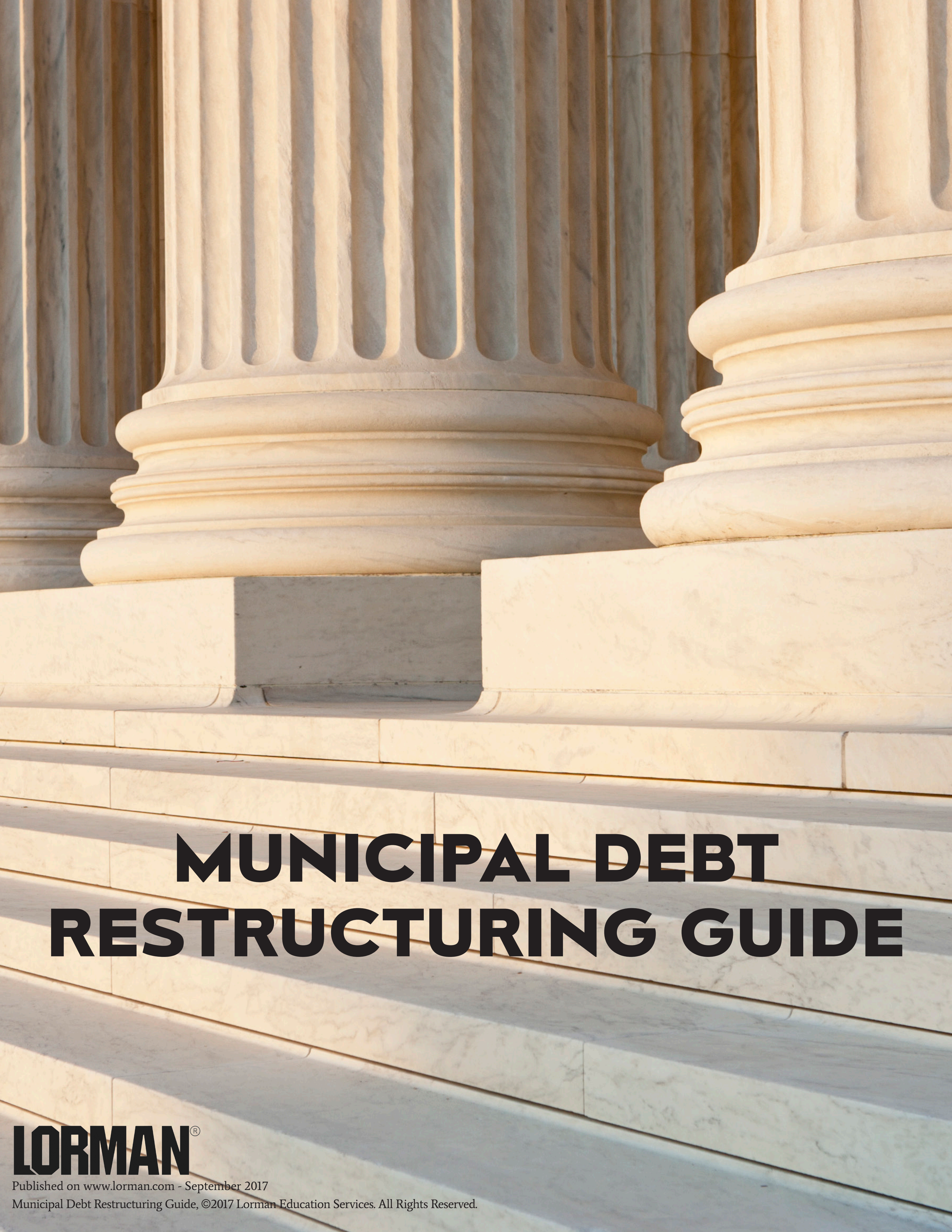

# MUNICIPAL DEBT RESTRUCTURING GUIDE

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Published on www.lorman.com - September 2017

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**Municipal Debt Restructuring Guide**

With economic turmoil taking its toll on consumer confidence and overall employment, numerous municipalities nationwide have faced a distinct lack of revenue as fewer of their residents are employed and paying taxes that help to subsidize local services, agencies, and employees. While this might initially cause just a reduction in services, many towns and cities are soon excessively burdened by their long-term debts and short-term commitments, with brutally no money to cover their expenses or continue to offer local services. If the city were a person or corporation, it already would have been targeted for bankruptcy by its creditors and those who depend on it for payment. That, of course, cannot happen in the traditional sense.

