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## Municipalities in Bankruptcy

By J. Clay Christensen and Cori H. Loomis

**E**conomic hardships have forced numerous municipalities to seek protection under Chapter 9 of the Bankruptcy Code. Falling incomes and decreased business revenues combine to devastate tax receipts, leaving states and cities in financial straits. Small communities may be doubly impacted when the loss of a large employer results in people moving away to pursue employment elsewhere. We are seeing this play out today throughout the country, as well as in Oklahoma with our state's recent \$1.3 billion budget shortfall.

The purpose of municipal bankruptcy is to provide an umbrella under which insolvent municipalities can obtain temporary protection from creditors so that the municipality can establish a repayment plan with its creditors.<sup>1</sup> Recent well-known examples of large municipal bankruptcies include San Bernardino, California, and Detroit.

On the horizon it appears that Atlantic City, New Jersey, may be the next large filing as city leaders predict they will be out of cash by June of this year.<sup>2</sup> Puerto Rico's financial crisis has also been in the news lately. However Puerto Rico municipalities are statutorily precluded from filing Chapter 9 bankruptcies.<sup>3</sup> Unless Congress amends the Bankruptcy Code, Chapter 9 will remain unavailable to otherwise qualifying entities in Puerto Rico.

Within the 10th Circuit, of which Oklahoma is a part, 19 Chapter 9 cases have been filed since 1984. In roughly the same time period, the 9th Circuit saw 53 such cases filed, while the 5th Circuit saw about 35. Interestingly of those 19 10th Circuit filings, 13 were filed in Oklahoma.

Many may not realize that Chapter 9 bankruptcy is available to more than simply towns and cities. The Bankruptcy Code<sup>4</sup> defines municipality as any "political subdivision or public

agency or instrumentality of a State."<sup>5</sup> The term public agency is not defined in the code, but has been found to mean any authority or agency that is subject to control by a public authority, whether at the municipal or state level.<sup>6</sup> The term instrumentality of a state is also undefined. Therefore in addition to cities, entities eligible for Chapter 9 have included industrial authorities, water and sanitation districts and hospital trust authorities.

### ELIGIBILITY REQUIREMENTS FOR CHAPTER 9

The eligibility requirements under Chapter 9 "are to be construed broadly to provide access to relief in furtherance of the Code's underlying policies."<sup>7</sup> To be eligible, a debtor must be 1) a municipality, 2) authorized by state law to file bankruptcy, 3) insolvent, 4) desirous of effecting a reorganization plan and 5) meet one of several prebankruptcy debt negotiation options.<sup>8</sup> Oklahoma has specifically authorized bankruptcy as an option for qualifying municipalities.<sup>9</sup>

Unlike Chapter 11 debtors, Chapter 9 debtors must be insolvent. The Bankruptcy Code has eliminated the balance sheet test for insolvency of municipalities.<sup>10</sup> With respect to a municipality, insolvency is defined in one of two ways: the municipality is generally not paying its debts as

they become due or it is unable to pay its debts as they become due.<sup>11</sup>

Regarding prebankruptcy negotiation, a municipality must 1) negotiate in good faith with its creditors holding a majority in amount of claims of each class that it intends to impair, whether those creditors agree to such treatment or not, 2) be unable to negotiate because such action is impracticable or 3) reasonably believe a creditor may try to obtain a preferential transfer.<sup>12</sup>

Whether negotiations with creditors are impracticable depends upon the circumstances of each case. Debtors have satisfied this element by evidence of sheer volume of creditors,<sup>13</sup> by a need to file quickly to preserve their assets,<sup>14</sup> by a need to act quickly to protect the public from harm<sup>15</sup> or by showing creditors are not willing to negotiate.<sup>16</sup>

#### CHAPTER 9 HAS A LIMITED EFFECT ON MUNICIPAL OPERATIONS

Although municipalities may partake in the federal bankruptcy process, the 10th Amendment to the Constitution places substantial restrictions on the power federal bankruptcy courts would otherwise have over Chapter 9 debtors. The court's reduced role is codified in the first several sections of Chapter 9. Bankruptcy courts are expressly prohibited from interfering with any of the debtor's political or governmental powers, its property, revenues or income producing property without the consent of the debtor.<sup>17</sup> Consequently neither Bankruptcy Code §541 nor §363 is applicable in Chapter 9. As a result no bankruptcy estate is created in the case, and municipalities do not need the court's permission to deal with assets. The absence of §363 also means debtors do not need court permission to use a secured lender's "cash collateral,"<sup>18</sup> eliminating one of the most hotly contested issues found in Chapter 11.

There is also a reduced role for the U.S. trustee in these cases. The function of the U.S. trustee is largely set forth in 28 U.S.C. §586. Under this provision the trustee is to "super-  
vise the administration of cases and trustees in cases under chapter 7, 11, 12, 13, or 15 of title 11..."<sup>19</sup> Noticeably absent from this statute is any reference to Chapter 9. Indeed the U.S.

trustee neither monitors the financial operations of the debtor nor oversees the administration of the case. Trustees do not conduct initial debtor meetings or meetings of creditors in Chapter 9 cases.<sup>20</sup> The trustee's sole role in Chapter 9 cases is to establish a creditors' committee<sup>21</sup> and to appoint a trustee to prosecute avoidance actions if the debtor refuses to take such action itself.<sup>22</sup>

Once a Chapter 9 bankruptcy petition is filed and the petitioner's eligibility established, it has far fewer burdens than a Chapter 11 debtor. For example Chapter 9 debtors file only a list of creditors.<sup>23</sup> They are not required to file bankruptcy schedules or statements of financial affairs.<sup>24</sup> Further debtors have no monthly or other reporting obligations because 11 U.S.C. §§1106 and 1107 are not operative in Chapter 9.<sup>25</sup>

#### ADJUSTMENT OF MUNICIPAL DEBT

In addition to the reduced oversight and reporting duties noted above, four additional code provisions make Chapter 9 especially beneficial to municipalities. First, Chapter 9 debtors enjoy an expanded automatic stay.<sup>26</sup> Even though no estate is created in a Chapter 9 case, the automatic stay under 11 U.S.C. §362 protects both the municipality and its property. Additionally 11 U.S.C. §922 extends the stay to prohibit, among other things, proceedings against officers and inhabitants of the debtor where those proceedings seek to enforce a claim against the debtor.

