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Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code

Executive Summary

Federal law permits municipalities to seek protection from their creditors by filing for bankruptcy under chapter 9, but only if the state specifically authorizes its municipalities to file. The state may attach various requirements subject to granting authorization such as approval by a state body prior to filing, state appointment of a trustee, and state control over the municipal debt readjustment plan. Once the state has granted authorization to file, courts have construed such consent as state policy favoring the pre-emption of federal bankruptcy law over state policies which undercut the efficacy of chapter 9.

Federal bankruptcy law will pre-empt state actions which prevent the municipal-debtor enjoying the "breathing space" of the automatic stay provisions to formulate a debt readjustment plan, and the power to impair debt. Short of destroying these two primary benefits of chapter 9, federal bankruptcy law does not provide definitive limits on state action. To the extent that courts construe state intent in ascertaining federal pre-emption, a conditional grant of authorization subject to state requirements would be evidence of state intent not to relinquish control over particular issues affecting the municipal-debtor. However, the scope of federal pre-emption already appears quite narrow reflecting the strong deference to state sovereignty in the bankruptcy code.

Table of Contents

I. Introduction

Federal municipal bankruptcy laws were first introduced in 1934 during the depths of the Great Depression as municipalities across the country struggled to provide necessary services while facing a dramatic drop in tax revenues. The enactment of federal bankruptcy laws allowing municipalities to impair debt was necessary because of the inadequacy of traditional state remedies.

Prior to the establishment of federal bankruptcy laws, the principal state remedy for creditors was an action for mandamus to compel increased taxes. [1] However, imposing new taxes was often counterproductive because of the inability or unwillingness of the citizenry to pay, the rush of individual creditors filing separate mandamus suits, and the "hold-out" problem among creditors. [2] Rather than enter a voluntary comprehensive agreement with the city and creditors, minority creditors often derailed efforts to reach voluntary agreements by "holding-out" to use the mandamus remedy to get a tax levy for full payment. [3]

At the same time, state law could not force an unwilling creditor to compromise his claim without violating the constitutional prohibition against state impairment of contracts. [4] Thus, without a federal bankruptcy law which permitted municipalities to scale down their indebtedness and bind all creditors, both creditors and debtors were "at an impasse to neither's advantage". [5]

The fundamental objective underlying the enactment of federal municipal bankruptcy law is to provide court protection for distressed municipalities, allowing them to adjust their debts in a manner which enables them to continue to provide essential public services. [6] Unlike private individuals or corporations, a municipality cannot liquidate all of its assets to satisfy creditors. Chapter 9 provides a municipal debtor with two primary benefits: (1) a breathing spell with the automatic stay; and (2) the power to readjust debts through a bankruptcy plan process. [7]

Federal law permits municipalities to seek protection from their creditors by filing for bankruptcy under chapter 9, but only if the state specifically authorizes its municipalities to file. States have approached the authorization requirement in a variety of ways: some grant or deny authorization by state statute, others attach preconditions to authorization, and still others do not have statutes on the subject. [8] Currently, the state of California authorizes its taxing agencies and instrumentalities to file for Chapter 9 pursuant to state statute, without attaching any preconditions or requirements to the filing.

This paper will focus on the issue of state consent under the federal bankruptcy code, examining whether a state may impose preconditions on a municipal-debtor subject to authorization. Typical requirements proposed by the California Legislature and already in use by other states include: approval by a state body prior to filing, state appointment of a trustee, and state control over the municipal debt readjustment plan. [9] The following pages will describe the federal bankruptcy statutory and constitutional framework for evaluating these state requirements.

II. Federal Bankruptcy Law Requires that the State Specifically Authorize a Municipality to File for Chapter 9.

Section 109 of Chapter 9, the federal bankruptcy statute, describes the requirements for filing for bankruptcy, including the requirement of specific, state authorization. The state of California grants specific authorization by statute in Cal Govt Code 53760.

The absence of authorization would violate state sovereignty because the state has ultimate control over its municipalities. A state's power to grant or deny consent may also include the power to force a municipality to file for chapter 9.

Federal Bankruptcy Law

11 U.S.C. 109. Who may be a debtor

> (c) An entity may be a debtor under chapter 9 of this title if and only if such entity ---
>
> (1) is a municipality;
>
> (2) is specifically authorized, in its capacity as a municipality or by name, 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 under such chapter;

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; and

(c)(5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title. [10]

California Authorization Statute

Cal Gov Code 53760. Right to file proceedings in bankruptcy

Any taxing agency or instrumentality of this State, as defined in Section 81 of the act of Congress entitled "An act to establish a uniform system of bankruptcy throughout the United States," approved July 1, 1898, as amended, may file the petition mentioned in Section 83 of the act and prosecute to completion all proceedings permitted by Sections 81, 82, 83, and 84 of the act. [11]

A) State Consent is Critical to the Constitutionality of Chapter 9.

Much of the structure of Chapter 9 is shaped by two federal constitutional restraints: the Contracts Clause and the 10th Amendment. [12] On the one hand, the Contracts Clause prohibits the states from passing any law which impairs contracts, [13]and gives Congress the power to establish uniform bankruptcy laws. [14] Therefore, a state cannot pass laws which would relieve a municipality of its debts. (A more detailed treatment of the state's power to readjust debts will follow in Part III, Chapter II). On the other hand, the interest of protecting state sovereignty under the 10th Amendment overrides Congress' explicit federal bankruptcy and limits the degree of federal intrusion into municipal and state governance. [15]

In keeping with the deference to states under the 10th Amendment, federal bankruptcy law does not give municipalities powers independent of those granted by the state. Rather it is the state which must decide whether to empower its municipalities to utilize federal bankruptcy laws. The Supreme Court upheld the constitutionality of the 1937 Municipal Bankruptcy Act in Bekins v. Lindsay-Strathmore Irrigation District:

The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by the state legislation. The bankruptcy power is competent to give relief to debtors in such a plight. . . . The state acts in aid, and not in derogation, of its sovereign powers. It invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue. [16]

In other words, federal bankruptcy law is a valid exercise of federal power and not an unconstitutional intrusion on state sovereignty insofar as it requires the municipal-debtor to obtain state consent, the filing is voluntary and not forced upon the municipality by the federal courts, and judicial control over state property and revenues is limited. This deference to state sovereignty is codified in the requirement for specific state authorization and other provisions of the federal bankruptcy code.

