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The Chapter 9 Crucible

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Chapter 9 of the Bankruptcy Code is a ghost, of sorts. Everyone knows about it and it's existed for a long time, but there isn't much substantive law there. Any bankruptcy practitioner, upon first contact with a municipal bankruptcy case, may be shocked by the lack of substantive law to be found in Chapter 9. The dearth of detail has long caused bankruptcy lawyers and courts to turn to the far more substantive provisions of Chapter 11 for practical guidance. Even more interesting, and many times frustrating, is that the interests of constituents who are not recognized to have any *legal* standing will nonetheless have important, and sometimes dramatic, influence over the direction of a municipal case.

Under other chapters of the Bankruptcy Code, the constituents can predictably be corralled and branded: debtor, secured creditors, unsecured creditors, equity security holders, perhaps a trustee and, of course, the Office of the United States Trustee. In a Chapter 9 case, this defined universe of identifiable interests is expanded to include the more amorphous opinions and positions of the public, the media and politicians of various shapes and sizes. Such opinions and positions are often at odds with the legal dictates of the Bankruptcy Code, but recent experience acts as a reminder that such constituents must be "classified" and "treated" during the course of a Chapter 9 case just as if they were creditors holding claims.

This point is often made before a Chapter 9 bankruptcy case has even begun. Section 109(c) of the Bankruptcy Code restricts eligibility under Chapter 9 of the Bankruptcy Code to a municipality that is (1) specifically authorized to be a debtor under such chapter by state law or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor; (2) is insolvent; (3) wishes to effect a plan to adjust its debts; and (4) has sought from its primary creditors an agreement regarding their claims or has negotiated in good faith, or is unable to negotiate because it is impracticable. The nebulous nature of these conditions to entry has provided both economic and non-economic stakeholders an opening to advance their agendas and interests through an eligibility contest.

Recent Cases

To illustrate, one can compare the roads taken into Chapter 9 bankruptcy, separately, by the cities of Vallejo and San Bernardino in California. Vallejo's Chapter 9 bankruptcy, filed in 2008, was commenced in the Eastern District of California after the city engaged in a lengthy, ongoing and good-faith effort to negotiate with each of its key constituents, bondholders, unions and the like. Those constituents not satisfied with the outcome of pre-petition negotiations challenged Vallejo's eligibility under section 109(c), but because Vallejo had put in real time and effort to avoid bankruptcy, the challenge was disposed of quickly and an order for relief was entered.

The City of San Bernardino, in contrast, made use of an "emergency off ramp" created under California law to truncate its pre-petition negotiations with creditors. Assembly Bill 506 had been enacted in 2011 to force municipalities to participate in third-party mediation with their stakeholders (unions, creditors, taxpayers, etc.) before they would be eligible to file a bankruptcy petition. The legislature, though, left open a loophole that permits a California municipality to declare a "fiscal emergency" and file Chapter 9 bankruptcy without engaging the most important creditor constituents in negotiations in advance, or declaring such negotiations impracticable. In the San Bernardino case, the eligibility fight went

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on for a very long time, though Judge Meredith A. Jury, sitting in the Central District of California, ultimately ruled that city eligible.

The courtroom battles over eligibility in both *Vallejo* and *San Bernardino* were colored by the very public positions taken by elected officials at all levels and by the reporting and editorializing of the local and even national press. Bankruptcy court decisions in Chapter 9 cases often cite judges' own first-hand observations of the debtors and their creditors through public, out-of-court statements. S*ee, e.g., In re City of San Bernardino*, 499 B.R. 776, 791 (Bankr., C. D. Cal. 2013) ("Having had a firsthand view of this City and its struggles, the attitudes and actions of its major creditors, the concerns of its unions, particularly the safety employees, and the paucity of options for a City with such substantial, undisputed fiscal woes, this Court would exercise its discretion to not dismiss this case."); *In re City of Detroit*, 504 B.R. 191, 206 (Bankr., E. D. Mich. 2013) ("The City no longer has the resources to provide its residents with the basic police, fire and emergency medical services that its residents need for their basic health and safety … To reverse this decline in basic services, to attract new residents and businesses, and to revitalize and reinvigorate itself, the City needs help.")

