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Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code

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Robin Jeweler
Legislative Attorney
American Law Division

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Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code

Summary

Because municipalities are government entities, their economic problems have historically been addressed politically through state-based remedies, such as the creation of a financial control board, not through judicial intervention. Chapter 9 of the U.S. Bankruptcy Code, 11 U.S.C. § 901 *et seq*., is entitled "Adjustments of Debts of a Municipality." Though rarely used, this chapter of the Code has important historic antecedents and may be a important tool for insolvent municipal entities. The term "bankruptcy," however, is a misnomer when it comes to chapter 9. For many reasons, chapter 9 differs from chapter 11, which governs the reorganization of private business. This report provides an overview of chapter 9.

The paramount feature of a municipal reorganization is the requirement that the municipal debtor and a majority of its creditors reach an agreement on a plan to readjust the municipality's debts. The outcome of any reorganization cannot be predicted with certainty. Several basic principles may provide guidance as one considers the likely course of a major municipal reorganization. First, the policy underlying chapter 9 is unlike that of other chapters: municipalities are not subject to liquidation or strict judicial control. Municipal authorities do not need judicial permission to exercise governmental functions. Second, development of the reorganization plan is largely the initiative of municipal authorities.

Even though the U.S. Bankruptcy Code is designed to give the cash-strapped municipal debtor "breathing room" and an opportunity to marshal its assets, nothing in the law relieves it from the requirements of applicable nonbankruptcy law. Filing bankruptcy does not lift from the municipality the burdens imposed upon it by myriad state and federal laws. Reorganization and, ultimately, repudiation of debt may be facilitated by a chapter 9. But the manner in which the municipal debtor reaches its goal for rehabilitation will still be shaped, in large part, by the constraints of the federal and state laws under which it operates.

On December 6, 1994, Orange County, California, filed under chapter 9, the largest municipal bankruptcy filing to date. The County reorganized successfully, and its case was closed in 2000. Though the underlying causes of the County's financial problems were arguably unique, chapter 9 proved to be sufficiently flexible to accommodate the needs of a large municipal debtor and its creditors.

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Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy Code

Background

State and local governments provide services crucial to the everyday life of most Americans. These may include education, police protection, public transportation, water and utilities, to name only a few. When the finances of a municipal entity are threatened, the notion or threat of a "bankruptcy" causes wide spread consternation. In 2005, the destruction wrought by Hurricanes Katrina and Rita on the Gulf Coast led many to speculate on the likelihood of municipal insolvencies and bankruptcy filings.[1] Although states (and the District of Columbia), cannot file for relief under the U.S. Bankruptcy Code, municipalities may be eligible.[2] Chapter 9 of the Code, 11 U.S.C. § 901 *et seq.,* is entitled "Adjustments of Debts of a Municipality." The term "bankruptcy," however, is a misnomer when it comes to chapter 9. For many reasons, this chapter differs from the other chapters of the Code governing liquidation and reorganization of consumers and business.

From 1988 to 2005, only 172 chapter 9 reorganizations were filed, the vast majority by small government agencies like municipal utilities, school districts or entities established for a single project such as a hospital or convention center.[3]

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[1] *See, e.g.,* Jennifer Medina, *Local Governments Face Bankruptcy, Layoffs or Both,* THE N.Y. TIMES, Oct. 4, 2005 at A17. As a result of hurricanes, municipal governments in southern Louisiana are running out of money and seek federal aid "to avoid bankruptcy or huge layoffs and reductions in city services." *But see* Joint Report from the Bureau of Governmental Research and the Public Affairs Research Council of Louisiana, MUNICIPAL BANKRUPTCY IN PERSPECTIVE (April 2006) available online at [http://www.la-par.org/Publications/PDF/Municipal%20Bankruptcy.pdf] concluding that most local governments in Louisiana are not experiencing severe financial distress as a result of the hurricanes, but many parishes are.

[2] 11 U.S.C. § 109(c). A municipality is defined as "a political subdivision or public agency or instrumentality of a State." 11 U.S.C. § 101(40). A public agency or instrumentality may include incorporated authorities, commissions, and other entities which are organized for the purpose of constructing, maintaining and operating revenue producing enterprises. These include entities whose revenues are derived from taxes or assessments or from income producing property and public improvement districts, school districts, and revenue producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge or highway authorities. 6-900 COLLIER ON BANKRUPTCY ¶ 900.02[2][a][ii] (15th ed. rev.)