B) Under Federal Bankruptcy Law, the State Specifically Authorizes the State a Municipality To File For Chapter 9, and Consent May Not Be Implied.

After the 1994 Bankruptcy Reform Act, state consent cannot be implied or "generally authorized" but must be "specifically authorized". [17] This reaffirmation of state control over a chapter 9 filing was prompted by the chapter 9 filing of Bridgeport, Connecticut. In 1991, Bridgeport, with a population of 140,000 and a $2 million dollar debt, became was the largest city at that time to have attempted to utilize federal bankruptcy protection.

In In re City of Bridgeport, the court found implied state consent from state home rule delegation despite the vigorous opposition to the filing by the state and a state-created Financial Review Board. [18] The court reasoned that the "or" language contained in 109(c)(2) did not imply *exclusive* authorization from one source, but included the possibility of different sources of "general" authorization. Thus, the objections by an entity empowered to give authorization did not change the implied authorization which existed under home-rule delegation. [19]

In the only post-1994 Bankruptcy Reform Act case on the subject of "specific" authorization, the bankruptcy court in the Orange County bankruptcy has interpreted 109(c)(2) to require statutory consent that is "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication". [20] The court rejected the argument that the state of California intended to broadly authorize *an instrumentality of a county* to file to chapter 9, and dismissed the bankruptcy petition of the Orange County Investment Pool (OCIP) on the basis that it was not a "municipality" nor was it "specifically authorized" to file. [21]

The California statute specifically authorizes federal bankruptcy filing for "any taxing agency or instrumentality of the state" as defined by federal bankruptcy law. [22] In other words, California's determination of "who" can file is co-extensive with the federal bankruptcy code's definition of a "municipality". The federal bankruptcy code's definition of "municipality" was itself ambiguous, however, according to the bankruptcy court in the Orange County case. [23] The court ultimately concluded that an instrumentality of a county was not an instrumentality of the state authorized to file for chapter 9 under

California statute, because a *narrow* interpretation of state authorization was necessary in order to maintain state control over municipalities and limit federal intrusion into state sovereignty:

First, Congress could easily have written Sec 101(4) to include instrumentalities of a County, public agency or political subdivision, but did not. . . . *Second, this leap of logic presents potential Constitutional problems because it would reduce state control over those entities entitled to file chapter 9.* Lastly, interpreting Sec. 101(4) this way would blur the boundaries surrounding the term "municipality" to the extent that any entity set up by a political subdivision or public agency would qualify for chapter 9. [24]

This interpretation of 109(c)(2) after the post-1994 Bankruptcy Reform Act emphasizes specificity and statutory authorization. The court in the Orange County bankruptcy, in dicta, suggested that the state could comply with the federal bankruptcy code's requirement for specific state authorization by identifying entities by specific category in the state statute. [25] For example, the state may authorize all "municipalities" to file as defined by the federal bankruptcy code, or the state could also name specific entities within certain categories or reference to the actual name of the municipality. [26]

C) A State May Deny a Municipality Authority to File For Chapter 9.

A state's power to grant consent to file also includes the converse authority to deny authorization. [27] A handful of states, such as Georgia and Iowa, directly prohibit filing. [28]

The 1994 Bankruptcy Reform Act's requirement of "specific" state authorization reaffirms state control over the chapter 9 filing and lends support to state authority to deny authorization. [29] Although the court in the pre-1994 Bridgeport case recognized Bridgeport's chapter 9 filing despite vigorous opposition from the state of Connecticut, Bridgeport does not support the view that the state may not deny authorization. [30] In Bridgeport, the court did not find that the city circumvented state authority denying authorization to file chapter 9, the court merely found that there was implied authorization from other sources. However, in practice, commentators have suggested that the city of Bridgeport was attempting to use federal bankruptcy as an "alternative (perhaps an escape) from the strictures of state supervision)". [31]

D) Federal Bankruptcy Law Probably Does Not Prohibit the State From Forcing a Municipality to File for Chapter 9.

There is no case law on the issue of whether a state may force a municipality to file for chapter 9. The resolution of this issue probably pertains more to state constitutional issues regarding state governance of municipalities, rather than federal bankruptcy law. Federal bankruptcy law prohibits "involuntary" filings, *in deference to state sovereignty*. [32] Since a forced filing by the state would not implicate state sovereignty, federal bankruptcy law probably does not pose a constraint to state exercise of such power.

While the 1994 Bankruptcy Reform Act clarified that authorization must be "specific", the language of 109(c)(2) as highlighted in the earlier Bridgeport discussion allows authorization from different state sources "by State law, *or* by a governmental officer *or* organization empowered by State law to authorize such entity to be a debtor . . .." [33] For example, the state of New York provides that a municipality *or* its state-created financial review board may file for federal bankruptcy protection. [34] In the event that a municipality refuses to file for chapter 9, this conflict would most likely be governed by state law, rather than federal bankruptcy law because it involves two state bodies empowered to grant authorization.

III. The State May Attach Preconditions to State Authorization as Long as Such Requirements Do Not Undercut the Efficacy of Chapter 9

States have a strong interest in preventing their municipalities from filing bankruptcy, in order to protect the credit of all municipalities in the state. By imposing preconditions prior to granting authorization to file, the state may be able to discourage frivolous filings, and maintain control of the municipal-debtor during bankruptcy. However, the gate-keeper function appears to be less critical in light of the actual dearth of frivolous chapter 9 filings: over the entire history of chapter 9 through 1991, a total of 452 chapter 9 cases were filed, mostly among special purpose districts. [35]

Typically, states have focused on the following requirements in exercising control over municipal-debtors: a) the state serves as a gate-keeper by requiring prior approval before filing; b) the state controls the debtor during bankruptcy through the appointment of a trustee who acts on behalf of the municipal-debtor and proposes a plan of readjustment; and c) the state enacts state "bankruptcy" procedures in the form of municipal-distress statutes which may run concurrently with federal bankruptcy laws.

