 81 L. Ed. 457, 57 S. Ct. 5 (1936).

14 *United States v. Bekins*, 304 U.S. 27, 82 L. Ed. 1137, 58 S. Ct. 811 (1938), *reh'g denied* 304 U.S. 589, 82 L. Ed. 1549, 8 S. Ct. 1043 (1938).

15 *Leco Properties, Inc. v. R.E. Crummer & Co.*, 128 F.2d 110 (5th Cir. 1942). Further, the court had no jurisdiction to determine the existence the city or boundary disputes in the nature of *quo warranto*. *Green v. City of Stuart*, 135 F.2d 33 (5th Cir. 1943), *cert. denied* 320 U.S. 769, *reh'g denied* 320 U.S. 813, 88 L. Ed. 491, 64 S. Ct. 157 (1943).

16 Upon the adoption of the Bankruptcy Reform Act of 1978, the roman numerals which had previously been used to identify chapters of the Bankruptcy Act were abandoned in favor of Arabic numbers. Hence, since the effective date of the Bankruptcy Code, "Chapter IX" has become Chapter 9.

17 *See, In re Richmond Unified School District,* 133 B.R. 221 (Bankr. N.D. Cal. 1991), (a Chapter 9 debtor may voluntarily divest itself <u>by consent</u> of its autonomy rights under § 904 of the Bankruptcy Code.

18 11 U.S.C. § 109(c). Claims by holders of industrial revenue bonds are not governed by Chapter 9, and amounts owed by private companies to the holders of industrial development bonds are not to be included among the assets of the municipality. S Rep No 95989, 95th Cong, 2d Sess. 109 (1978). The determination of whether or not an entity is a "municipality" can be difficult. Although originally Chapter 11 relief was sought and denied because of the debtor's status as a municipality, the Court in *In re Jersey City Medical Center*, 817 F.2d 1055 (CA3, 1987), ruled that a public municipal hospital was a proper debtor under Chapter 9. Conversely, the cases American Milling Research and Development, Inc., No. 7400129 and Fort Cobb Irrigation District, No. 7600679, were initially filed under Chapter 9 but were converted to Chapter 11 bankruptcies.

19 11 U.S.C. § 101(29).

20 Only a "person" is eligible for relief under Chapters 7 and 11 of the Code. "Governmental unit" is excluded from the definition of "person." 11 U.S.C. § 101(33).

21 11 U.S.C. § 109(c)(2).

22 *See:*

ALA. CODE § 11-81-3

ARIZ. REV. STAT. ANN. § 35-603
ARK. CODE ANN. § 14-74-103
IDAHO CODE ANN. § 67-3903
MINN. STAT. ANN. § 471.831
MO. ANN. STAT. § 427.100
MONT. CODE ANN. § 7-7-132
NEB. REV. ST. § 13-402
OKLA. STAT. ANN. TIT. 62 §§ 281, 283
S.C. CODE ANN. § 6-1-10
TEX. LOC. GOV'T CODE § 140.001
WASH. REV. CODE § 39.64.040

Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1402 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition …."

23 *See, e.g.,* Ga. Code Ann §§ 36-80-5.

24 *In re Pleasant View Utility Dist. of Cheatham County, Tenn.*, 24 BR 632 (BR MD Tenn., 1982). The court concluded that the term "generally authorized" as used in § 109(c) mans only that the state should give some indication that the municipality has the necessary power to seek relief under the federal bankruptcy law. The court so held despite legislative history of the section which indicated that the Senate rejected the House's proposal that a municipality would be eligible to file a Chapter 9 petition unless such filing was prohibited by state law. *See* HR Rep No 595, 95th Cong, 1st Sess. 263264, 318319, reprinted in [1978] US Code Cong & Admin News 5963, 62206222. The Senate's position was a departure from the earlier notion that a municipality's authority to file a municipal bankruptcy was an inherent element of existence. *See In re South Beardstown Drainage & Levee Dist.*, 125 F.2d 13 (CA7, 1941). *See also In re City of Wellston*, 43 BR 348 (BR ED Mo, 9184), in which the court held that a grant of powers to act for the preservation of peace and good order and for the benefit of trade and commerce was sufficient to authorize the filing of a Chapter 9 petition.