[3] New Generation Research, THE 2006 BANKRUPTCY YEARBOOK & ALMANAC 20 (16th ed. 2006).

Many observers characterize chapter 9 filings as "rare."[4] Because municipalities are government entities, their economic problems have historically been addressed politically through state-based remedies, such as the creation of a financial control board, not through judicial intervention. Although the financial problems of cities like New York, N.Y. or Camden, N.J., received widespread publicity, they did not file under the U.S. Bankruptcy Code.

History, however, may not always be an accurate predictor of the future. In addition to regional disaster-related problems in the Gulf Coast, observers speculate that future chapter 9 filings may be driven by municipal pension and health care liabilities. Press accounts indicate that these liabilities may reach crisis levels for many municipalities.[5] The city of San Diego, Ca., for example, has struggled with onerous pension liabilities, compounded by alleged fiscal mismanagement. Although it has not filed under chapter 9, there has been public debate on the wisdom of such a remedial course.[6]

Legislative History

The first municipal debt provisions under federal bankruptcy law were enacted in 1934 as emergency legislation for the relief of distressed minor subdivisions of the states.[7] Although Congress has express power to establish "uniform Laws on the subject of Bankruptcies throughout the United States,"[8] the U.S. Supreme Court found the original provisions to be an unconstitutional infringement of state sovereignty, violating the Tenth Amendment[9] in *Ashton v. Cameron Co. Water Improvement Dist*.[10] The Court articulated its concern over the possibility of usurpation of state sovereignty by the federal government:

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[4] In re City of Desert Hot Springs, 327 F.3d 930, 937 (9th Cir. 2003), *cert. den.* 540 U.S. 1110 (2004)

[5] *See, e.g.,* Gary Kaplan and Joel Moss, *Distressed Cities See No Clear Path: Health, Pension Obligations Threaten Fiscal Crisis,* THE NATIONAL LAW JOURNAL, March 6, 2006, at S1; Mary Williams Walsh, *Once Safe, Public Pensions Are Now Facing Cuts,* THE NEW YORK TIMES, Nov. 6, 2006 at A1; *Paying Health Care From Pensions Proves Costly,* THE NEW YORK TIMES, Dec. 19, 2006 at A1; Bob Porterfield, *Retiree Health Care Overwhelming Governments*, Sept. 25, 2006 at [http://abcnews.go.com/Health/wireStory?id=2485444&CMP=OTC-RSSFeeds0312].

[6] *Compare* Mike Allen, *Analysts Say Bankruptcy No Option for City,* 25 SAN DIEGO BUSINESS J. 1 (Sept. 27, 2004) *with* Patrick Shea, *San Diego's Pension Crisis: The case for municipal bankruptcy*, SIGNONSANDIEGO.COM, THE SAN DIEGO UNION TRIBUNE (February 18, 2005) at [http://www.signonsandiego.com/news/metro/pension/20050218-704-thecasef.html].

[7] 48 Stat. 798 (May 24, 1934).

[8] Article I, section 8, cl. 4 of the United States Constitution.

[9] The Tenth Amendment provides:

> 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.

[10] 298 U.S. 513 (1936).

> If federal bankruptcy laws can be extended to respondent, why not to the State? If voluntary proceedings may be permitted, so may involuntary ones, subject of course to any inhibition of the Eleventh Amendment. If the State were proceeding under a statute like the present one, with terms broad enough to include her, apparently the problem would not be materially different. Our special concern is with the existence of the power claimed — not merely the immediate outcome of what has already been attempted. And it is of the first importance that due attention be given to the results which might be brought about by the exercise of such a power in the future.[11]

Congress revised the bankruptcy law's municipal reorganization provisions in 1937.[12] The Court reconsidered its objections in *Ashton* and held the Act constitutional in *United States v. Bekins*.[13] The Court acknowledged that the federal measure was necessary because the Constitution's contract clause[14] prohibits the states, but not the federal government, from enacting any law that alters contractual obligations and therefore severely limits the ability of the states to afford adequate relief to an insolvent municipality. The Court also recited those factors, retained and incorporated into present chapter 9, which it deemed vital to protect state autonomy: state consent to the municipal filing for reorganization; judicial restraint from interference with the fiscal or governmental affairs of the political subdivision; and, prohibition of involuntary proceedings.[15]