The state's authority to control the municipal debtor is independent of federal bankruptcy law. A municipality may file for chapter 9 only with state consent. In other words, since municipalities do not have any federal bankruptcy powers independent of those granted by the state, and what power the municipality has under state law is delegated by the state, the state is free to attach requirements to its authorization statute.

The only apparent limitation imposed by federal bankruptcy law is that the state may not impose requirements which undercut the efficacy of chapter 9.

Thus, federal bankruptcy law does not dictate that state control over the municipal-debtor must be enacted as a *precondition* to filing, because such requirements may be imposed at *anytime* by the state. For example, the state of Pennsylvania liberally grants authorization to file chapter 9, but the *effect* of filing chapter 9 automatically triggers the appointment of a state plan coordinator, and subjects the municipality to state procedures which act concurrently with the federal bankruptcy laws. [36] The Pennsylvania authorization statute has the advantage of flexibility in both retaining state control over the municipality while not unduly delaying or preventing a bankruptcy filing.

The structure of the Pennsylvania statute is itself also shaped by state constitutional constraints. For example, Pennsylvania's constitution prohibits state interference into local government and enactment of special legislation affecting only one or a few local governments. [37] Under the authorization statute, compliance with state aid procedures are voluntary rather than mandatory, and the municipal-debtor has the option of rejecting any readjustment plan proposed by the state appointed fiscal coordinator. If the municipal-debtor rejects the state proposed readjustment plan, it then runs the risk of losing state grants and funding. [38]

Although this paper does not explore California's state constitutional constraints, it underscores the importance of the state constitution and state law in shaping the state's control of a municipal-debtor. The focus on the remaining analysis will be on how federal bankruptcy law effects the types of requirements which a state may impose on a municipal-debtor.

A) Federal Bankruptcy Law Limits Judicial Interference into State and Municipal Governance Thereby Allowing the Municipal-Debtor to Maintain Control of Its Fiscal Affairs During Bankruptcy.

Together, sections 903 and 904 preserve the constitutionality of the federal bankruptcy laws by severely curtailing the power of the federal court's interference into municipal affairs. [39]

The hands-off policy reflected in these sections preserve the state's authority to control the municipal-debtor.

903. Reservation of State Power to Control Municipalities

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, but ---

> (1) a state law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
>
> (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

904. Limitations on jurisdiction of the powers of the court.

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. [40]

The purpose of the unequivocal language protecting state sovereignty in 903 is "to remove any inference that the legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness." [41] Because a municipality's level of expenditures is viewed as an inherently political issue, federal courts are not allowed to interfere with democratic decision-making by appointing a trustee to manage or control the municipal-debtor. [42]

According to critics, the freedom to set spending priorities removes "one of the principal disincentives to fiscal irresponsibility" and is the chief difference between municipal and private bankruptcy. [43] Creditors cannot force an involuntary filing, submit their own plan of reorganization, move for the appointment of a trustee, or contest decisions of the municipality regarding its property and revenues. [44] Instead, the creditor's primary tools are to object to the bankruptcy filing or the plan of confirmation, while the court's sole remedy when a debtor fails to propose a plan on a timely basis or a plan which cannot be confirmed is to dismiss the case. [45]

B) The State May Appoint a Trustee At Anytime.

While *the court* is prohibited from appointing a trustee to manage the affairs of the municipal-debtor after a chapter 9 is filed pursuant to 904, [46]the statute is silent on whether and when a state may appoint a trustee. The likely interpretation of the federal bankruptcy code is that a state appointment of a trustee as a precondition to filing or as an effect of filing or even during bankruptcy is valid, because such state authority would exist independent of federal bankruptcy law. A hands-off policy is further supported by 903 which denies federal bankruptcy power to "limit or impair the power for the State to control, by legislation or otherwise, a municipality". [47]

In In re Richmond Unified School District, the bankruptcy court held that the debtor-school district was entitled to dismiss its chapter 9 case, even though there was an alleged conflict of interest between the state and the school district. [48] While this case pertains to a dismissal of a chapter 9 case, the court's rationale explaining the lack of bankruptcy court authority to dismiss a state-appointed Administrator is applicable to the present issue of the state's discretion to appoint a trustee:

In the first place, unless the Administrator is divested of authority for reasons unrelated to the matters now before the court, he will retain control of the District, whether or not the court dismisses the case, because, as previously mentioned, the court may not interfere with the District's management, section 904. . . . Secondly, and more significantly, Chapter 9 was drafted to assure that application of federal bankruptcy power would not infringe upon the sovereignty, powers and rights of the states, including, presumably, states alleged to have a conflict of interest. [49]

As a state matter, states vary as to the degree of authority delegated to a trustee. For example, New Jersey, Connecticut, and Kentucky simply give a state appointed official or body the power to approve a filing. [50] On the other hand, after Richmond School District filed for bankruptcy, the state of California appointed a trustee to assume all the legal rights and duties of the District's governing board as consideration for an agreement to loan the school district $19 million dollars. [51] The California State Legislature has recently gone even further by appointing a trustee who will assume all powers granted to the Orange County Board of Supervisors if a readjustment plan is not filed by the County by January 1, 1996, *and* the voting power of the public creditors in order to prevent a denial of a confirmation plan. [52] If a trustee and a plan are approved, the Orange County Transportation Authority will receive $1.917 million dollars annually from 1997 to 2013. [53]

C) A State May Control the Formulation of the Debt Readjustment Plan.

Under Chapter 9, the imposition of a binding readjustment plan allows a municipality to resolve the hold-out problem among creditors. The power to "impair contracts" or scale down debts is unique to federal bankruptcy law; states are prohibited from "impairing contracts" under the Contracts Clause of the Constitution. [54]

1) The "Debtor" has the Exclusive Right to Propose a Debt Readjustment Plan In Chapter 9.

