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POLICY BRIEF

# Local Government Bankruptcy in California: Questions and Answers

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## Introduction

Unanticipated events or prolonged imbalances between resources and spending can result in people, businesses, or governments becoming unable to pay their debts or contractual obligations. The United States Constitution authorizes Congress to make laws safeguarding these parties as they develop financial recovery plans that dismiss or restructure debts and other obligations. The process by which people and businesses file for this relief frequently is referred to by the section of federal bankruptcy code authorizing the process, primarily Chapter 7 (individuals) and Chapter 11 (businesses). The process by which local governments seek relief is known by the section of code where its rules are detailed: Chapter 9. States have no means of filing for bankruptcy. All bankruptcy cases are heard in the United States Bankruptcy Court (the court).

Chapter 9 was established in 1937. Since that time, only about 600 cases have been filed nationwide and these cases typically have involved single-purpose entities (such as water or sanitation districts). Recently, three California municipalities filed for Chapter 9 relief: Stockton, San Bernardino, and Mammoth Lakes. These filings—occurring just months after the City of Vallejo completed its three-year Chapter 9 process—have raised questions about the use of Chapter 9 in California. This document addresses some of these questions.

## What Is Chapter 9?

Chapter 9 is a section of federal bankruptcy code created exclusively for local governments to adjust or reduce their obligations when their resources are inadequate to cover their obligations. Similar to other forms of bankruptcy, such as Chapter 7 and 11, Chapter 9 provides filers protection from their creditors while they develop plans to move toward financial stability. Under Chapter 9, a local government's recovery plan may include reducing payments on bonds or other debts and/or rejection of burdensome contracts and other agreements. Chapter 9 differs from other forms of bankruptcy in certain respects. First, the decision to file a Chapter 9 case is fully at the discretion of the locality. Creditors are not permitted to force a local government to file Chapter 9. Second, the court cannot compel a locality to sell its assets or increase tax rates in order to raise revenues to meet its obligations. Finally, the local government may not be forced to dissolve or reorganize its governance structure.

### Which Local Governments May File Chapter 9?

Federal bankruptcy laws permit all local governments—counties, cities, special districts, school districts, and community college districts—to file for relief under Chapter 9 *provided that their state government authorizes this action*. Nationwide, states have taken different approaches with regards to granting local governments authority to file for Chapter 9 relief, ranging from granting broad, unrestricted access to prohibiting use of Chapter 9 by local jurisdictions. The majority of states require local governments to seek permission to file for Chapter 9 relief from their respective state legislatures on a case-by-case basis. California provides its local governments with broad authority to file Chapter 9, but generally requires cities, counties, and special districts to engage in a "neutral evaluation" process (described in a nearby box) prior to filing for Chapter 9 relief.

### When May Local Governments File Chapter 9?

Beyond being specifically authorized by their state, Chapter 9 requires localities to meet several criteria to be eligible to file for relief. Specifically, a local government must:

- ***Be Insolvent.*** A local government is considered insolvent if it is unable to (1) pay its current obligations or (2) pay obligations that will become due during the next fiscal year.

- ***Have No Feasible Alternatives to Bankruptcy.*** The Chapter 9 process is intended to be a local government's last resort in addressing unsustainable obligations. For this reason, the local government is expected (with limited exceptions) to exhaust all possible alternatives prior to pursuing the use of the

### California's Neutral Evaluation Process and "Fiscal Emergencies"

Prior to filing for Chapter 9 relief, Chapter 675, Statutes of 2011 (AB 506, Wieckowski), requires cities, counties, and special districts to work collaboratively with creditors, employee groups, and other interested parties to attempt to resolve the local government's fiscal problems. As part of this process, the local government and affected parties select a "neutral evaluator" to review the local government's fiscal condition. The neutral evaluator has limited powers and may not impose an agreement on any party. If at the conclusion of the neutral evaluation process no resolution has been reached, the local government may file for Chapter 9 relief.

Chapter 675 also allows local governments experiencing fiscal emergencies to bypass the neutral evaluation process. Specifically, the governing body of any local government that would be unable to pay its obligations within 60 days may adopt a resolution by a majority vote declaring a fiscal emergency. This declaration allows the local government to file for Chapter 9 relief immediately.

***Does a Declaration of Fiscal Emergency Mean Insolvency?*** It is important to note that municipalities may declare a fiscal emergency for reasons other than to signal insolvency. This is because the State Constitution gives greater scheduling flexibility with regards to placing proposed tax increases on the ballot to local governments that have declared a fiscal emergency.