Chapter 9's modern genesis is in legislation enacted in the wake of New York City's financial crisis in 1975. Although New York City did not file in bankruptcy, the procedural mechanisms of old chapter IX were generally believed to be totally inadequate to govern the reorganization of a major municipality like New York. Among the procedural obstacles was the requirement that the petitioning municipality obtain the prior consent of owners of fifty-one percent of its outstanding securities *before* the bankruptcy court could approve the petition as properly filed. The petitioning municipality was thus required to locate its creditors, draw up a plan, and negotiate and obtain the required consents before it could even file its reorganization. Until the case was filed, the municipality could not even *ask* the court to issue a stay of all pending litigation — the usual first, critical rehabilitative procedure in bankruptcy. Hence, in 1976, Congress enacted major substantive revisions pursuant to P.L. 94-260 to chapter IX of the Bankruptcy Act of 1898. The procedures effected by P.L. 94-260 were incorporated as chapter 9 of the current law, the Bankruptcy Reform Act of 1978, P.L. 95-598, as amended.

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[11] *Id.* at 530 (citations omitted).

[12] 50 Stat. 653 (August 16, 1937).

[13] 304 U.S. 27 (1938).

[14] Article I, section 10, clause 1 includes the prohibition against the passage, by any state, of a "Law impairing the Obligation of Contacts".

[15] *Bekins,* 304 U.S. 27 at 51.

Although financial crises have threatened more than one city — New York in 1975, Cleveland, Ohio in 1979, and Bridgeport, Conn. in 1991,[16] to name only a few — only one major county, Orange County, Ca., has reorganized under chapter 9 since its enactment in 1978. Even so, this chapter of the Code has been amended twice since enactment. In 1988, Congress passed amendments generally concerned with the definition of municipal "insolvency"; the rights of creditors as general obligation bondholders and special revenue bondholders; and, the status of municipal financing leases.[17]

Chapter 9 was again amended by § 402 of the Bankruptcy Reform Act of 1994, P.L. 103-394. These amendments require that a municipality be specifically authorized by the state to file in bankruptcy and is discussed below. The Reform Act of 1994 also created a National Bankruptcy Review Commission to study the Bankruptcy Code and make recommendations for change. Its report made only passing reference to chapter 9.[18] Likewise, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, P.L. 109-8, which made major changes to consumer and business bankruptcy practice, does not significantly alter chapter 9 procedure.

How Does Chapter 9 of the U.S. Bankruptcy Code Work?

Bankruptcy Court Jurisdiction

A major business reorganization under chapter 11 of the Code is a fluid process. The debtor is expected to negotiate a business plan for rehabilitation with its creditors who ultimately vote to accept or reject it. The process is designed to facilitate consensus. The Code, and judicial oversight, establish parameters designed to promote debtor rehabilitation, maximize the bankruptcy estate for distribution among creditors, and ensure fair dealing.

Chapter 9 differs from all other operative bankruptcy chapters (that is, 7, 11, 12, and 13) in several fundamental ways. First, general bankruptcy procedures do *not* apply in chapter 9 unless they are expressly adopted. 11 U.S.C. § 901. Second, chapter 9 does not preclude state legislation addressing reorganization, sometimes referred to as "composition" of indebtedness, although state legislation may not bind

[16] Bridgeport, Conn. filed under chapter 9 in 1991. The bankruptcy court found it to be eligible to file, but sustained the State of Connecticut's objection to the filing on the ground that it was not "insolvent", *i.e.,* incapable of paying its debts as they became due. In re City of Bridgeport, 129 B.R. 332 (Bankr.D. Conn. 1991). The court interpreted insolvency as being dependent upon a cash flow analysis, *i.e.,* an inability to pay debts as they become due, not a projected budget deficit.

[17] P.L. 100-597.

[18] REPORT OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION, *Chapter 4: Other Recommendations and Issues,* 981-1007 (Oct. 20, 1997).

an impaired, nonconsenting creditor.[19] 11 U.S.C. § 903. Third, in deference to the Tenth Amendment and principles of federalism, court jurisdiction is greatly circumscribed. The court may not interfere with the debtor's political or governmental powers, property or revenues, or use or enjoyment of income-producing property. 11 U.S.C. § 904. The focus of chapter 9 is not necessarily to attempt to balance the rights of the debtor and its creditors but to meet the needs of a municipal debtor.