Under 942, the "Debtor" has the exclusive right to propose a readjustment plan either with the filing of the petition or within such a time as the court directs. [55] This rule is dictated by the 10th Amendment of the Constitution which requires that a municipality, as a political subdivision of a state, be left in complete control over the political and governmental affairs even during a municipal bankruptcy. [56]

However, state sovereignty is not implicated when it is the state which attempts to control the municipal-debtor by approving or proposing a plan. Consequently, while the state is not the "debtor" per se, federal bankruptcy law does not appear to prohibit the state from acting on behalf of the municipal-debtor through an appointed trustee. [57] The primary constraints on state actions under the federal bankruptcy code regarding the validity of state requirements are: a) federal pre-emption of state policies which undercut the efficacy of chapter 9; and b) uncertainty regarding whether federal bankruptcy law pre-empts all other independent state efforts to adjust debt, including state "bankruptcy" laws.

a) Courts Have Construed State Authorization to File for Chapter 9 As State Policy Favoring the Pre-emption of Federal Bankruptcy Law over State Policies Which Undercut the Efficacy of Chapter 9.

Although 903 reserves state power to control municipalities, the federal bankruptcy courts have not interpreted this provision to limit the application of *substantive* provisions of Chapter 9. [58] In Alliance Capital Management L.P. v. County of Orange, movants brought a motion for relief from stay in order to file a writ of mandate in state court to force the County to set aside certain revenues to pay noteholders. Movants argued that relief was necessary because state court provided the only forum to adequately protect movants' interests (the only forum to compel the County to make set-asides), and granting relief from the stay would further the Congressional policy of providing "maximum flexibility to states in solving the debt problems of municipalities." [59] The bankruptcy court rejected both arguments reasoning that by filing Chapter 9, the County has consented to the bankruptcy court's jurisdiction and the court's power to order adequate protection as a condition for continuance of the automatic stay. [60] More importantly, the bankruptcy court also rejected the argument that 903 intended "maximum flexibility for the states" to solve municipal debt problems on the basis that " 903 will should not be interpreted to undercut the efficacy of Chapter 9". [61]

In other words, the court refused to lift the stay so that a creditor could pursue a writ of mandamus in state court, because the main benefits of chapter 9, which include the "breathing spell" provided by an automatic stay and the power to adjust debts through a binding plan process, would be lost. [62] Moreover, the court reasoned that removing these primary benefits could not be the intent of Congress in enacting federal bankruptcy law, nor of the State of California in authorizing its municipalities to use chapter 9. [63]

Similar reasoning was applied in In re City of Columbia Falls, Montana, Special Improvement District No. 25 where the court rejected state efforts to prevent a municipal-debtor from impairing their obligations to bondholders *after* the state had already authorized the chapter 9 filing. [64] Under state law, the City of Columbia was required to fund a revolving fund until all bonds and interests were "fully paid and discharged". [65] The court concluded that federal bankruptcy law superseded these state law requirements to allow the municipal-debtor to modify or extinguish the municipality's obligations to bondholders. [66] The court reasoned that the federal bankruptcy pre-emption of state law in this case was not an unconstitutional interference with state powers in violation of the 10th Amendment of the Constitution and 903 of the federal bankruptcy statute:

Far from interfering with the ability of the state of Montana to control its municipalities, it is concluded that Montana has affirmed that its municipalities may avail themselves of the benefits of the federal bankruptcy process, including the modification and termination of these sorts of debts, and as such does not interfere with the power of the State of Montana to control a municipality or in the exercise of the political or governmental powers of such municipality. [67]

In Bridgeport, the bankruptcy court went even further than Alliance or Columbia Falls to narrowly construe the power of the state to control the municipal-debtor during bankruptcy. The Bridgeport court denied the state the authority to approve a plan of readjustment. [68] Although the state of Connecticut had created a Financial Review Board with authority to approve Bridgeport's budget and all borrowing, the court held that a "budget" was conceptually different from a (readjustment) "plan". [69] This distinction appears rather superficial.

As discussed earlier in Chapter I, Bridgeport may be distinguished on the narrow ground that the court found implied state consent to file for bankruptcy. [70] The 1994 Bankruptcy Reform Act overturned the implied consent concept and reaffirmed state control of the chapter 9 filing by requiring "specific" authorization. [71] Nevertheless, a reaffirmation of state control over the filing of the bankruptcy may not be equivalent to reaffirmation of state control of the municipal-debtor during the bankruptcy *after* the state has granted authorization.

However, the better view following Alliance and Columbia Falls, is that state actions which do not undercut the efficacy of Chapter 9 are valid. The courts have construed state consent as a state policy to avail municipalities of the primary benefits of the automatic stay and debt readjustment provisions of the federal bankruptcy code. Thus, federal bankruptcy appears to pre-empt state law that prevents the municipal-debtor from exercising the opportunity to readjust debt. To the extent that chapter 9 is applied in such a manner as to impair or limit state control of the municipality beyond the automatic stay and debt readjustment provisions, the state would have standing to challenge this under 903. [72]

The precise balance between federal bankruptcy law and state law remains an open question. [73] Federal bankruptcy law does not provide definitive limits on state authority, short of state actions which deny a municipality the opportunity to impair debt. The courts have construed state consent to file for chapter 9 as consent to allow federal pre-emption of state policies which undercut the efficacy of chapter 9. To the extent that courts are examining state intent as instructive on federal pre-emption, a state authorization statute subject to preconditions expresses a conditional grant of state authorization and may deny federal pre-emption in those areas specified. On the other hand, federal bankruptcy law's deference to state sovereignty already suggests a narrow scope for federal pre-emption limited to creating "breathing space" for the Debtor to formulate a readjustment plan.

b) The State May Enact State "Bankruptcy" Procedures Which Do Not Impair Contracts In Violation of the Contracts Clause of the U.S. Constitution.

As discussed earlier, states may appoint a trustee who assumes the duties and legal rights of the municipal-debtor *within* the federal bankruptcy framework. Alternatively, numerous states have enacted the equivalent of state bankruptcy procedures through municipal distress statutes such a those found in New York and Pennsylvania, which may act concurrently with federal bankruptcy laws. [74] The latter approach, while not the focus of this paper, raises questions concerning the constitutionality of state "bankruptcy" procedures, as well as pre-emption issues when federal and state laws conflict.