But *see In re North & South Shenango Joint Municipal Authority*, No. 8100408 in the United States Bankruptcy Court for the Western District of Pennsylvania. There, the bankruptcy court found that a joint municipal authority which had been created under Pennsylvania law to construct and operate sewer systems, had been "generally authorized" to file a petition under Chapter 9. The court relied on the distinction in Pennsylvania law between municipal authorities like the debtor authorized to do all acts "necessary or convenient for the promotion of their business," and political subdivisions, which were required to obtain the approval of the state Department of Community Affairs before they could file a petition for relief under the federal bankruptcy law. The court found that the decision to restrict political subdivisions' resort to bankruptcy evidenced a contrary intent regarding municipal authorities. 14 BR 414 (BR WD Pa, 1981). The Third Circuit declined to exercise jurisdiction over the appeal. *Pennbank v. Washbaugh*, 673 F.2d 1301 (CA3, 1981). However, the District Court, to which an appeal was

also taken, reversed the Bankruptcy Court and held that there was no sufficient showing of state authorization. 80 BR 57 (BR WD Pa, 1982). The case was then handled in a state court proceeding. (Letter of Kirkpatrick, Lockhart, Johnson & Hutchinson, Pittsburgh, Pennsylvania to author dated August 8, 1984).

25 *See e.g.,* 4 Collier on Bankruptcy, § 900.03 n 12.

26 Villages at Castle Rock Metropolitan District No. 4, No. 89 B 16240 (D Colo., May 11, 1990).

27 *In re Carroll Township Authority*, 119 BR 61 (BR WD Pa, 1990).

28 *In re City of Bridgeport*, 128 BR 688 (D Conn 1991).

29 *See* Bankruptcy Reform Act of 1994 Section by Section Description appearing at 140 Cong. Rec. H 10771 (daily ed 10/4/94).

30 *In re County of Orange*, 183 BR 594 (BC CD Cal. 1995). *See also In re AlleghanyHighlands Economic Development Authority*, 720 BR. 647 (BC WD Va. 2001).

31 Since 1949, there have been 11 economic downturns in the United States, and the states and their local governments not only have weathered those financial storms but have provided substantial support to the eventual economic recovery by expenditures for infrastructure and other purposes that have increased employment and GDP growth. In each of these economic downturns, increased government debt financing for needed essential infrastructure and improvements was what helped provide the stimulus for recovery. These bond-funded projects have stimulated the economy by providing increased employment for construction, purchase of goods, and the ripple effect that such increases in salaries and purchases have on tax revenues, employment, and GDP. See *"The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress,"* by James E. Spiotto in the MUNICIPAL FINANCE JOURNAL, Winter/Spring 2013.

32 Even Alaska and Florida have some indirect control on debt. Alaska has a limitation on taxes and a municipality may not levy ad valorem taxes for any purpose in excess of 3% assessed value of the property in the municipality. However, these limitations do not apply to taxes levied for payment of principal and interest on bonds. Alaska Stat. §§ 29.45.090, 29.45.100 and 29.47.200 (2012). Florida has a limitation on ad valorem taxes to finance or refund capital projects only if approved by the voters.

33 Compare Alabama—Ala. Const. Art. XII, § 225 and Ark. Const. § 342 (2012) (debt may not exceed a particular percentage of valuation) with Washington, DC—D.C. Code § 47-102 (setting debt limit at 1878 levels). Alabama is somewhat unique in providing that any tax to be levied must be levied by the state legislature and does not grant the local government the power to levy taxes on its own.

34 The number was thirteen states before 2011 and California's adoption of the neutral evaluator process before municipalities are able to file a Chapter 9.

35 50 ILL. COMP. STAT. 320/1 *et seq*.

36 65 ILL. COMP. STAT. 5/8-12-1 through 5/8-12-20.

37 *See* "Assembly and Governor OK Measure to Prevent Municipal Receivership"; Available at http://www.rilin.state.ri.us/news/pr1.asp?prid=6591.

38 For a detailed study of the New York City fiscal crisis see Donna Shalala and Carol Bellamy, "A State Saves a City: The New York Case," Duke Law Journal, 1976(6) (January 1977); United States Congress, House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (95th Cong. 1st Sess., August 1977).

39 *New York Times*, October 19, 1975, Section 4 at 1.

40 53 Pa. Stat. §§ 11701.101-11701.501.

41 Former Mich. Comp. Laws. § 141.2802 (this provision has been replaced by the Local Government and School District Fiscal Accountability Act). *See also* Eric Scorsone, Local Government Financial Emergencies and Municipal Bankruptcy, Michigan Senate Fiscal Agency Issue Paper; Available at http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf.

42 Mich. Comp. Laws §§ 141.1501-141.1531 (2011).

43 Mich. Comp. Laws. § 141.1519 (2011).

44 Mich. Comp. Laws. § 141.1523 (2011).

45 Local Financial Stability and Choice Act, Mich. Pub. Act 436 of 2012, Mich. Comp. Laws, § 141.1541 *et seq*. The new act contains 19 different possibilities that would allow for the state financial authority to conduct a preliminary review of a local government's finances to determine the existence of probable stress. The state financing board is required to complete a final report and then to submit that report to the local emergency financial assistance loan board to determine if probable financial stress exists for the local government.

