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## SYMPOSIUM

### **BANKRUPTCY AND BEYOND: EXPLORING THE CAUSES OF AND SOLUTIONS TO MUNICIPAL FINANCIAL DISTRESS**

#### INTRODUCTION

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All law professors, when planning a law review symposium, hope that they will convince the best possible commentators on the chosen topic to travel to their law school to spend a day speaking to a primarily local audience. In 2014, one topic was certain to lure the most creative legal thinkers to Pennsylvania's capital city: municipal financial distress. On April 14, 2014, a stellar group of experts in municipal finance, bankruptcy, and state and local government law assembled in Harrisburg to discuss the causes of and potential solutions to municipal financial distress with an

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\* Professor, Widener University School of Law. My deepest gratitude to the participants in the *Widener Law Journal* Symposium, *Bankruptcy and Beyond: Solving the Problem of Municipal Financial Distress*. Those participants include the six authors whose work is included in this issue, as well as Judge Thomas Bennett, Judge Mary France, Jarad Handelman, Mark Kaufman, General William Lynch, Guy Neal, Matthew Parlow, Frank Shafroth, and David Thornburgh. Tonya Evans, Michael Hussey, and Tim Lambert kept the discussions moving in their role as panel moderators. Special thanks are also due to the members of the editorial board of the *Widener Law Journal* for 2013-2014 and 2014-2015, especially Mitchell Jones, Richard Rinaldi, and Olivia Unger.

audience filled with individuals deeply affected by the City of Harrisburg's 2011 bankruptcy filing and subsequent state-supervised recovery.<sup>1</sup> This issue of the *Widener Law Journal* presents the work of several of the speakers who presented that day.

The City of Detroit's historic Chapter 9 bankruptcy filing in July 2013 turned the eyes of the nation and the world to the problems of America's struggling post-industrial cities. In the three years before Detroit filed the largest municipal bankruptcy in United States history, several other general-purpose municipalities had done so, including Jefferson County, Alabama,<sup>2</sup> and two California cities, Stockton<sup>3</sup> and San Bernardino,<sup>4</sup> each one generating an enormous amount of local and national interest in municipal financial woes. Harrisburg's filing illustrated several of the common causes of municipal financial problems: a struggling urban core with a large percentage of its population living below the poverty line;<sup>5</sup> a small property tax base;<sup>6</sup> and an ill-advised bond deal including financing devices that can euphemistically be

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<sup>1</sup> *In re City of Harrisburg*, 465 B.R. 744 (Bankr. M.D. Pa. 2011) (dismissing Harrisburg's bankruptcy petition); *Walker v. City of Harrisburg*, No. 569 M.D. 2011 (Pa. Commw. Ct. Sept. 23, 2013), available at <http://www.pacourts.us/assets/files/setting-651/file-3053.pdf?cb=8e8741> (confirming recovery plan for City of Harrisburg).

<sup>2</sup> Barnett Wright, *Jefferson County Files Largest Government Bankruptcy in U.S. History*, THE BIRMINGHAM NEWS BLOG (Nov. 10, 2011, 5:00 AM), [http://blog.al.com/spotnews/2011/11/jefferson\\_county\\_files\\_for\\_lar.html](http://blog.al.com/spotnews/2011/11/jefferson_county_files_for_lar.html).

<sup>3</sup> See Bobby White, *Stockton Files for Bankruptcy Protection*, WALL ST. J., June 29, 2012, at A2.

<sup>4</sup> See Steven Church, Dawn McCarthy & Michael Bathon, *San Bernardino, California, Files Chapter 9 Bankruptcy*, BLOOMBERG (Aug. 2, 2012, 7:38 PM), <http://www.bloomberg.com/news/2012-08-02/san-bernardino-california-files-for-bankruptcy-protection-2-.html>.

<sup>5</sup> *State and County Quick Facts*, U.S. CENSUS BUREAU (Dec. 4, 2014), <http://quickfacts.census.gov/qfd/states/42/4232800.html> (reporting that between 2009 and 2013, 32% of Harrisburg residents lived below the poverty line).

<sup>6</sup> See PA. DEP'T OF COMMUNITY & ECONOMIC DEVELOPMENT, MUNICIPALITIES FINANCIAL RECOVERY ACT CONSULTATIVE EVALUATION 15 (Oct. 20, 2010), available at [http://www.newpa.com/sites/default/files/uploads/Local\\_Gov/Act47/City-of-Harrisburg-Act-47-Consultative-Report-102010.pdf](http://www.newpa.com/sites/default/files/uploads/Local_Gov/Act47/City-of-Harrisburg-Act-47-Consultative-Report-102010.pdf) (explaining that 48% of Harrisburg's land is tax exempt).

described as creative.<sup>7</sup> Although each filing municipality brought its own unique story to Chapter 9, each filed for bankruptcy after suffering multiple crippling blows to its financial well-being.<sup>8</sup>

Although Detroit, Stockton, Jefferson County, and Harrisburg caused lawyers to take a fresh look at Chapter 9, a rarely used part of the Bankruptcy Code (the "Code"), bankruptcy is just one part of the story of municipal decline and rebirth. The articles in this issue trace that trajectory and highlight the characteristics of municipal financial distress that make its resolution different from the resolution of business failure.