Eligibility to File

In order to be eligible to file, the debtor municipality must be "specifically" authorized to file under state law in its capacity as a municipality, or by name; it must be insolvent;[20] and it must either (a) have obtained agreement to a reorganization plan by a majority of creditors whose claims it intends to impair; or (b) demonstrate that it has negotiated in good faith with creditors and failed to obtain agreement;[21] or (c) prove that negotiation is impracticable.[22]

Prior to the 1994 amendment, municipalities were required to be "generally authorized" to file under state law. The few courts that had considered eligibility had split over the question what constitutes "general authorization" to file. In *In re Pleasant View Utility District,*[23] the court concluded that general authorization to file did not require express authorization. Several courts followed the *Pleasant View* analysis,[24] while others interpreted the "general authorization" requirement as

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[19] Only once has the alteration of a municipal bond contract been sustained by the Supreme Court. In Faitoute Co. v. Asbury Park, 316 U.S. 502 (1942), the Court sustained a New Jersey statute authorizing state control over insolvent municipalities. The plan involved an exchange of securities for new bonds with extended maturity and a lower interest rate. In response to this decision, however, Congress, amended the bankruptcy law to proscribe state laws addressing composition of indebtedness from becoming binding on non-consenting creditors. *See,* 11 U.S.C. § 903. To allow each state to enact its own version of Chapter 9 of the Bankruptcy Code would frustrate the constitutional mandate of uniform bankruptcy laws. *See,* H.Rept. 686, 94th Cong., 2d Sess. 19, *reprinted in* 1976 U.S. CODE CONG. & ADM. NEWS 539, 557.

[20] *See,* In re Hamilton Creek Metropolitan Dist., 143 F.3d 1381 (10th Cir. 1998).

[21] *See,* In re Sullivan County Regional Refuse Disposal District, 165 B.R. 60 (Bankr.D.N.H. 1994). The court dismissed the chapter 9 filings of the county solid waste disposal districts which failed to establish prepetition good faith negotiations. The debtor districts s did not seriously attempt until four or five weeks prepetition to develop feasible repayment plan in response to creditor's repeated demands; the districts never exercised assessment powers; and districts never set out for creditors comprehensive workout plan.

[22] 11 U.S.C. § 109(c).

[23] 24 B.R. 632 (Bankr.M.D.Tenn. 1982).

[24] *See,* In re City of Bridgeport, 128 B.R. 688 (Bankr.D.Conn. 1991); In re Greene County Hospital, 59 B.R. 388 (Bankr.S.D.Miss. 1986); In re City of Wellston, 43 B.R. 348 (Bankr.E.D.Mo. 1984).

requiring *express* authorization.[25] Municipal debtors filing under chapter 9 after October 4, 1994 must be expressly authorized under state law to do so.[26]

Filing the Plan; Appointment of a Trustee

Only the municipal debtor may file a reorganization plan, and, unlike chapter 11, there is no statutory time frame for doing so, although a court may impose one.[27] A trustee is *not* appointed in chapter 9. If the debtor fails to propose a plan on a timely basis, or if the debtor proposes one that cannot be legally confirmed or that creditors do not accept, the court's sole remedy is dismissal.[28] Dismissal operates to restore the debtor and creditors to their procedural and substantive rights under applicable nonbankruptcy law.

The Automatic Stay

Among the greatest advantages to the chapter 9 municipal debtor are the automatic stay and the opportunity to acquire post-petition financing. A petition filed in bankruptcy operates as an automatic stay of *all* actions, including judicial and administrative ones, intended *to enforce a claim* against the debtor, including its officers and inhabitants.[29] The stay does *not* operate to delay or waive application of non-commercial or nonbankruptcy-related laws.

Ordinarily, the automatic stay operates to protect a debtor's property which may be held by a third party, subject to certain express exceptions. Hence, a third party holding property of the debtor would be prohibited by the stay from disposing of it, even under a colorable legal claim to it. One important area of exceptions to the automatic stay is for actions for the set-off of a wide variety of financial instruments and agreements, such as forward contracts and repurchase agreements.[30] Amendments to the Code added in 1984, 1990, and 2005 apply to municipalities and are designed to protect the smooth functioning of investment markets.