Second, unlike Chapter 11, only the debtor may file a plan of reorganization.<sup>27</sup> Consequently the debtor never battles over exclusivity periods<sup>28</sup> as Chapter 11 debtors often must. Third, no Chapter 9 case can be converted to a liquidation.

Fourth, the Bankruptcy Code does not prescribe any predetermined deadlines within which a plan must be filed. These benefits allow the debtor far more control over its restructuring efforts and timeline.<sup>29</sup>

Formulating a plan for a municipality's debts is very similar to Chapter 11. Both the required content and process for confirmation are nearly identical. The plan must categorize creditors

**“Whether negotiations with creditors are impracticable depends upon the circumstances of each case.”**

into similar classes. The plan may, but is not required to, provide for repayment of all debts in full. Each class of impaired claims must vote for the plan. Should less than every impaired class vote for the plan, the debtor may still obtain confirmation through a “cramdown” as long as one impaired class accepts the plan, just as in Chapter 11.

Municipalities possess financial options for funding plan payments not available to Chapter 11 debtors. Debtors across the various chapters of the Bankruptcy Code may obtain loans and other traditional lending facilities, but municipalities have additional opportunities. Municipal bond offerings can bring in needed funds as well as small, local sales tax increases.

Ultimately Chapter 9 bankruptcy offers cities, towns, trust authorities and other municipalities a flexible, favorable arena within which to adjust debts. In light of the ongoing budget crises in Oklahoma, we may well see more Chapter 9 cases on the horizon.

1. *In re Hamilton Creek Metro. Dist.*, 143 F.3d 1381, 1386 (10th Cir. 1998) (citing *In re Addison Community Hosp. Auth.*, 175 B.R. 646, 649 (Bankr.E.D.Mich.1994) and H.R.Rep. No. 95-595, at 263 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 5963.)

2. *Atlantic City Makes Debt Payment as Mayor Averts a Default*, [www.abi.org/newsroom/bankruptcy-headlines/atlantic-city-makes-debt-payment-as-mayor-averts-a-default](http://www.abi.org/newsroom/bankruptcy-headlines/atlantic-city-makes-debt-payment-as-mayor-averts-a-default).

3. 11 U.S.C. §101(52).

4. 11 U.S.C. §101 *et seq.*

5. 11 U.S.C. §101(40)

6. *In re Greene Cty. Hosp.*, 59 B.R. 388, 389-90 (S.D. Miss. 1986).

7. *In re Hamilton Creek Metro. Dist.*, *supra*, 143 F.3d at 1384.

8. 11 U.S.C. §109(c).

9. Okla. Stat. tit. 62, §283.

10. *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 32-33 (Bankr. D. Colo. 1999)

11. 11 U.S.C.A. §101(32)(C)

12. 11 U.S.C. §109(c)(5).

13. *In re County of Orange*, 183 B.R. 594, 607 (Bankr.C.D.Cal.1995) (quoting *In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 79 n. 55.)

14. *In re City of Vallejo*, 408 B.R. 280, 298 (B.A.P. 9th Cir. 2009) (citing *Valley Health Sys.*, 383 B.R. 156, 163 (Bankr. C.D. Cal. 2008).

15. *In re City of Vallejo*, 408 B.R. 280, 298 (B.A.P. 9th Cir. 2009).

16. *In re City of Detroit, Mich.*, 504 B.R. 97, 179 (Bankr. E.D. Mich. 2013) (It is impracticable to negotiate with a group that asserts that their position is immutable.)

17. 11 U.S.C. §904.

18. The term cash collateral means cash, deposit accounts, negotiable instruments and similar assets upon which a lender has secured interest. *See*, 11 U.S.C. §363(a).

19. 28 U.S.C. §586(3).

20. 11 U.S.C. §901 does not make §341 applicable to Chapter 9.

21. 11 U.S.C. §§901(a), 1103.

22. 11 U.S.C. §926.

23. 11 U.S.C. §924.

24. *See*, Fed. R. Bankr. P. 1007(b)(1).

25. *See*, 11 U.S.C. §901(a).

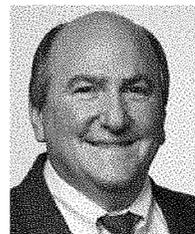
26. 11 U.S.C. §§362, 901(a), 922(a).

27. Compare 11 U.S.C. §1121(c) and §941.

28. 11 U.S.C. §1121(b).

29. 11 U.S.C. §941.

## ABOUT THE AUTHORS



J. Clay Christensen is the managing director for Christensen Law Group PLLC. He has nearly 30 years as a practicing attorney in Oklahoma City and surrounding areas. He graduated from OU in 1986 with high honors and in the top 3 percent of his class. Mr. Christensen practices corporate governance, bankruptcy, oil and gas, real estate and agricultural law.



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