Conceptually, federal bankruptcy laws were enacted by Congress and made available to states to get around the U.S. Constitutional prohibition against state impairment of contracts. [75] 903(1) of the federal bankruptcy code attempts to codify this principle by prohibiting state law from prescribing a "method of composition of indebtedness" without the consent of creditors, However, as Collier points out, it is not clear whether 903(1) is co-extensive with the Contracts Clause. [76] In other words, a state law that adjust debts but complies with the Contracts Clause may be a valid exercise of state authority, thereby making 903(1) an unconstitutional intrusion on state sovereignty.

There are two cases suggesting that state *extension* of municipal debt with no reduction in principal payments is not an impairment of contracts in violation of the Contracts Clause. In Faitoute Iron & Steel Co. v. City of Asbury, the U.S. Supreme Court upheld a 1933 New Jersey law that permitted a state plan of adjustment of municipal debt over the objection of minority creditors if the city and 85% of the creditors agreed. [77] However, in 1946 Congress reacted to Faitoute by adding the amendment prohibiting state composition of debt which is reflected today in 903(1). According to the legislative history, the amendment was intended to pre-empt state bankruptcy law and provide uniform federal law for the adjustment to municipal debt. [78]

In more recent history, the bankruptcy court in Ropico, Inc. v. City of New York upheld the New York State Emergency Moratorium Act for the City of New York as an extension of debt, and not an impairment of contract in violation of both the Contracts Clause of the Constitution and the jurisdiction by the federal bankruptcy court over impairment of contracts. [79] Technically, the City of New York did not utilize federal bankruptcy protection, but relied upon remedies provided by the state municipal-distress statute. The New York Moratorium Act suspended payment of principal on the city's short-term notes for three years and reduced the interest after maturity to 6%. [80] According to the Ropico majority: as long as the contract rate of interest on the notes was paid until the original maturity date, the fact that a Moratorium Act provided for lower interest payment post-maturity did not render the Emergency Moratorium Act a "composition". [81]

In Ropico, a federal pre-emption issue was not addressed, because the court interpreted the Contracts Clause and the federal bankruptcy clause prohibiting impairment of contracts to be co-extensive and not violated by the New York State Moratorium Act for the City of New York. [82] However, in a related case of Subway-Surface Supervisors Assoc. v. New York City Transit Authority, involving suspension of wage increases in a collective bargaining agreement and preference payments to bondholders in response to the New York City fiscal crisis, the court held that the state's exercise of police powers overrode the Contracts Clause where such impairment was "reasonable and necessary to serve an important public purpose." [83] The court further held that such state actions were not deemed to be a "plan" of readjustment in violation of jurisdiction under the federal bankruptcy law. [84]

The New York experience reflects the court's flexibility in interpreting the state municipal distress statutes and the Contracts Clause to allow for state remedies outside of federal bankruptcy. State municipal distress statutes allow states to comprehensively and pro-actively assist municipalities in preventing default. For most municipalities, filing for federal bankruptcy is typically a last resort. The U.S. constitutional authority of states to enact parallel state bankruptcy procedures remains unclear given the limited case law on the subject.

IV. Conclusion

A state has the power to grant or deny "specific" authorization for its municipalities to file for federal bankruptcy protection under 11 U.S.C. 109(c)(2). The requirement of state consent protects state sovereignty from federal intrusion, and has been critical to the constitutionality of the federal bankruptcy law.

Since federal bankruptcy law does not grant the municipalities power independent of that delegated by the states, federal bankruptcy law does not bar state actions to control municipal debtors. Deference to state sovereignty is reflected in federal bankruptcy law under sections 903 and 904 which severely curtail the interference of federal courts and creditors in the governance of the municipality and the state. The unequivocal language of 903's reservation of state power is "to remove any inference that the (municipal bankruptcy) legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness." [85]

While the court and creditors cannot appoint a trustee or propose a plan of confirmation, this paper concludes that the state may take such actions at anytime. Where the state acts to control the debtor, state sovereignty is not implicated. The state may, in effect, assign powers from the municipality to a trustee who acts on behalf of the municipal-debtor, if such state authority is valid under state law.

State imposition of preconditions to filing a chapter 9 provides both a gate-keeper function to discourage frivolous filings and a mechanism to maintain state control over the municipal-debtor during bankruptcy. Generally, states have a strong interest in preventing a municipal bankruptcy filing in order to protect the credit of all municipalities in the state. However, federal bankruptcy law does not dictate that state measures to control the municipal debtor must be imposed *prior* to filing. The state could conceivably attach the requirements as a precondition, or as an effect of filing, or even enact *ad hoc* legislation during the bankruptcy case, because such state authority exists outside of federal bankruptcy.

Various factors may shape the structure of the state authorization statute, including the need for flexibility to prevent delays in emergency filings and the relationship between states and municipalities under the state constitution. As a subject for another paper, the analysis provided underscores the importance of state constitution and state law in defining the scope of state authority to control a municipal-debtor.

The effect of state consent has been construed by the bankruptcy courts as an expression of the state's willingness to allow federal bankruptcy laws to pre-empt state policies which undercut the efficacy of chapter 9. For example, since the primary benefits of chapter 9 are the automatic stays which allow municipalities "breathing space" to develop a plan and the power to readjust debts, the courts have denied creditors relief from stay to file writ of mandamus in state courts and also rejected state polices prohibiting a municipal-debtor from impairing debt. The court has reasoned that removing these benefits from a municipal-debtor is simply inconsistent with the state's authorization to file for chapter 9 in the first place.

Short of destroying the primary benefits of chapter 9 of an opportunity to readjust debt, federal bankruptcy law does not provide definitive limits on state actions. State requirements that do not undercut the efficacy of municipal bankruptcy would appear to be valid. To the extent that the courts construe state intent in ascertaining federal pre-emption, a conditional grant of authorization subject to state requirements would be evidence of the state's intent not to relinquish control over particular issues. However, the strong deference to state sovereignty under federal bankruptcy law suggests that the scope of federal pre-emption may already be narrowly limited to readjustment of debt.

