New Jersey Municipalities, Chapter 9, and Creditors' Rights
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The City of Detroit filed the largest municipal bankruptcy in U.S. history on July 18, 2013. Shortly after the filing, I was contacted by a reporter and asked whether such a filing by a New Jersey municipality was likely. My conclusion was that such a filing, while possible, was unlikely.[1] Municipal bankruptcies are rare; there have been fewer than 800 of them since the first municipal bankruptcy statutes were enacted in the 1930s. In contrast, there have been tens of thousands of "private" bankruptcy filings in that same timeframe. Moreover, New Jersey's municipalities have not made robust use of bankruptcy relief. The most recent bankruptcy filing by a city in New Jersey, by Camden in 1999, was dismissed (with Camden's consent) three days after the filing. Before that, a bankruptcy filing by a public hospital, Jersey City Medical Center in 1983, had resulted in a confirmed plan of adjustment, but JCMC was a public hospital and not a city, township, town, or borough. It was my opinion, therefore, that a chapter 9 bankruptcy filing by a New Jersey municipality was highly unlikely.

What a difference 18 months makes! Since I made my "prediction," the cities of Detroit and Stockton, CA have confirmed chapter 9 plans of adjustment. Both cities (as well as the City of San Bernardino, CA) had prevailed against vigorous challenges to their eligibility for chapter 9 relief. In both cases, the bankruptcy judges had ruled that, notwithstanding state constitutional protections, pension benefits could be modified in bankruptcy. In both cases, bondholders and noteholders (or, more accurately, the debt insurers) agreed to significant haircuts on their claims, and, in the Stockton case, one noteholder, Franklin Templeton Investors, had a haircut crammed down on it.

While Detroit and Stockton worked through their bankruptcy cases, the economy and financial condition of Atlantic City, NJ continued to deteriorate. Faced with competition from tribal casinos, the increased popularity of online gambling, and the enactment of legislation legalizing casinos in Maryland, Massachusetts, New York, and Pennsylvania, Atlantic City lost its monopoly on East Coast gaming. The results were painful, but not surprising. Four casinos closed in 2014 alone, leaving eight casinos operating, three of which are currently in bankruptcy.[2] February 2015 casino revenue was down by 14.8 percent overall from February 2014 and down 1.9 percent in the eight surviving casinos.[3] One of the most significant casualties of Atlantic City's financial and economic slide has been the Revel casino, which closed on September 2, 2014, only two years after it opened on April 12, 2012, and filed its second bankruptcy petition in two years on June 19, 2014. To add insult to injury in the Revel case, the facility, which cost $2.4

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[1] "Experts: Detroit Bankruptcy Filing Unlikely to be Played Out in SN.J.," *NJBIZ*, July 22, 2013 (David N. Crapo quoted).
[2] A chapter 11 plan of reorganization has been confirmed (although not yet consummated) in the Trump Entertainment bankruptcy.
[3] *See* "February Casino Revenue Down 14.8 Percent in Atlantic City; Surviving Casinos Down 1.9 Percent," *Associated Press*, retrieved on March 13, 2015 from http://foxbusiness.com/markets/2015/03/12/february-casino-revenue-down-148-percent-in-atlantic-city-surviving-casinos/.

billion to build, has just been sold for $82 ***million***, less than 5 percent of the construction costs.

On January 22, 2015, Governor Chris Christie appointed Kevin Lavin as the emergency manager for Atlantic City and Kevyn Orr (the emergency financial manager of Detroit during Detroit's bankruptcy case) as his advisor. Lavin's appointment was followed by a reduction in Atlantic City's credit rating. Orr's appointment as Lavin's advisor has raised the specter that Atlantic City may file for relief under chapter 9. In an initial (and admittedly preliminary) 60-day report issued on March 23, 2015, Lavin did not mention the possibility of a bankruptcy filing, although he found that Atlantic City was "simply incapable of funding even its reduced budget." At this point, however, a bankruptcy filing is by no means out of the question. Like Detroit, Atlantic City is experiencing the implosion of its primary industry – gaming.[4] Like those in Stockton, Atlantic City's real estate values have shrunk, substantially reducing property tax revenues. Additionally, like Detroit and Stockton, Atlantic City faces significant retiree pension and health care obligations for which sufficient reserves have not been created.

Atlantic City is not the only seriously financially strapped New Jersey municipality. In the wake of Lavin's appointment, and citing a recent ruling by the Superior Court of New Jersey ordering the state to pay $1.57 billion in state funding benefits, Moody's has placed seven New Jersey municipalities under review for the possible downgrade of the ratings of their general obligations bonds, additionally citing their high reliance on state aid and lack of other financial resources to replace that aid: Newark, Paterson, Asbury Park, Kearny, Union City, and Weehawken. In sum, chapter 9 bankruptcy filings by New Jersey municipalities seem much more possible now than they did in 2013.