Chapter 9 process—including negotiating with its creditors and employee groups, implementing expenditure reductions, and, if possible, increasing revenues. A locality is not expected, however, to accept offers from creditors or employee groups that would provide short-term relief but create greater costs in the long term. Similarly, it is not expected to reduce expenditures beyond the level required to maintain its basic functions or increase revenues when limited by constitutional voter approval requirements or other constraints.

- ***Demonstrate Intent to Develop a Plan to Adjust Debts.*** In general, the local government must display a willingness to develop a plan to adjust its obligations and not appear to be using the Chapter 9 process simply to evade creditors or delay payments on its obligations.

## What Happens After a Local Government Files for Relief?

The resolution of a Chapter 9 case requires a significant commitment from the local government in terms of time, utilization of professional staff, and resources. The process typically includes the five major steps described below. If a local government does not make timely progress through these steps, the court may dismiss the case and remove the locality's bankruptcy protections.

***Local Government Files Case and Obtains Automatic Stay.*** Upon filing a Chapter 9 case, a local government receives an "automatic stay," which stops collection activities by its creditors and protects it from litigation. The automatic stay provides a locality time to evaluate how best to restructure its obligations.

The recent bankruptcy filing of the town of Mammoth Lakes provides an example of the effect of the automatic stay. Mammoth Lakes filed for Chapter 9 in July 2012, primarily motivated by a legal judgment against the town which obligated it to pay a land developer $43 million—an amount that is more than twice the town's annual General Fund budget. During the year prior to its filing, the town attempted to negotiate a reduced settlement with the developer but no agreement could be reached. In February 2012, the developer sought and received a writ of mandate from a state court requiring the town to pay the judgment in full. Still desiring to reduce its obligation to the developer, the town filed for Chapter 9 protection in July 2012 and received an automatic stay that protects it from the developer's collection efforts while it develops a recovery plan that proposes to reduce the size of the judgment.

***Court Determines Local Government Eligibility.*** Before a local government may submit a proposal to adjust or reduce its debts or other obligations, the court must determine that the locality is eligible for Chapter 9 protections. This eligibility determination is made based on the criteria described in the previous question "When May Local Governments File Chapter 9?". Specifically, the locality must be authorized by the state to file for Chapter 9 relief and (1) be insolvent, (2) have no practical alternatives to filing bankruptcy, and (3) demonstrate intent to develop a plan to adjust debts.

***Local Government Develops a Plan of Adjustment.*** The primary goal of the Chapter 9 process is the development and implementation of a plan to adjust a local government's obligations in a way that restores its financial stability. Such a plan is commonly referred to as a plan of adjustment or a bankruptcy recovery plan. The two primary tools

provided to a local government by Chapter 9 to adjust its obligations are the ability to modify the terms of its outstanding bonds and other debt and the authority to reject various contracts, including those with current and retired employees. The locality is given exclusive discretion over how it uses these tools and the development of its plan of adjustment. In its plan, the local government must detail its proposed changes to its obligations to its creditors. Generally, creditors are categorized into classes based on the degree of assurance they had been given that their claim will be paid. For instance, a claim in which the creditor is entitled to city assets in the event of default (referred to as a "secured" claim) typically is given priority over a claim without similar assurance (an "unsecured" claim). While a plan may propose that different classes of creditors be treated differently, the plan of adjustment typically provides for equal treatment of creditors within the same class.

***Creditors Approve Plan of Adjustment.*** Once a locality has created a plan of adjustment, it must submit it to its creditors for their review and approval. The local government does not need the approval of all of its creditors, but must, at a minimum, have the consent of one class of creditors that would be negatively affected by the plan.

***Court Approves Plan of Adjustment.*** After a local government has created a plan of adjustment and secured the consent of at least one class of impaired creditors, it must submit the plan to the court for approval. In deciding whether to approve a plan, the primary questions the court considers are:

- Would the plan require the local government to violate state or local laws?
- Has the locality obtained approval from regulatory bodies or its electorate, if necessary?
- Does the plan disproportionately benefit specific individuals or groups?
- Would the local government and affected parties be better off under the plan than would be the case if the issue were addressed outside of the Chapter 9 process?
- Will the locality be able to meet its adjusted obligations and avoid the need for further adjustment in the foreseeable future?

Once the court approves a plan of adjustment, it creates a new contractual agreement between the locality and its creditors. This new agreement replaces any agreements that existed prior to the Chapter 9 filing.