Several cases have even suggested that the state may have the authority to enact state "bankruptcy" procedures through municipal distress statutes which extend debt. Numerous states such as New York and Pennsylvania have enacted municipal distress statutes providing for comprehensive state remedies which kick-in before chapter 9 and run concurrently with federal bankruptcy law. The limited case law in this area leaves open the question of whether states may enact state "bankruptcy" statutes which run concurrently with the federal bankruptcy law or pre-empt federal bankruptcy laws, yet not constitute a violation of the Contracts Clause of the Constitution.

Appendix A

Relevant Federal Constitutional Provisions

Article I., 8,. 4

"The Congress shall have Power . . . To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States."

Article I. 10, cl. 1

"No State shall . . . make any . . . Law impairing the Obligation of contracts."

10th Amendment

"The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

Appendix B

Survey of Authorization Statutes

in Various States [86]

No Authorization Statutes

Alaska

Alabama

Authorization Statutes with No Restrictions on Filing of Chapter 9

Arkansas *[Ark Stat. Ann. 47-74-103 (1994)]*

Arizona *[A.R.S. 35-603, 35-604 (1995)]*

California *[Cal Govt Code 53760 (1995)]*

Florida *[Fla Stat 218.01 (1994)]*

Missouri *[1995 MO S.B. 414, Signed by Governor April 11, 1995]*

Nebraska *[Neb. Rev. St. 13-402 (1994)]*

New York *[NY CLS Loc Fin 85.80 (1994)]*

Oklahoma *[62 Okl. St 286 (1995)]*

Authorization Statues Prohibiting Filing of Chapter 9

Georgia *[O.C.G.A. 36-80-5 (1995)]*

Iowa *[Iowa Code 76.16 (1995)]*

Authorization Statutes with Preconditions to Filing

Connecticut *[Conn. Gen. Stat. 7-566 (1994)]*

Kentucky *[KRS 66.400 (Michie 1995)]*

New Jersey *[NJ Stat 52:27-40 (1994)]*

Pennsylvania *[53 P.S. 11701.261-11701.263 (1995)]*

States with Municipal Distress Statutes

New York *[NY Stats, Title 6-A, commencing 85.00 (1995)]*

Pennsylvania *[Penn Code, Chapter 30E, Financially Distressed Municipalities Act]*

Appendix C

Survey of California Legislative Proposals re State Authorization.

a) SB 19, Kopp

This bill proposes that any municipality in the state (as defined by Section 101(40) of the federal bankruptcy code) with written approval of the Local Agency Bankruptcy Committee under terms and conditions imposed by such a committee may file for chapter 9.

The bill also authorizes the Governor to appoint a trustee to oversee the bankrupt municipality with specific powers to be granted by the Governor. The Committee may overrule proposed actions by the Trustee.

Cal.. No. 19, 1995-96 Second Extraordinary Session, Introduced May 8, 1995.

b) CA AB. 2 (Caldera)

Permits any municipality, as term is defined in specific Federal law, to file as a debtor.

Cal AB. 2, 1995-1996 Second Extraordinary Session, Introduced February 17, 1995.

c) SIB. 1274 (Killea)

Proposed bill would authorize any municipality, as term is defined in specific federal law, to file as a debtor.

1274, 1995-1996 Regular Session, Introduced February 24,1995.

d) AB. 29 (Archie-Hudson)

This bill permits any municipality, as that term is defined in specific federal law, to file as a debtor and would condition such filing on receiving statutory approval by the Legislature. Plan of adjustment shall be submitted to Legislature prior to being submitted to the Bankruptcy Court.

Cal AB. 29, 1995-1996 Second Extraordinary Session, Introduced May 4, 1995.

e) SB 1276 (Killea)

The bill authorizes the Governor to appoint a trustee for Orange County if the county board of supervisors has not filed a plan of adjustment with the bankruptcy court by January 1, 1996. This bill transfers statutory powers from board of supervisors to the trustee. It also authorizes the trustee to assume specified powers of public-entity creditors to the extent necessary to prevent a denial of a confirmation plan of adjustment. In addition, if the plan of adjustment is confirmed and a trustee is appointed, the Orange County Transportation Authority will be paid $1.917 million dollars annually from 1997 to 2013 instead of the County.

Cal SB 1276, Approved by Governor October 9, 1995.(This act shall become operative only if SB 727 of the 1995-1996 Regular Session, SB 863 of the 1995-1996 Regular Session, and Assembly Bill 1664 of the 1995-1996 Regular Session are all enacted and become operative on or before January 1, 1996.)

Notes

[1] Michael McConnell and Randall C. Picker, When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy, 713 Practicing Law Institute 35, 12 (1995); 4 Collier on Bankruptcy, P 900.01 at 900-2 (L. King 1994). (return to text)

[2] Id. (return to text)

[3] McConnell and Picker, supra note 1, at 13. (return to text)

[4] U.S. Const. art. I., 10, cl. 1; See Appendix A. (return to text)

[5] David L. Dubrow, Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?, 24 The Urban Lawyer 3, 548 (Summer 1992). (return to text)

[6] House Report No. 95-595, 95th Cong., 1st Session 263 (1977), U.S. Code Cong. & Admin. News 1978 pp. 5787, 6221. (return to text)

[7] In re County of Orange et al. v. County of Orange, 179 Bankr. 185, 191 (Bankr Ct. C.D. Cal. 1995). (return to text)

[8] See Appendix B for Sample Survey of State Authorization Statutes. (return to text)

[9] See Appendix C for Survey of California Legislative Proposals. (return to text)

[10] 11 U.S.C. 109� (1995). (return to text)

[11] Cal. Gov Code 53760 (1995). (return to text)

[12] U.S. Const. art I, 8, 10; See Appendix A. (return to text)

[13] U.S. Cont. art. I., 10; See Appendix A. (return to text)

[14] U.S. Const., art. I, 8, cl. 4; See Appendix A. (return to text)