David Unkovic, the first Receiver for the City of Harrisburg, surveys the causes of municipal fiscal problems and the challenges of their resolution in *Municipal Distress: Reflections of a Receiver*.<sup>9</sup> Mr. Unkovic writes from a unique vantage point; he was the first state-appointed receiver for any municipality in Pennsylvania, the state legislature having enacted Pennsylvania's receivership law in response to the well-publicized financial travails of its capital city.<sup>10</sup> In his article, Mr. Unkovic highlights some of the political challenges that threaten long-term solutions to the problems facing American cities today.

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<sup>7</sup> See generally DOUGLAS F. SCHLEICHER ET AL., THE HARRISBURG AUTHORITY RESOURCE RECOVERY FACILITY FORENSIC INVESTIGATION REPORT (Jan. 12, 2012), available at <http://todaysthehdayhbg.files.wordpress.com/2012/01/harrisburg-report-1-17-12.pdf> (explaining the financing deals that precipitated Harrisburg's financial distress).

<sup>8</sup> See, e.g. *In re City of Detroit*, 504 B.R. 191, 206 (Bankr. E.D. Mich. 2013) (explaining that Detroit's decades of population, employment, and revenue losses led to "decaying infrastructure, excessive borrowing, mounting crime rates, spreading blight, and a deteriorating quality of life"); *In re City of Stockton*, 493 B.R. 772, 778-80 (Bankr. E.D. Cal. 2013) (enumerating the causes of Stockton's financial decline, including the subprime mortgage crisis, an excessively optimistic approach to financing public building projects, and excessive employee compensation); *In re Jefferson County, Alabama*, 484 B.R. 427, 434 (Bankr. N.D. Ala. 2012) (describing the causes of Jefferson County's financial woes as its sewer system indebtedness and the loss of tax revenue caused by a state court ruling invalidating the county's occupation tax).

<sup>9</sup> David Unkovic, *Municipal Distress: Reflections of a Receiver*, 24 WIDENER L.J. 9 (2015).

<sup>10</sup> See Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 476-77 (2014) (explaining the legislative responses to Harrisburg's financial distress).

Every municipality that files for bankruptcy has insufficient revenues to meet its expenses. A bankruptcy filing cannot fix the revenue problem, but can enable a municipality to reduce its expenses. Debt service is a significant municipal expense. As Mr. Unkovic explains, problems with municipal financing devices were major contributors to the financial distress in many municipalities, including Harrisburg and Detroit.<sup>11</sup> Municipalities have traditionally financed their operations by issuing two types of bonds: revenue bonds and general obligation bonds.<sup>12</sup> Revenue bonds are secured by the payments generated from the project funded by the bonds, and the Code recognizes that secured status.<sup>13</sup> When a municipality issues general obligation bonds, it promises its taxing power, or "full faith and credit," to support its payment obligation.<sup>14</sup> Participants in the municipal bond market have long considered general obligation bonds to be especially safe because of this full faith and credit pledge.<sup>15</sup> Detroit's proposal, early in its bankruptcy case, to pay some of its general obligation bondholders a fraction of what they were owed shattered this perception.<sup>16</sup> Detroit ultimately settled with its bondholders,<sup>17</sup> leaving judicial resolution of the meaning of full faith and credit for another day. Professor Randle Pollard of the Indiana University Kelley School of Business contributes to the ongoing debate over the security for general obligation bonds in *Feeling Insecure – A State View of*

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<sup>11</sup> Unkovic, *supra* note 9, at 12-13.

<sup>12</sup> See Christine Sgarlata Chung, *Government Budgets as the Hunger Games: The Brutal Competition for State and Local Government Resources Given Municipal Securities Debt, Pension and OPEB Obligations, and Taxpayer Needs*, 33 REV. BANKING & FIN. L. 663, 684-85 (2014).

<sup>13</sup> 11 U.S.C. § 928 (2012).

<sup>14</sup> Chung, *supra* note 12, at 684.

<sup>15</sup> NATIONAL ASSOCIATION OF BOND LAWYERS, GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY, AND DISCLOSURE CONSIDERATIONS at i (Aug. 2014).