What should creditors expect in a chapter 9 filing by a New Jersey municipality? First, and perhaps most important, municipal creditors can expect a shift in focus from the traditional goal in municipal bankruptcies of restructuring bond debt to reduction of both bond and retiree-related debt. Detroit's bankruptcy resulted in modest reductions in pension obligations. Facing stiff opposition from the California Public Employee Retirement System ("CalPERS"), Stockton left pensions intact but reduced employee compensation, thereby indirectly restructuring its pension obligations. In both Stockton and Detroit, retirement health benefits were essentially eliminated. A Voluntary Employee Benefit Association ("VEBA"), with an initial contribution by Detroit, was established for Detroit's retirees who were otherwise expected to take advantage of Obamacare and (if eligible) Medicare for their health benefits. Stockton's confirmed plan similarly eliminated retiree health benefits.

Holders of both general obligation and special income bonds took significant haircuts in both Detroit and Stockton. Detroit shed billions in bond debt. Stockton similarly shed hundreds of millions. The ability of Detroit and Stockton to obtain such substantial concession from its note holders and bondholders (or, more accurately, from the

[4] Indeed, its prior primary industry – the resort business – had similarly collapsed.

insurers of that debt) was a surprise to both the insurers and the municipal bond markets. Although not enjoying the constitutional protections most states provide for public workers' pensions,[5] municipal bond debt was generally paid in full. After all, went the common wisdom, how could municipalities expect to access capital markets if they didn't pay their bonds in full and on a timely basis? Nevertheless, with one exception, bondholders negotiated their haircuts with Stockton and Detroit, albeit in hard-fought negotiations that, in the case of Detroit, continued after the commencement of the confirmation hearing.

Creditors can also expect the very initiation of a chapter 9 case to be long and complex process. In contrast to the filing of a voluntary bankruptcy petition[6] and not unlike the filing of an involuntary petition,[7] the filing of a chapter 9 petition does not constitute the entry of an order for relief under the Bankruptcy Code.[8] Rather, the municipal debtor must demonstrate its eligibility for relief under chapter 9.[9] As evidenced by the Stockton, San Bernardino, and Detroit bankruptcies, demonstrating eligibility can be a long, complex, and hotly contested process.[10]

To establish eligibility, the municipal debtor must first demonstrate that (i) it is, in fact, a "municipality" as defined by the Bankruptcy Code[11] and (ii) it has been "specifically authorized" under New Jersey law to file a bankruptcy petition.[12] New Jersey law "specifically authorizes" by statute the following public entities to seek bankruptcy relief: counties, cities, townships, towns, and boroughs, as well as various authorities and districts at the local, county, or regional levels.[13] Because they actually part of the state government, state-level authorities and corporations are ***not*** "specifically authorized" to file bankruptcy petitions.[14] A bankruptcy filing by a New Jersey "municipality" requires prior approval of a Local Finance Board.[15] Additionally, the filing must be authorized by the appropriate municipal authorities.[16] In that regard, for example, the chapter 9 bankruptcy petition filed on behalf of the City of Harrisburg, PA was dismissed as not being "specifically authorized" under Pennsylvania law, because it was filed upon the vote of the City Counsel without the approval of the mayor, which is required under Pennsylvania law.

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[5] An exception is Rhode Island. Following the chapter 9 filing by the City of Central Falls, Rhode Island enacted legislation providing all municipal bondholders with liens in the event of a chapter 9 bankruptcy filing. The result in Central Falls was that, in contrast to Detroit and Stockton, the Central Falls plan provided for the payment of the city's bonds, but substantially reduced pension benefits.
[6] *See* 11 U.S.C. § 301(b).
[7] *See* 11 U.S.C. § 303(f).
[8] *See* 11 U.S.C. § 921(d).
[9] *See* 11 U.S.C. § 921(c).
[10] To his credit, Bankruptcy Judge Steven Rhodes moved the hotly-contested eligibility determination process in the Detroit case relatively expeditiously.
[11] *See* 11 U.S.C. §§ 109(c)(1) (limiting chapter 9 relief to "municipalities") and 101(40) (defining "municipality").
[12] *See* 11 U.S.C. § 109(c)(2).
[13] *See* NJSA 52:27-40, which was enacted in 1935 (and amended in 1938) during the Great Depression.
[14] *See* 11 U.S.C. § 101(40) (excluding states from the definition of "municipality).
[15] *See* NJSA 52:27-40 (conditioning a bankruptcy filing on approval by the Municipal Finance Commission); and *N.J.S.A.* 52:18A-46 (replacing the Municipal Finance Commission with the Local Finance Board).
[16] *See* NJSA 52:27-41 (a bankruptcy filing must by authorized by an ordinance or resolution [as applicable] adopted by the affirmative vote of two-thirds of the members of the municipality's governing body).