Municipalities looking to regain fiscal solvency have the opportunity to restructure their debts through the use of Chapter 9 bankruptcy proceedings. This process will see the elimination of nonessential debts and services, while others will be restructured so that the municipality can more easily meet its financial obligations light of reduced tax income or significantly increased financial burdens. Because Chapter 9 is designed for municipalities rather than individuals, it does not permit for full liquidation of any assets when seeking to pay off creditors or finance local obligations. Instead, restructuring must be done through a series or reorganizational moves, tax changes, and regulatory oversight.

**Eligibility for Chapter 9 Restructuring: A Tough Series of Requirements for Cities**

The Chapter 9 bankruptcy program is undoubtedly an asset for cities and towns that cannot make payment to their creditors while maintaining local services, but there are still a number of key requirements that must be met before the process can proceed. First and foremost, there are some very specific conditions under which a Chapter 9 filing can be made. These include the following:

- The filer must be a municipality of some sort
- The municipality is authorized by state laws to be considered a debtor during Chapter 9 filing
- The municipality is, at the time of filing, deemed to be insolvent
- The municipality must be willing to consent to a plan of management and restructuring as part of the Chapter 9 process

Additionally, the municipality must show that it has either negotiated with its creditors in a good faith attempt to make payment, or that it has received the consent of a majority of its creditors when filing a Chapter 9 bankruptcy petition.

If a city or town is judged to be eligible for a Chapter 9 bankruptcy proceeding, they will move on to the actual petition process. Preparing and submitting the bankruptcy petition will immediately impose a "stay" on all payments due, all negotiations for debt payment that might be in process, and any other attempts by creditors to reclaim the money owed to them by the municipality. Because the municipality also serves a local community, this petition is unique in that it prevents creditors from pursuing separate bankruptcy actions against employees of the municipality or residents who live within that city or town's stated borders.

**Beginning the Restructuring Process: The Role of a Plan of Adjustment**

In Chapter 9 filings, towns and cities must create a "plan of adjustment" that details exactly how their restructured debts will be paid off in a timely manner. This plan almost always includes a combination of revenue increases and cuts to common expenses within the municipality, but it may include other factors judged by the municipality to help with their full satisfaction of their obligations. This might include hiring freezes, pay cuts, and several other options.

While it is up to a town or city to develop their plan of adjustment, they cannot enforce that plan and adhere to its provisions unless a majority of their creditors agree to the plan and vote to make it effective. If that happens, the plan will become the reorganization blueprint for the city as it seeks to satisfy its creditors. If those creditors do not vote in favor of the plan, however, the city will have to enact revisions that will more satisfactorily provide for both restructuring and full payment. Furthermore, there are seven considerations that are used to determine if a plan of adjustment is valid, enforceable, and able to meet with federal regulations for reorganization. These include:

1. The plan of adjustment must comply with the bankruptcy code as it defines Chapter 9 proceedings, and it must include the good faith payment of any existing claims, as well as the solicitation and classification of those claims.

2. The municipality needs to comply with every provision of the Chapter 9 bankruptcy code within their plan of adjustment, including provisions that go well beyond good faith payment and claim solicitation.

3. Payments and final balances owed to creditors with a valid claim must be publicly stated and disclosed within the plan of adjustment in order for it to be considered valid by the federal government.

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4. The plan of adjustment does not include any condition or provision that would stop creditors from enforcing the plan with the full weight of federal law and local statutes.

5. The plan must provide the full payment of administrative expense claims lodged by identified creditors.

6. Any new plans, procedures, or regulations specified in the plan to assist with the payment of claims made by creditors must be enacted or approved before the plan itself can be approved and enforced. This can include everything from public referenda on tax hikes to salary freezes, employment cuts, and more.

7. The plan must be deemed to be in the best interest of the municipality's creditors.

**Upon Agreement, the Plan of Adjustment Immediately Goes Into Effect**

Though a municipality may have to submit several different versions of its plan of adjustment before it receives final creditor approval, a simple majority vote at any point will immediately put the plan into action make all of its conditions legally enforceable under state and federal law. All claims lodged against the city by creditors included in Chapter 9 will immediately commence good faith payment, while those claims that were not included in the plan of adjustment will immediately be cancelled, discharged, and removed as one of the city's financial obligations.