[15] U.S. Const., amend. X; See Appendix A; Bekins v. Lindsay-Strathmore Irrigation District, 304, U.S. 27, 58 (1942). (return to text)

[16] Id. at 53-54 (The Supreme Court struck down the first municipal bankruptcy statute enacted in 1934 as an unconstitutional infringement on state sovereignty in Ashton v. Cameron County Water Improvement District, 298 U.S. 513 (1936). Bekins overturned Ashton to uphold the constitutionality of federal bankruptcy protection for municipal debtors.) (return to text)

[17] The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (Enacted on October 22, 1994 and effective in cases filed after that date.); See Collier, supra note 1, at 900-17; S. Rep. No. 989, 95th Cong., 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5896-5897. (According to the legislative history, the new language was intended to clarify the split in the courts over the interpretation of "generally authorized". The "generally authorized" language was itself a compromise between earlier House and

Senate bills: the House bill provided that a municipality must not be prohibited from filing while the Senate bill required specific state authorization. The earlier Senate version appears to have eventually prevailed in the 1994 Bankruptcy Reform Act. According to those earlier Senate discussions, "[a]bsent . . . a requirement for affirmative action by the state, a serious constitutional question would be raised in connection with the 10th Amendment.") (return to text)

[18] In re City of Bridgeport, 128 B.R. 688, 688 (Bankr. Ct. D. Conn. 1991). (return to text)

[19] Id. at 693. (return to text)

[20] In re County of Orange; Orange County Investment Pools, 183 B.R. 594, 604 (Bankr. Ct. C.D. Cal. 1995). (return to text)

[21] Id. at 605. (return to text)

[22] Id.; Cal Govt. Code 53760 (1995) (California's authorization statute was passed in 1949 and refers to the 81 of an earlier bankruptcy code which was eventually included in the 1937 Bankruptcy Act. Section 81 provides a list of types of public entities that are authorized to file. Amendments to the 1976 bankruptcy code enacted 84 intended to broadened the applicability of Chapter 9, by more generally categorizing the list of entities contained in 81. (H.R. Rep. No. 686, 94th Cong., 2nd Sess. 20 (1975). 84 is nearly identical to that of 101(4) of the federal bankruptcy code in defining a "municipality" as a "political subdivision or public agency or instrumentality of the State."). (return to text)

[23] Id. (return to text)

[24] In re Orange County, 183 B.R. at 602 (emphasis added). (return to text)

[25] Id. at 604. (return to text)

[26] Id. (return to text)

[27] Bekins, 304 U.S. at 58 (In dicta, the Supreme Court suggested that a potential constitutional obstacle to the 1937 Municipal Bankruptcy Act was the right of states to *prevent* their municipalities from seeking federal bankruptcy protection. The Court did not reach this issue, because the state of California had granted authorization in Bekins.) (return to text)

[28] See Appendix B. (return to text)

[29] 1994 Bankruptcy Reform Act, supra note 16. (return to text)

[30] In re Bridgeport, 128 B.R. at 688. (return to text)

[31] McDonnell and Picker, supra note 1, at 17. (return to text)

[32] Bekins, 304 U.S. at 58. (return to text)

[33] 11 U.S.C. 109(c)(2) (1995); In re Bridgeport, 128 B.R. at 693 (In Bridgeport, the court interpreted the "or" language as indicating that the power to grant authorization may exist in several sources, thus finding that a governmental body which denied authorization did not bar a finding of implied consent from state statute authorizing home rule. After the

1994 Bankruptcy Reform Act, authorization may not be implied, but must be specific.) (return to text)

[34] NY CLS Loc Fin 85,80 (1994); See Appendix B. (return to text)

[35] McDonnell and Picker, supra note 1, at 22 (There have been a total of 452 chapter 9 filings over the history of federal bankruptcy statute through 1991: 362 municipal bankruptcy cases were filed between 1938 and 1972 and of that number 95% were filed before 1952; from 1972 to 1991, there were an additional 90 chapter 9 filings. Excluding the special purpose districts, which are the large majority of insolvent municipal debtors, *there have been only three Chapter 9 filings by general municipalities between 1972 and 1984,* and none of these were related to the long-term financial health of the cities. In 1991, Bridgeport, Connecticut with a population of 140,000 and a $2 million dollar debt was the largest city at that time to have *attempted* to utilize Chapter 9; the case was eventually dismissed for not meeting the "insolvency" requirement. In 1994, Orange County of California became the largest municipality to file for Chapter 9 reporting a $1.7 billion loss on a $7.4 billion dollar investment pool.) (return to text)

[36] 53 P.S. 11701.261-11701.263 (1995); See Appendix B. for language of statute; Ronald K. Snell and Scott Makey, "Locals in Distress: What Can States Do?" the Fiscal Letter - A Bimonthly Report on Government Finance Issues in the State, Vol. XIII, No. 3 p. 7-8 (Published by National Conference of State Legislatures, May/June 1991). (return to text)

[37] Id. (return to text)

[38] Id. (return to text)

[39] Id. at 904-2; B.R. Rep. No. 94-686, 94th Cong., 1st Sess. 18 (1975). (return to text)

[40] 11 U.S.C. 903, 904 (1995). (return to text)

[41] Collier, supra note 1, P 903.02. at 903-3. (return to text)

[42] In re Richmond Unified School District, 133 B.R. 221, 224 (Bankr. Ct. N. Dt. 1991) (The court may appoint a trustee pursuant to 926 for the limited purpose of prosecuting avoidance actions.); See also John Jacobs, "Orange County's Leadership Crisis," Sacramento Bee, June 25, 1995 (Although municipal bankruptcy law prevents court intervention into the governmental affairs of the city, critics note that the problem of financial distress may indeed reflect a failure in the democratic political process. According to an analyst with the Moody Investors of New York, "This event in Orange County (bankruptcy) is indicative of risk, the breakdown of local governance and the inability to find a solution. We view the passive approach the state has taken to his problem pretty negatively."); "A Trustee for Orange County," Sacramento Bee, June 30, 1995 (The recent defeat of the sales tax measure prompted another commentator to write: "Orange County is not broke; it is unable, or unwilling, to govern itself and take responsibility for its debt.") (return to text)