### What Role Does the Court Play?

Unlike other types of bankruptcy cases, under Chapter 9 the court has two primary responsibilities: determine a locality's eligibility and approve its plan of adjustment. In carrying out these responsibilities, however, federal law does not give the court specific guidance regarding many significant matters—such as determining whether a local government has filed a case in good faith, intends to develop a plan to adjust debts, and has created a plan of adjustment that provides equitable treatment of its creditors. For this reason, the degree to which the court's actions affect the outcomes of a Chapter 9 filing can vary from case to case.

Despite the lack of specific guidance in some areas, federal law clearly limits the court's power to dictate how a locality addresses its fiscal situation and prohibits it from interfering with the local government's operations, organization, or laws during or after the Chapter 9 case. As a result, the locality retains its authority to govern its own affairs—including managing its day-to-day operations, collecting revenues, making

expenditures, buying or selling property, and borrowing.

### Can the Plan of Adjustment Bypass State or Local Laws?

The court may not approve a plan of adjustment that requires actions that would violate state or local laws, with the exception of laws relating to contractual agreements. This is true even if a law would hinder a locality's ability to recover from bankruptcy. For instance, the court may not authorize a local government to increase property tax revenues beyond the limits stipulated in the State Constitution or bypass voter approval requirements for increasing other forms of taxation. Similarly, a plan of adjustment must observe local laws, including those that require certain expenditure levels or restrict revenue increases. For example, the charter of the city of San Bernardino includes a provision stipulating a process for determining the salary of public safety employees. Chapter 9 does not authorize the court to set aside local charter provisions. Thus, the city will be limited by this provision if it attempts to reduce employee compensation costs during its Chapter 9 process.

### Can the Plan of Adjustment Reduce Obligations on Bonds and Other Debt?

Chapter 9 affords a local government the ability to significantly modify its bond and other long-term debts in order to lower its payments to creditors. In general, a locality's debt payments may be reduced by decreasing the total amounts owed, lowering the interest rates, and/or extending the length of time during which the debts are to be repaid.

The recent bankruptcy filing by the city of Stockton provides an example of how a municipality may seek to modify various types of debt. The city of Stockton filed for Chapter 9 in June 2012, citing unsustainable employee compensation and retiree expenses, excessive debt load, and the economic downturn as primary factors. In developing its proposed plan to adjust its obligations (which has not yet been reviewed by the court), the city prioritized among its existing bonds and other debts based on whether the debts were secured or unsecured. Among its secured debts, highest priority was given to those backed by assets that the city considered to be essential to its operations. For example, for a high-priority debt—such as certificates of participation backed by the city's library and police and fire stations—the city proposed to continue funding payments from its General Fund but extended the time frame for repayment. For a low-priority debt—such as unsecured pension obligation bonds—the city proposed to cancel all future payments from its General Fund.

### Can the Plan of Adjustment Void Collective Bargaining Agreements?

One of the tools provided to local governments in the Chapter 9 process is the ability to reject contracts, such as agreements with its vendors or professional consultants. Under certain circumstances, local governments also may use the Chapter 9 process to "reject"(that is, nullify) contracts with employee groups known as collective bargaining agreements. Specifically, a locality may reject collective bargaining agreements if it can show that (1) the agreement hinders its ability to achieve fiscal stability, (2) the employee group otherwise would bear a disproportionately small burden of the locality's bankruptcy, and (3) the locality negotiated in good faith with the employee group but no resolution was reached.

In some cases, this authority to reject collective bargaining agreements can provide a local government significant leverage in negotiations with employee groups, allowing the local

government to achieve concessions without actually rejecting the bargaining agreement. The Chapter 9 case of the city of Vallejo, filed in 2008, provides such an example. About a month after filing its Chapter 9 case, Vallejo requested approval from the court to reject collective bargaining agreements with four of its employee groups. Following the motion, the employee groups challenged the city's eligibility for Chapter 9. After an initial decision and an appeal by the employee groups, the court found that the city was eligible for Chapter 9 relief. Following its decision, the court delayed its hearing on the rejection of the collective bargaining agreements to allow time for additional negotiation. During this period, three of the four employee groups reached agreement with the city. The court then approved the rejection of the fourth collective bargaining agreement based on the criteria described above. This decision was appealed to the United States District Court, which affirmed the bankruptcy court's position.

### Can the Plan of Adjustment Change Benefits for Retirees?

A local government's agreements with retirees to provide pension or health benefits are generally considered contracts which may be subject to rejection under Chapter 9. However, Chapter 9 cases addressing retiree benefits have been rare. In its Chapter 9 case, Vallejo became the first and only California locality to use a plan of adjustment to significantly reduce health benefits for its retirees by decreasing its payments to a flat rate of $300 per month. To date, no California local governments have used Chapter 9 to change pension benefits for current retirees; however, pension benefits were changed in at least one case in another state (Central Falls, Rhode Island). Due to the lack of case law regarding the treatment of retiree benefits in Chapter 9, it is not clear if and under what circumstances local governments would be permitted to reduce retiree benefits in future Chapter 9 filings. It is possible that differing benefit and contractual requirements in different states could result in Chapter 9 applying differently from one state to another.