Labor and Retiree Benefit Contracts

Once in bankruptcy, a municipality has to deal with its debts and other obligations and develop a plan to return to financial viability. A municipal debtor has generally borrowed and contracted its way into insolvency, so it must propose a plan to repay existing creditors and adjust its contractual relationships to avoid further insolvency after emergence from bankruptcy. The largest and most difficult contracts to adjust are collective bargaining agreements with unionized workers and pension and retiree benefit contracts.

The U.S. Supreme Court long ago decided that these contracts are executory in nature and, like any other such contract, can be assumed or rejected under section 365 of the Bankruptcy Code. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984). Section 365 is one of those sections explicitly incorporated into every Chapter 9 case. 11 U.S.C. § 901(a). Responding to an uproar from organized labor, Congress amended the Bankruptcy Code immediately after the Supreme Court's ruling in *Bildisco* to impose procedural and substantive conditions on the rejection of labor and retiree benefit contracts. 11 U.S.C. §§ 1113, 1114.

Those sections of Chapter 11 of the Bankruptcy Code, however, are not incorporated into Chapter 9 cases. In other words, unlike in the corporate setting, a municipality can theoretically reject a collective bargaining agreement or retiree benefit program without any warning and without negotiation. Indeed, in *Vallejo*, Judge Michael McManus held that even before rejection of a collective bargaining agreement, a municipal debtor may unilaterally impose temporary changes (inevitably reductions) in pay and benefits to union members regardless of the protections afforded by the contract. The City of San Bernardino followed Vallejo's lead a few years later. The litigation that followed San Bernardino's action was unsuccessful, and the city's unilateral adjustments were deemed necessary and appropriate; ultimately the underlying collective bargaining agreements were rejected as well.

A Balancing Act

Common to all municipal bankruptcies, indeed common to all bankruptcies, is shared pain. The mid-sized and larger cities that have availed themselves of Chapter 9 protection in recent years (Detroit, San Bernardino, Vallejo and Stockton) have all emerged from bankruptcy largely as a result of having negotiated tough deals with key constituencies. Those deals, negotiated in the crucible of public opinion and under constant scrutiny from the media, are of necessity political in nature. It should come as no surprise, therefore, that the decisions blessing those agreements are equally political. As we noted herein, a judge's legal analysis is often colored by his or her understanding of the real world in which the debtor municipality must operate. There is no such thing as conversion of a municipal bankruptcy case from Chapter 9 to Chapter 7 for liquidation. Unless a deal can be struck (or imposed), a city cannot operate to serve its citizens.

Lawyers, especially bankruptcy lawyers, are usually control freaks by nature. The Chapter 9 environment imposes special challenges on counsel. There are so many lines of communication, collective and individual agendas, to say nothing of the ever-present court of public opinion. Undoubtedly, in mega-case Chapter 11s, the courtroom may be filled with local and regional reporters, but in a municipal bankruptcy, this presence is exponentially greater. The politicians involved can seem to possess an insatiable appetite to talk to the media before and after each hearing. Corralling these disparate lines of communication is a daunting task, especially for debtor's counsel.

Conclusion

The bankruptcies of Detroit, and in San Bernardino, Vallejo and Stockton, CA, all resulted in confirmed plans. It is an overstatement to say that in each, these plans of adjustment were fully consensual. However, the great majority of the key constituents in each case negotiated and arrived at settlements with these cities in the lead-up to confirmation. In hindsight, each of these cities had good reasons to seek protection under the Bankruptcy Code. A Chapter 9 "playbook" for bankruptcy practitioners is developing and there is some instructive case law derived from these recent filings, but bankruptcy practitioners unfamiliar with this chapter of bankruptcy should anticipate some surprising twists and turns.

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