As another condition to chapter 9 eligibility, the bankruptcy filing must generally be preceded by either an agreement with creditors holding at least half, in amount, of the claims the debtor proposes to impair in its plan[17] or, failing that, by good faith negotiations by the municipality with its creditors constituencies.[18] The requirement of good faith negotiations is excused if they would be futile.[19] In the *Detroit* case, Judge Rhodes found that negotiations between Detroit and its unions, bondholders, and employee pension plans would have been futile. It goes without saying that the good faith negotiation requirement provides fertile grounds for objecting to chapter 9 eligibility.

Finally, only "insolvent" municipalities are eligible for relief under chapter 9.[20] The chapter 9 petition of the City of Camden was dismissed once Camden conceded its solvency; the chapter 9 petition of the City of Bridgeport, CT was dismissed when the bankruptcy court found the city to be solvent. By contrast, Bankruptcy Judge Steven Rhodes easily found Detroit to be insolvent. When is a municipality insolvent? Because municipal assets cannot be subject to a forced sale, a "balance sheet approach" to insolvency is not appropriate to determine chapter 9 eligibility. Instead, the Bankruptcy Code mandates the use of an "equitable insolvency" or "cash flow" test that considers the municipality's failure or ability to pay its undisputed debts as they come due.[21] The application of this test can be quite complex, and there is not complete agreement on how to apply it. Hence, like the good faith negotiation requirement, the insolvency requirement provides fertile grounds for objection to chapter 9 eligibility.

Once a municipality has been found to be eligible for chapter 9 relief, creditors should expect more limited protections and powers in chapter 9 than they enjoy in chapter 11. Because a municipality is generally not a "person" for purposes of the Bankruptcy Code,[22] creditors cannot obtain the conversion of a chapter 9 case to either a chapter 11 reorganization or a chapter 7 liquidation.[23] As a result, the restructuring of debt under chapter 9 is the only remedy under the Bankruptcy Code available with respect to municipalities. It bears noting, moreover, that consistent with the protections accorded states under the 10th Amendment to the Constitution, the Bankruptcy Code does not authorize involuntary filings under chapter 9.[24]

In point of fact, as written, chapter 9 provides for very little meaningful creditor involvement in the restructuring process, at least once a case is filed. Creditors cannot use a chapter 9 bankruptcy to force the sale of municipal assets[25] or to obtain the appointment of an operating trustee.[26] Grounds for dismissing a chapter 9 case are

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[17] *See* 11 U.S.C. § 109(c)(5)(A).
[18] *See* 11 U.S.C. § 109(c)(5)(B).
[19] *See* 11 U.S.C. § 109(c)(5)(C).
[20] *See* 11 U.S.C. § 109(c)(3).
[21] *See* 11 U.S.C. § 101(32)(C).
[22] *See* 11 U.S.C. § 101(41).
[23] *See* 11 U.S.C. § 109(b) and (d) which limit eligibility for relief under chapters 7 and 11, respectively, to persons.
[24] *See* 11 U.S.C. § 303(a) (limiting involuntary filings to cases under chapters 7 and 11).
[25] *See* 11 U.S.C. §§ 904(2) (prohibiting interference with "any of the property or revenues of the debtor) and 904(3) (prohibiting interference with "the debtor's use and enjoyment of any income-producing property").
[26] *See* 11 U.S.C. § 926(a) (a chapter 9 trustee may be appointed only to liquidate avoidance actions and then only if the debtor will not bring the actions).

limited largely to delay, particularly delay in proposing and obtaining confirmation of a plan.[27] There is no creditors' meeting in a chapter 9 case.[28] Although a committee is possible in a chapter 9 case, it cannot be formed until the order for relief is entered,[29] which can be several months after the petition is filed if the eligibility hearing is hotly contested and raises complex issues. Chapter 9 does not expressly provide for the debtor to pay the expenses and fees of committee professionals, a disincentive to serving on or representing such a committee. The chapter 9 debtor need not file the detailed schedules required by chapters 7 and 11; only a list of creditors is actually required.[30] Chapter 9 debtors may obtain unsecured financing without notice and hearing or court approval.[31] Compliance with the requirements of § 327 of the Bankruptcy Code governing the retention of professionals is not required in chapter 9, although payments to professionals must be disclosed, and the bankruptcy court must determine whether they are reasonable.[32] Only the chapter 9 debtor may file a plan; no other parties are authorized to do so.[33] The bankruptcy court, not the Bankruptcy Code, sets the deadline for filing a chapter 9 plan.[34]