If probable stress is found, the governor is then required to appoint a review team for that local government, and that review team, after investigating the circumstances and meeting with the local government, must submit a written report to the governor within 60 days following its appointment, although it may be granted one extension of 30 days to conduct its analysis. In its report, the review team must conclude either that a financial emergency exists or that one does not exist, and within 10 days of receiving the report, the governor must also make a determination as to the existence or not of a financial emergency. The decision is appealable to the Michigan Court of Claims within 10 business days by a resolution approved by two-thirds of the members of the local government's governing body.

Should a financial emergency be found, the local government must either (1) enter into a consent decree with the state, (2) agree to the appointment of an emergency manager, (3) enter into a neutral evaluation process or (4) file a Chapter 9 bankruptcy petition if so approved by the governor. If it does not choose an option, the local government must proceed under a neutral evaluation process. Each of the options provides a process for resolving the causes of financial distress.

If the neutral evaluation process or other options do not result in a resolution, the governing body of the local government must adopt a resolution recommending that it proceed under Chapter 9 and submit that resolution to the governor and state treasurer for consideration and approval by the governor.

46 Ind. Code § 6.1.1-20.3 *et seq*. (2012).

47 Cal. Gov't Code §§ 53760; 53760.1; 53760.3; 53760.5; and 53760.7 (as amended and added by Cal. A.B. 506; signed into law on October 9, 2011). This provision was first put to the test by the City of Stockton, California, which filed a Chapter 9 petition in June 2011 after going through a neutral evaluator process. San Bernardino in August 2012 avoided the neutral evaluator process by declaring a fiscal emergency, as discussed below.

48 These alternative debt resolution mechanisms consistent with Section 903 of the Bankruptcy Code are described in detail in Chapter IV of Municipalities in Distress. See also *James E. Spiotto, "The Role of the State in Supervising and Assisting Municipalities in Times of Financial Distress*," 33 MUNICIPAL FINANCE JOURNAL, (2013); *The Pew Charitable Trusts*, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS, July 2013.

49 "Regional Governmental Bodies" could include counties, municipalities, or regional governmental bodies for special purposes such as transportation, public safety, or health services.

50 *In re Jefferson Cnty., Alabama*, 474 B.R. 228 (Bankr. N.D. Ala. 2012) (discussion of nature of special revenues); *Bank of N.Y. Mellon v. Jefferson Cnty., Ala. (In re Jefferson Cnty., Ala.)*, 482 B.R. 404 (Bankr. N.D. Ala. 2012) (analysis of necessary operating expenses); *In re Sierra Kings Health Care Dist.*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

51 *In re Jefferson Cnty.*, 474 B.R. 228, 267 (Bankr. N.D. Ala. 2012).

52 *Id*. at 271.

53 *Id*.

54 For further discussion on the importance of the 1988 Amendments, *see In re Jefferson Cnty., Ala.*, 474 B.R. 228 (Bankr. N.D. Ala. 2012); *Bank of N.Y. Mellon v. Jefferson Cnty., Ala. (In re Jefferson Cnty., Ala.)*, 482 B.R. 404 (Bankr. N.D. Ala. 2012) (analysis of necessary operating expenses).

55 H.R. Rep. No. 100-1011 (1988) at 3.

56 *Jefferson Cnty.*, 474 B.R. at 268.

57 *Id*. at 268-69.

58 *Jefferson Cnty*., 474 B.R. at 753 (quoting Senate Report, p.1).

59 *Id*. at 754.

60 *Id*.

61 *See generally Jefferson Cnty*., 474 B.R. at 268 ("It is clear from both the House and Senate Reports accompanying the 1988 amendments that eliminating the potential loss of a creditor's lien on revenues was a critical purpose behind the enactment of § 928 and § 922(d).")

62 *Id*. at 271 (quoting Senate Report at 11).

63 *Id*. at 270 (emphasis in original) (quoting Senate Report at 12).

64 Senate Report, at 12 (emphasis added).

65 11 U.S.C. § 902(2).

66 11 U.S.C. § 902.

67 *See Heffernan Memorial Hospital District*, 202 B.R. 147 (Bankr. S.D. Cal. 1996).

68 *In re County of Orange*, 189 BR. 499 (C.D. Cal. 1995).

69 *Id*.

70 The states include: Alabama, Alaska, Arkansas, California Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Nevada, New Jersey, New York, North Carolina, North Dakota, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Virginia and West Virginia.

71 S.B. 222, 1015-2016 Reg. Sess. (Cal. 2015).

72 *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

73 11 U.S.C. § 926.