[43] McConnell and Picker, supra note 1, at 12. (return to text)

[44] Dubrow, supra note 5, at 552. (return to text)

[45] Id.; In re Richmond Unified School District, 133 B.R. at 221. (return to text)

[46] Id. at 224 (The court may appoint a trustee for the limited purpose of prosecuting avoidance actions pursuant to 926.). (return to text)

[47] 11 U.S.C. 903 (1995). (return to text)

[48] In re Richmond Unified School District, 133 B.R. at 221 (Creditors argued in opposing the motion by the state and debtor-school district to dismiss the bankruptcy case, that the school district had a conflict of interest as the largest creditor (owed $36 million dollars) and as the Administrator of the school-district.) (return to text)

[49] Id. (return to text)

[50] See Appendix B. (return to text)

[51] In re Richmond, 133 B.R. at 222. (return to text)

[52] Cal SB 1276, Chapter 747, Approved by the Governor October 9, 1995; Interview with Henry Kevane, Esq. and David Konig, Esq. of Murphy, Weir and Butler of San Francisco. (return to text)

[53] Id. (return to text)

[54] U.S. Const. art. I., 10, cl. 1; See Chapter I; Appendix A. (return to text)

[55] 11 U.S.C. 941 (1995) (Chapter 9 creditors may not submit a plan but may vote on the plan or object to the confirmation. This stands in direct contrast to chapter 11 which allows a debtor an exclusive period to file a plan after which any party in interest may file a plan. A court will confirm a plan in chapter 9 if it is "in the best interest of creditors and is feasible" and meets with other requirements set out in 943. However, a bankruptcy court may still confirm a plan over such a vote if the court believes the plan to be "fair and equitable" and does not discriminate against the objecting class of creditors.") (return to text)

[56] Bekins, 304, U.S. at 58. (return to text)

[57] See also 11 U.S.C. 943(b)(4), 943(b)(6) (1995) (The state's authority to propose a readjustment plan as a trustee in a bankruptcy case is further supported by provisions reinforcing state sovereignty in the plan confirmation. For example, 943(b)(4) prohibits confirmation if the plan proposes any state action that the debtor is prohibited from taking under applicable law, and 943(b)(6) stipulates that the court's power to confirm a plan does not override the power of the electorate to veto an action proposed under the plan if the electorate had such power outside of Chapter 9.) (return to text)

[58] Collier, supra note 1, P 903.02 at 903-4 to 903-5; Alliance Capital Management L.P. v. County of Orange, 179 Bankr. 185 (Bankr. Ct., C.D. Cal. 1995); In re City of Columbia Falls, Montana, Special Improvement Dist., No. 25, 143 B.R. 750 (Bankr. Ct., D. Mont. 1992). (return to text)

[59] Alliance, 179 Bankr. at 191. (return to text)

[60] Id. at 189. (return to text)

[61] Id. (return to text)

[62] Id. (return to text)

[63] Id. (return to text)

[64] In re City of Columbia Falls, 143 B.R. at 759. (return to text)

[65] Id. at 757. (return to text)

[66] Id. at 758. (return to text)

[67] Id. at 759. (return to text)

[68] Bridgeport, 128 B.R. at 699. (return to text)

[69] Id. (A "plan" involved a readjustment of pre-petition obligations, while a "budget" pertained to future expenditures.) (return to text)

[70] Id. (return to text)

[71] 1994 Bankruptcy Reform Act, supra note 16. (return to text)

[72] Collier, supra note 1, P 903.02 at 903-5. (return to text)

[73] See also Laura Jereski, "Who Bears the Loss Becomes Critical Orange County Issue," The Wall Street Journal, January 10, 1995; Interview with Henry Kevane, Esq. and David Konig, Esq. of Murphy, Weir and Butler of San Francisco; In re Orange County, Response to Official Committee of Unsecured Creditors of the County of Orange to Various Objections to the Motions for Dismissal of Chapter 9 Petitions Filed by Orange County Investment Pools and County of Orange, Case No. SA 94-222272-JR, p. 6, March 28, 1995 (In the dismissal of the investment fund (OCIP) bankruptcy petition in Orange County, an unresolved issue was whether federal bankruptcy law's goal of equality in distribution among creditors would override state trust law. If a trust was not recognized, then Investment Pool participants would be general unsecured creditors, and would share pro rata in the distribution of funds. The dismissal of the OCIP's bankruptcy petition prevented a resolution of this issue.) (return to text)

[74] NY Stats, Title 6-A, commencing 85.00 (1995); Penn Code, Chapter 30, Financially Distressed Municipalities Act; See Appendix B; Snell and Mackey, supra note 35. (return to text)

[75] Bekins, 304 U.S. at 51. (return to text)

[76] Collier, supra note 1, at 903-9; (See Appendix B). (return to text)

[77] Faitoute Iron & Steel v. City of Asbury, 316 U.S. 502, 502 (1942). (return to text)

[78] H.R. Rep. No. 2246, 79th cong., 2d Sess. 4 (1946) ("State adjustment acts have been held to be valid, but a bankruptcy law under which the bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the United States, as the bonds of almost every municipality are widely held. Only under a Federal law should a creditor be forced to accept such an adjustment without his

consent.") (return to text)

[79] Ropico, Inc. v. City of New York, 425 F.Supp. 970, 977 (S.D. New York, 1976). (return to text)

[80] Id. (return to text)

[81] Id.; Under the U.S. Constitution, article I, 8, the state may not impair contracts. (See Appendix A). 11 U.S.C. 903(1) prohibits "state law prescribing a method of composition of indebtedness" which binds any creditor that does not consent to such composition. (return to text)

[82] Id. at 977. (return to text)

[83] Id.; See also Subway-Surface Supervisors Assoc. v. New York City Transit Authority, 44 N.Y.2d 101, 109 (1978). (return to text)

[84] Id. (return to text)

[85] Collier, supra note 1, at 903-3. (return to text)

[86] This is not a comprehensive list. (return to text)