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[25] *See,* In re North and South Shenango Joint Municipal Authority, 80 B.R. 57 (W.D.Pa. 1982); In re Carroll Township Authority, 119 B.R. 61 (Bankr.W.D.Pa. 1990).

[26] *See,* In re Slocum Lake Drainage District, 336 B.R. 387 (Bankr.N.D.Ill. 2006)(holding that the debtor drainage district was not specifically authorized to file a chapter 9 under Illinois law); In re County of Orange, 183 B.R. 1995 (Bankr.C.D.Ca. 1995). Orange County and a consolidated investment fund, the "Orange County Investment Pool" or OCIP, filed separate chapter 9 petitions. Although the County was permitted to file, the bankruptcy court held that the OCIP was not specifically authorized to file chapter 9.

[27] 11 U.S.C. § 941.

[28] 11 U.S.C. §§ 930, 941, 942.

[29] 11 U.S.C. §§ 362, 922.

[30] 11 U.S.C. § 362(b)(6) & (7).

The Bankruptcy Estate; Control of Property

A municipal debtor, unlike one under chapter 11, does *not* need bankruptcy court approval to borrow and spend money. Indeed, there is not a separate bankruptcy "estate" in a chapter 9 case, so the debtor is free to control property without regard to restrictions generally applicable to estate property.

Although a municipal debtor retains autonomy, the Code does impose some affirmative obligation on it to act to reorganize its debt. An initial requirement is that the debtor file its petition in "good faith."[31] While a finding of "good faith" reposes a great deal of discretion in the court, it is a protective criterion for the creditors.

In addition to the automatic stay, a chapter 9 debtor may avail itself of a wide array of bankruptcy powers, including the right to avoid preferences,[32] to set aside fraudulent conveyances,[33] to borrow money on the security of liens senior to existing liens of record,[34] to reject executory contracts,[35] and to bind all creditors by a confirmed plan.[36]

The fundamental character of chapter 9 is defined by the jurisdictional constraints imposed upon the court, discussed *supra*. Narrower provisions tailored to municipal reorganization, most of which were added by the 1988 amendments, include special protections for leases to the municipality,[37] and requirements for the segregation, separation, and protection from avoidance actions of municipal revenues dedicated to general bondholders versus special revenue bondholders.[38] These provisions clarify that payments to bondholders cannot be "recaptured" as avoidable

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[31] 11 U.S.C. § 921(c). *See,* In re City of Desert Hot Springs, *supra* note 4. The City was a defendant in a lawsuit in which the plaintiff was awarded a judgment of 3 million dollars, and thereafter attempted to freeze city funds. After somewhat complicated judicial proceedings, including a retrial and appeals, the City filed under chapter 9. Plaintiff/creditor moved to have the case dismissed as being filed in bad faith. The bankruptcy court denied the motion, which the Ninth Circuit Court of Appeals declined to review.

[32] 11 U.S.C. § 547. An "avoidable preference" allows the debtor to nullify or "avoid" prepetition transfers from the debtor to others. A creditor who may have lawfully received money from the debtor within a specified time prior to the filing may be compelled by the court to disgorge and return it to the debtor for the benefit of the bankruptcy estate. The purpose of requiring creditors in specified situations to disgorge monies received from the debtor legally prior to bankruptcy is to maximize the estate to permit equitable distribution among all creditors.

[33] 11 U.S.C. § 548.

[34] 11 U.S.C. § 364(c).

[35] 11 U.S.C. § 365.

[36] 11 U.S.C. § 944.

[37] 11 U.S.C. § 929. This section provides that a lease to a municipality is not to be treated as an executory contract or unexpired lease solely because it is subject to termination in the event the debtor fails to appropriate rent.

[38] 11 U.S.C. §§ 922(d), 927, 928.

preferences, and that monies from special projects which are financed by and dedicated to special bondholders are not converted to general obligation funds by virtue of bankruptcy.

Rejection of Executory Contracts; Labor Relations

In 1984, the United States Supreme Court, in *National Labor Relations Board v. Bildisco*,[39] allowed a chapter 11 debtor to unilaterally abrogate a collective bargaining agreement (CBA), finding the labor contract to be an "executory contract" under 11 U.S.C. § 365 subject to rejection by the debtor, upon presentation of evidence that the agreement burdens the estate and that the equities favor rejection. In 1984, Congress overturned the *Bildisco* holding by enactment of a new § 1113 of the Code which requires a chapter 11 debtor to negotiate proposed modifications of a CBA with the authorized representative of the employees covered by such agreement. Many steps are required of the debtor, and ultimately, court approval is necessary for debtor rejection or modification of a CBA.