Full restructuring will proceed according to the agreed upon plan, often taking several years to complete. When all creditors' claims have been paid off, the city will be free to control its own fiscal destiny in terms of hiring, tax adjustments, pay raises, and additional services offered to those within its borders. In an era of dwindling tax revenues, shaky employment prospects, and rapid increases in municipal expenses, Chapter 9 bankruptcy remains the primary way for towns and cities to regain fiscal solvency and reach an agreement with their creditors. Even so, this is not the only way to create greater fiscal health and long-term solvency in the face of a financial crisis.

## Beyond Bankruptcy: How Municipalities Can Restructure Without Chapter 9

Though Chapter 9 is probably the most effective way to reach an agreement with the largest number of creditors and pursue long-term fiscal solvency, it's exceedingly rare for towns and cities to actually invoke the bankruptcy code to solve their fiscal issues. In fact, only a handful of cities and towns actually pursue a Chapter 9 restructuring plan each year, and it most often makes the news due to its rarity. That's because most cities prefer to try an array of other options before they resort to bankruptcy, which is often considered the last and least preferable way to reign in spending, debt obligations, and other fiscal concerns.

### For One-Time Fiscal Problems, Municipalities Often Seek Revenue Relief

Cities and towns are certainly no strangers to fiscal uncertainty, since the vast amount of their ability to spend comes from local bonds and taxes. In many cases, these municipalities can find themselves between a rock and a financial hard place due to a one-time financial oversight or big expense. In those cases, it simply does not make sense for the municipality for file for the full scale protection of Chapter 9 bankruptcy. Instead, this issue is almost always more easily and effectively solved by seeking revenue through other sources.

These one-time financial struggles might come from a creditor that is not satisfied with the way a town or city is paying off one of their obligations. This will often cause the creditor to sue in order to gain a more favorable payment arrangement and one that guarantees they'll recoup their investment from the city instead of going through the process of default and, of course, Chapter 9 at a later point. Such a lawsuit would compel the city to pay their debts under what most states term a "writ of mandamus." Simply enough, a writ of mandamus is essentially an immediate and mandatory payment of a specific obligation to a creditor who demands such an arrangement.

The good thing about the issuance of a writ of mandamus, however, is that it allows municipalities to immediately and effectively raise taxes in order to comply with a creditor's request. While many tax increases would ordinarily not be permitted under state law, and others would require voter approval, the writ of mandamus allows municipalities to forego those limitations and do what is necessary to pay off one or more creditors who have already filed suit.

The best example of this type of law in effect can be found in the Commonwealth of Pennsylvania's Municipalities Financial Recovery Act. The legislation, passed by the state in 1987, allows municipalities to charge special, immediate taxes to cover a writ of mandamus until the obligation is satisfied. It goes into effect as soon as the writ is issued by the court and expires at the satisfaction of the city's obligation to the creditor who filed suit.

**Negotiated Debt Modifications Serve as a Good Preventative Measure**

When it comes to avoiding Chapter 9 bankruptcy at all costs, virtually all towns and cities will choose to enter negotiations with their creditors before they see federal protection from them. This happens initially after a city or town has defaulted on their payments to a creditor, typically a bondholder that was part of financing local services or municipal projects. A one-time default is not really the worst case scenario for municipalities, but it is still a pretty alarming indicator for bondholders and other creditors who have a significant interest in making sure that their original extension of credit is paid on time and in full.

Under most bondholder agreements, default will be either termed as a simple "default of obligations" or it will be termed an Event of Default. In either case, breaching the agreement and defaulting on a debt will force the municipality to have rather candid discussions with the bondholder. They will also need to speak with credit ratings agencies, who may be inclined to reduce the city's bond rating and thus make it significantly more difficult for the city to borrow money in the future. Other creditors aware of the default may want to enter into discussions with the municipality about its ability to make good on their own debts and stakes in the city's fiscal health.

The most common action taken by those cities that default on an obligation is known as a waiver agreement. The agreement virtually erases the default, giving the city the benefit of the doubt. This works for cities that are going through a momentary financial rough spot, but fully anticipate having the ability to make good on all of their credit payments in the future.

If the default is symptomatic of a larger problem, or if defaulted obligations spread to more of the city's bondholders, then more drastic action is often taken. This is typically pursued as a forbearance of obligations, giving the city a few months where it simply does not have to make a payment toward its financial obligations until it can get its fiscal house in order. Forbearance on municipal obligations, just like on corporate and consumer debts, allows those obligations to continue accruing interest even as payments are suspended for one month or several consecutive months.