<sup>16</sup> *Id.* at 20.

<sup>17</sup> Order Confirming Eighth Amended Plan for the Adjustment of Debts of the City of Detroit, Case No. 13-53846, at 48-53 (Bankr. E.D. Mich. Nov. 12, 2014).

*Whether Investors in Municipal General Obligation Bonds have a Mere Promise to Pay or a Binding Obligation.*<sup>18</sup>

Municipal debt adjustment under Chapter 9 and business reorganization under Chapter 11 share some common elements but are different in significant ways. From time to time, scholars call for the recognition of community interests in corporate bankruptcies.<sup>19</sup> When the community itself is the debtor, as is the case in municipal bankruptcies, one would assume that the recognition of community interests is embedded in the law. That assumption would be incorrect, however. Unlike the employees and investors affected by a business bankruptcy, who have a voice in the bankruptcy proceeding as creditors or owners of the debtor, a municipal debtor's residents—its taxpayers who rely on municipal services—do not have a clear statutory right to participate in a Chapter 9 case. Two of the authors in this symposium issue, Professor Christine Sgarlata Chung of Albany Law School and Professor C. Scott Pryor of Regent University School of Law, tackle the difficult question of how to give residents a voice in a municipal bankruptcy case by presenting two different proposals for taxpayer participation, one at each major flashpoint in a Chapter 9 case.

A judge in a Chapter 9 case makes two crucial determinations: whether the municipality is eligible for bankruptcy relief<sup>20</sup> and whether its plan to adjust its debts can be confirmed.<sup>21</sup> Professor Chung, in *Municipal Bankruptcy, Essential Municipal Services, and Taxpayer Voice*,<sup>22</sup> argues that courts should grant residents the opportunity to be heard at the eligibility stage. The Code requires that a municipality be insolvent to file for Chapter 9,<sup>23</sup> a requirement that the judges in the Stockton and Detroit cases

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<sup>18</sup> Randle B. Pollard, *Feeling Insecure – A State View of Whether Investors in Municipal General Obligation Bonds Have a Mere Promise to Pay or a Binding Obligation*, 24 WIDENER L.J. 19 (2015).

<sup>19</sup> See, e.g. Karen Gross, *Taking Community Interests into Account in Bankruptcy: An Essay*, 72 WASH. U. L.Q. 1031, 1031 (1994).

<sup>20</sup> 11 U.S.C. § 109 (c) (2012).

<sup>21</sup> *Id.* § 943.

<sup>22</sup> Christine Sgarlata Chung, *Municipal Bankruptcy, Essential Municipal Services, and Taxpayer Voice*, 24 WIDENER L.J. 43 (2015).

<sup>23</sup> 11 U.S.C. § 109 (c)(3) (2012).

interpreted to incorporate service delivery insolvency, or the inability to provide services at "the level and quality that are required for the health, safety, and welfare of the community."<sup>24</sup> Professor Chung posits that because municipalities must provide their residents with at least a minimal level of essential services,<sup>25</sup> the views of those residents deserve consideration in determining whether a municipality is insolvent and thus eligible for Chapter 9.

As Professor Pryor recognizes in *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*,<sup>26</sup> a taxpayer has a closer financial relationship with a municipality than a shareholder does with a corporation but unlike a shareholder, has no legal interest in the entity.<sup>27</sup> In arguing for taxpayer standing, Professor Pryor focuses on the other end of the Chapter 9 case, the plan confirmation stage. In order for the court to confirm a plan of adjustment, the court must find that the plan is feasible.<sup>28</sup> In his article, Professor Pryor expands on the tightly intertwined financial relationship between a municipality and its residents and suggests that courts give taxpayers the opportunity to be heard on the issue of a plan's feasibility.

Although Chapter 9 and Chapter 11 differ in important respects, Detroit's bankruptcy case and the Chapter 11 cases filed by two iconic Detroit companies, Chrysler and General Motors, share some common features. Professor David Skeel of the University of Pennsylvania Law School explores these similarities in *From Chrysler and General Motors to Detroit*.<sup>29</sup> In his article, Professor Skeel explains the parallels between the car companies' use of § 363 of the Code to sell all of their assets to government-backed entities and the centerpiece of the Detroit bankruptcy, the Grand Bargain under which the city transferred the Detroit

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<sup>24</sup> *In re City of Detroit*, 504 B.R. 191, 263 (Bankr. E.D. Mich. 2013) (quoting *In re City of Stockton*, 493 B.R. 772, 789 (Bankr. E.D. Cal. 2013)).

<sup>25</sup> Chung, *supra* note 22, at 70 (quoting *In re City of Detroit (Eligibility Opinion)*, 504 B.R. 97 at 170 (Bankr. E.D. Mich. 2013)).