The standards for approving a chapter 9 plan are not as strict or detailed as clearly as the standards for approving a chapter 11 plan. Chapter 9 does incorporate some of the confirmation requirements of chapter 11, including: (i) compliance with the solicitation requirements of § 1125; (ii) the good faith requirement of § 1129(a)(3); (iii) acceptance of the plan by one impaired class of creditors; and (iv) the "cram-down" provisions of 11 U.S.C. 1129(b) affecting creditor claims. Chapter 9 adds requirements that the plan: (i) provide for the payment of administrative expenses; (ii) be feasible; and (iii) be in the best interest of creditors.[35] Because municipal assets cannot be forcibly liquidated, there is no liquidation analysis. The best interest of creditors test is met by showing that the plan must provide better treatment to creditors than any alternative, a test that allows the municipal debtor far more leeway than the "best interest of creditors" test under chapter 11.

Under the circumstances, chapter 9 leaves most creditors with the role of spoiler. Creditors can contest the debtor's eligibility for chapter 9 relief, particularly with respect to its good faith pre-petition negotiations and insolvency. They can vote against and object to the chapter 9 plan, with special emphasis on the issues of feasibility (*e.g.*, has the debtor actually remedied the problems that pushed it into bankruptcy?) or the best interest of creditors test (*e.g.*, can the debtor raise taxes and/or lower expenses to

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[27] *See* 11 U.S.C. § 930.
[28] *See* 11 U.S.C. § 901(a) (11 U.S.C. § 341 not applicable in chapter 9 cases).
[29] *See* 11 U.S.C. § 1102(a)(1) (made applicable to chapter 9 cases by 11 U.S.C. § 901).
[30] *See* 11 U.S.C. § 924.
[31] *See* 11 U.S.C. § 901(a) (only motions to obtain secured financing or financing with superpriority status requires notice to parties-in-interest and court approval).
[32] *See* 11 U.S.C. §§ 901(a) (omits any reference to 11 U.S.C. § 327) and 943(b)(3) (a condition to confirmation is that the amount paid by the debtor for post-petition services and expenses are reasonable). It bears noting that Judge Rhodes reduced fee awards in the *Detroit* case.
[33] *See* 11 U.S.C. § 941.
[34] *Id.*
[35] *See* 11 U.S.C. §§ 901(a) (provisions of 11 U.S.C. § 1129 that are incorporated into chapter 9) and 943 (chapter 9-specific confirmation requirements).

provide a better recovery for creditors?). Additionally, the creditor can move to dismiss the case, particularly if the debtor seems unable to propose a confirmable plan.

Alternatively, creditors might achieve a better result by using the structure of chapter 9 to push negotiations with the municipal debtor. Ideally, those negotiations should precede the bankruptcy filing as is contemplated by chapter 9. Similarly, as with a chapter 11 case, creditors could negotiate the terms of the plan, as the various creditor constituencies did in *Detroit* and *Stockton*. To be sure, the courts in *Stockton* and *Detroit* ruled that pension and other retiree obligations can be modified in bankruptcy, notwithstanding state constitutional protections, and bondholders and noteholders were pressured into taking significant haircuts on their claims. Nevertheless, although important, well-reasoned, and, perhaps, compelling, the rulings and results in *Detroit* and *Stockton* are not controlling on other courts. Other bankruptcy courts may rule differently. Indeed, Franklin Templeton Investments has appealed the confirmation order in *Stockton*, providing a potential that Bankruptcy Judge Klein might not have had the last word on the issues raised in that case. In other words, creditors still have room to protect their interests in chapter 9.

Finally, creditors and other parties-in-interest can be proactive with respect to the possibility of a municipal bankruptcy and lobby their state legislatures for legislation protecting their interests in the event of municipal financial distress or bankruptcy. As noted above,[36] bondholders in Rhode Island obtained statutory lien protection for their claims. In Illinois, the governor has proposed legislation to specifically authorize Illinois municipalities to seek chapter 9 relief. The Pennsylvania legislature is considering legislation to revise its distressed municipality legislation. In California, one session of the legislature made it easier for municipalities to seek bankruptcy relief; a subsequent session tightened the requirements for bankruptcy.

In any event, the roles of spoiler, negotiator, and lobbyist (and it may be necessary for a creditor to take all three roles) require an open mind, a willingness to be reasonable, and guidance by counsel and other professionals familiar with the landscape of, and interface between, municipal finance and bankruptcy.

[36] *See* note 5 *supra*.