### What Is the Status of the Recent Bankruptcy Filings?

As mentioned previously, three California local governments—Stockton, San Bernardino, and Mammoth Lakes—have active Chapter 9 cases and a fourth—Vallejo—recently completed the Chapter 9 process. Figure 1 summarizes the Chapter 9 status of these municipalities.

### What Factors May Have Contributed to the Recent Bankruptcy Filings?

The factors contributing to a local government's decision to file for relief under Chapter 9 typically are varied and complex. From the information that has been made available to date, it appears that

**Figure 1**

**Status of Recent California Chapter 9 Bankruptcy Filings**

| City | Neutral Evaluation Process Started | Chapter 9 Filed | Eligibility Confirmed | Recovery Plan Approved |
|---|---|---|---|---|
| Vallejo | Not applicable[a] | May 2008 | September 2008 | August 2011 |
| Stockton | March 2012 | June 2012 | | |
| Mammoth Lakes | April 2012 | July 2012 | | |
| San Bernardino | Not applicable[b] | August 2012 | | |

[a] The city of Vallejo filed for Chapter 9 prior to the establishment of the state required neutral evaluation process.
[b] As permitted by state law, the city of San Bernardino bypassed the neutral evaluation process by declaring a fiscal emergency.

Stockton and San Bernardino's bankruptcy filings were driven by some similar factors including: long-term imbalances in revenues and spending, reduced tax revenues associated with the downturn in the economy, some constraints to reducing expenditures in the short term, and increasing costs to provide retiree benefits. Additionally, substantial borrowing appears to be a factor in Stockton's filing, and prior budgeting practices, such as borrowing from internal funds, appears to be a contributing factor in San Bernardino's case. By contrast, the bankruptcy filing by Mammoth Lakes appears to be driven by a single significant event—a recent legal judgment that required it to pay an amount more than twice its annual General Fund budget.

## Does the State Monitor the Fiscal Condition of Local Governments?

Historically, California has vested its local governments with significant fiscal independence, including the authority to adopt their own budgets, negotiate collective bargaining agreements with their employees, propose tax increases to their voters, issue debt, and (in many cases) establish themselves as a governmental entity, dissolve their governance structure, or modify their service boundaries. With the exception of K-12 education—where the State Constitution assigns the state a major responsibiliy—the state does not play a significant role in monitoring the fiscal health of its subordinate governments. Instead, the responsibility for reviewing local government fiscal conditions rests with local communities.

In the case of K-12 districts, the state has created a comprehensive system for monitoring the fiscal condition of school districts. As we discussed more extensively in our April 2012 report, *School District Fiscal Oversight and Intervention*, the state has assigned county offices of education the responsibility to review each school district's fiscal condition shortly after districts adopt their budgets and then at a few subsequent points in the fiscal year. School districts that show signs of fiscal distress receive assistance, with the type and amount of assistance depending on the gravity of a district's fiscal condition. In the most serious case—when a district no longer appears able to meet its financial obligations—the state provides it with an emergency loan and assumes administrative control until the district has demonstrated clearly that it is solidly on the road to fiscal recovery.

## Conclusion

Fiscally distressed local governments can use Chapter 9 proceedings to gain protection from their creditors while they develop financial recovery plans that dismiss or restructure debts and other obligations. Various parties—bondholders, lenders, vendors, employees, and retirees—can be affected by a local government's use of Chapter 9 to adjust its obligations. Generally, local governments in California are provided broad discretion over when to initiate a Chapter 9 case, as well as how to use the tools of Chapter 9 to adjust their obligations. Chapter 9 also does not interfere with a local government's authority over its own affairs or alter its primary functions or governance structure. Chapter 9 can provide insolvent local governments a means of aligning their resources and obligations that maintains their autonomy and allows them to continue meeting their primary function of providing public services to their residents. On the other hand, the use of Chapter 9 by local governments could require significant sacrifices from creditors and parties with whom they contract, including vendors and employees. Additionally, Chapter 9 is typically an expensive and time-consuming process for local governments.

## LAO Publications

This report was prepared by Brian Uhler, and reviewed by Marianne O'Malley. The Legislative Analyst's Office (LAO) is a nonpartisan office which provides fiscal and policy information and advice to the Legislature.

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