<sup>26</sup> C. Scott Pryor, *Who Pays the Price? The Necessity of Taxpayer Participation in Chapter 9*, 24 WIDENER L.J. 81 (2015).

<sup>27</sup> *Id.* at 91-92.

<sup>28</sup> 11 U.S.C. § 943 (b)(7) (2012).

<sup>29</sup> David A. Skeel Jr., *From Chrysler and General Motors to Detroit*, 24 WIDENER L.J. 121 (2015).

Institute of Arts to a nonprofit foundation in exchange for funds used to pay Detroit's pension beneficiaries. According to Professor Skeel, these three historic bankruptcies illustrate the need to update the Code's asset sales provisions.

Bankruptcy is one of many implements in the municipal distress resolution toolkit. Municipalities are creations of their states, and only states can make the major structural changes, such as boundary adjustments,<sup>30</sup> that many municipalities may need today in order to maximize revenues and operate more efficiently. Municipal bankruptcy law was originally intended to supplement and enhance state efforts to solve the fiscal problems of their municipalities.<sup>31</sup> Many states, including Pennsylvania, have extensive municipal financial oversight programs.<sup>32</sup> In the final symposium contribution, *Who Needs Local Government Anyway? Dissolution in Pennsylvania's Distressed Cities*,<sup>33</sup> Professor Michelle Wilde Anderson of Stanford Law School examines Pennsylvania's recently enacted amendments to its Municipalities Financial Recovery Act, commonly known as Act 47. In her article, Professor Anderson explains that Pennsylvania's current municipal boundaries, drawn in a time when steel, coal, and manufacturing were the pillars of the state's economy, today define an "exceptionally high number of small, fiscally-troubled local governments."<sup>34</sup> Although she values municipal disincorporation as a tool to alleviate municipal financial distress, Professor Anderson questions whether Pennsylvania's recently adopted disincorporation mechanism will be effective. Her article concludes with some suggestions for adopting an effective municipal disincorporation law that balances the interests of fiscal health and democratic rule.

It may be many years before the United States sees a municipal bankruptcy case of Detroit's magnitude. Detroit's legal

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<sup>30</sup> *Hunter v. Pittsburgh*, 207 U.S. 161, 178-79 (1907).

<sup>31</sup> *United States v. Bekins*, 304 U.S. 27, 54 (1938).

<sup>32</sup> The Pew Charitable Trusts, *The State Role in Local Government Financial Distress*, July, 2013, [http://www.pewtrusts.org/~media/Assets/2013/07/23/Pew\\_State\\_Role\\_in\\_Local\\_Government\\_Financial\\_Distress.pdf?la=en](http://www.pewtrusts.org/~media/Assets/2013/07/23/Pew_State_Role_in_Local_Government_Financial_Distress.pdf?la=en).

<sup>33</sup> Michelle Wilde Anderson, *Who Needs Local Government Anyway? Dissolution in Pennsylvania's Distressed Cities* 24 WIDENER L.J. 149 (2015).

<sup>34</sup> *Id.* at 149

and consulting fees, which exceeded \$170,000,000,<sup>35</sup> are certain to make other sizable cities wary about filing for bankruptcy. Even smaller struggling cities may not view bankruptcy as a palatable alternative; a city with a declining tax base and little industry will not solve its problems merely by cutting debt. Moreover, only about half of the states permit their municipalities to file for bankruptcy, so many cities will not be able to file for Chapter 9 no matter how dire their finances.<sup>36</sup> Municipal financial distress, however, will remain a pervasive problem for the foreseeable future. In Pennsylvania alone, 41 percent of the population lives in a municipality suffering some form of financial distress.<sup>37</sup> The articles in this symposium issue, by drawing lessons from recent cases of municipal financial distress, promise to guide policy makers as they seek solutions, both in bankruptcy and beyond, to the financial problems facing American municipalities.

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<sup>35</sup> Christine Ferretti & Robert Snell, *Detroit bankruptcy Fees Top \$170M*, THE DETROIT NEWS, Dec. 31, 2014, <http://www.detroitnews.com/story/news/local/wayne-county/2014/12/30/detroit-bankruptcy-fees-top/21074011/>.

<sup>36</sup> Moringiello, *supra* note 10, at 461-62.

<sup>37</sup> Eric Boehm, *WATCHBLOG: More Than 5 Million Pennsylvanians Live in Financially Distressed Municipalities*, PENNSYLVANIA INDEPENDENT, April 8, 2013, <http://paindependent.com/2013/04/watchblog-more-than-5-million-pennsylvanians-live-in-financially-distressed-municipalities/>.