Forbearance is often the first component of a two-step process, the latter of which involves debt modification. This is somewhat similar to bankruptcy restructuring, but it doesn't actually cancel the amount owed to the creditor or lump the money owed to all creditors under a single agreement. Instead, the city works with creditors during forbearance to negotiate payment terms that are friendlier to the municipality's budget and future financial considerations. The goal is often lowered interest or lower monthly payments, both of which would eliminate the risk of default when the city's financial health has been degraded due to any number of conditions.

Though it might appear at first that cities and towns would not have much leverage for negotiation when seeking a debt modification, the opposite is actually the case. Consumer and corporate debtors have reduced leverage because their creditors know that, in the worst case scenario, they'll be able to pursue liquidation of assets to recoup much of what they are owed. Municipalities, conversely, simply cannot be liquidated. Not only is the procedure not permitted under Chapter 9 restructuring, but it's simply impractical to liquidate public libraries, legislative offices, or municipal waste collection.

Because creditors know that liquidation is not an option for recouping their losses, they'll be far more inclined to give a city or town the time and payment amount it needs to continue paying on time until the full satisfaction or expiration of the bond.

**State-Imposed Oversight and Debt Intervention Programs**

Due in no small part to the federalist approach to government used in the United States, individual state governments will often assert themselves into municipality fiscal problems before those problems explode and qualify for procedures as dire as Chapter 9 bankruptcy. In fact, many states require such intervention and oversight before their cities and towns are permitted to proceed with bankruptcy procedures that the federal level. Other states actually use their legal right to intervention as a complete alternative to federal Chapter 9 processes, giving their cities and towns a way to avoid the national stigma of bankruptcy while still restructuring their debts.

In many cases, states appoint an emergency manager or a fiscal commissioner to oversee the restructuring of the city's debts. This will often involve the emergency manager or other appointee acting as a negotiator that helps to bridge the divide between the city's creditors and the city's own elected officials. The job of this appointee is generally to create a more favorable payment scenario similar to the debt modification and forbearance processes noted earlier. In this case, though, the negotiations pursued by the appointee are often enforceable under state law, in the state's highest courts, giving creditors more reason to lower their payment requirements and create a better structure for full satisfaction of the debt.

It's important to note that the vast majority of these state oversight and intervention programs, most notable in Pennsylvania and Michigan, do complete a full debt restructuring and a reorganization of the town's finances. In some cases, the appointee will effectively act as the government of the town while such an agreement is in place, superseding the votes and influence of a city's council, mayor, or appointed department heads. It is often up to the sole discretion of the appointee how to impose tax increases, reduce spending, control incomes, and adjust the size of a local government to fall more in line with their broader commitment to repaying their bondholders or other creditors.

Though controversial, this ability to execute singular authority over municipalities is another key reason that creditors are more likely to work with an appointed state official toward debt resolution than they would be to work with a mayor or city council. Though the inability to liquidate communities gives them greater negotiating power for debt modification and forbearance, the full legal and regulatory weight of a state government lends even more room for successful negotiation that benefits both ends of the bond.

**Judicial Receivership and the State Court System**

One of the most common ways to resolve a dispute, be it due to credit obligations or some other nemesis, is to simply invoke the court system. Creditors and bondholders routinely do this in order to force payment of a debtor's obligations and, in the case of a city or a town, it most often results in a writ of mandamus that allows for special tax increases and revenue adjustments to meet the demands of the creditor. That is not, however, the only way that the judicial system can aid in the restructuring of municipal debts.

Virtually all states across the country allow for what is known as "judicial receivership." In this type of court proceeding, the court essentially acts as the negotiating body between creditors and debtors. The judicial receiver is then charged with not only negotiating better payment terms for obligations, but also for essentially running the municipality in question and making financial decisions that benefit its long-term fiscal health. This role would continue until the payment obligation is completely satisfied or until the town is judged to be able to manage its own finances successfully without the intervention of an outside body.

It should be noted that, while this process is permitted by many states, it has been superseded by programs like the emergency manager in Michigan and the state-appointed financial manager permitted in Pennsylvania law. This makes its use increasingly rare, but still viable in states without intervention laws and fiscal appointees.

**Viable Ways to Remain Fiscally Sound and Devoted to Local Residents**

From Chapter 9 bankruptcy to state-mandated intervention programs and negotiations, communities have a variety of ways to restore their immediate fiscal health and ensure that they are capable of meeting their obligations in the future. These processes are generally defined by a combination of state and federal law, and any municipality considering a move to shore up their fiscal health should first check into local regulations and state guidelines for doing so.

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