This provision of the Code, applicable to chapter 11 debtors, however, is *not* expressly applicable to a chapter 9 debtor. Section 1113 was enacted to reconcile the conflict between the National Labor Relations Act and the Bankruptcy Code. Labor relations for state and local public employees are covered exclusively by state law.[40] Hence, a chapter 9 municipal debtor does not have to comply with § 1113 and may enjoy greater latitude than a private debtor under chapter 11 with respect to modification or rejection of labor agreements in bankruptcy. Collective bargaining agreements may be subject to rejection under chapter 9, like other executory contracts, with damages treated as prepetition debt. However, *Bildisco* has been held to apply to municipal debtors. The bankruptcy court overseeing the Orange County reorganization found that the County had not satisfied standards established by the *Bildisco* decision and state case law to establish the necessity for unilateral abrogation of its employee CBAs:

> The [Labor] Coalition further argues that before impairing its contractual rights on the basis of an emergency, the County must satisfy the following four-part test ...: (1) a declared emergency must be based on an adequate factual foundation; (2) the agency's action must be designed to protect a basic social interest and not benefit a particular individual; (3) the law must be appropriate for the emergency and obligation; and (4) the agency decision must be temporary, limited to the immediate exigency that caused the action. ... In my view, any unilateral action by a municipality to impair a contract with its employees must satisfy these factors if not as a legal matter, certainly from an equitable standpoint.[41]

The ability and standards by which a chapter 9 debtor may modify or abrogate CBAs with public employees are likely to vary from state to state.

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[39] 465 U.S. 513 (1984).

[40] The NLRA excludes "any State or political subdivision thereof" from the definition of "employer." 29 U.S.C. § 152(2).

[41] In re County of Orange, 179 B.R. 177, 184 (Bankr.C.D.Ca.1995)(citations and footnotes omitted).

Confirmation

Reduced to its bare essential, debt adjustment under chapter 9 simply requires the debtor and its creditors to reach some agreement on an acceptable reorganization plan. The municipality need not actually negotiate the plan with its creditors; it may file a debt adjustment plan or modifications to the plan unilaterally. But the plan must ultimately be approved by creditors in order to become effective. If consensus is reached, the court reviews the plan to determine that it "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted the plan."[42]

The Code also provides that an exchange of new securities for a claim covered by the plan, regardless of whether the exchange occurs before or after the filing of the petition, does not limit or impair the effectiveness of the plan. For purposes of accepting or rejecting the plan, a creditor who participates in an exchange will vote according to the number and amount of claims held prior to the exchange.[43]

11 U.S.C. § 943 directs the court to confirm a plan *if*: it complies with Code requirements; expenses incurred in connection with the case and the reorganization plan are disclosed and are reasonable; the debtor is not prohibited by law from taking any action necessary to carry out the plan; holders of administrative expense claims receive cash equal their claim, unless they have agreed to different treatment; any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out the plan has been or will be obtained; and, the plan is in the best interest of creditors and is feasible.

Orange County

On December 6, 1994, Orange County, California, filed under chapter 9. Its debt adjustment represents the largest municipal bankruptcy filing to date. The County was overseer of the Orange County Investment Pool (OCIP), comprised of its funds and those belonging to a wide variety of additional municipal entities, such as school and irrigation districts. The County Treasurer engaged in a high-risk investment strategy involving reverse repurchase agreements or "repos." The OCIP's 7.5 billion dollars in investment equity was leveraged into 20 billion dollars. The success of the investment strategy depended upon declining interest rates. When interest rates began to rise and creditors demanded increased collateral, the County's financial liquidity plummeted.[44] It filed under chapter 9 and instituted many lawsuits against its investment bankers and others. A plan of adjustment became effective in

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[42] 11 U.S.C. § 1129(b)(1). The standards imposed by these "terms of art," though not fully tested in chapter 9, are supported by a large body of judicial case law and cannot be viewed as conferring unfettered discretion upon a court applying them.

[43] 11 U.S.C. § 946.

[44] Philippe Jorion, BIG BETS GONE BAD: DERIVATIVES AND BANKRUPTCY IN ORANGE COUNTY (Academic Press 1995).

June 1996. In February 2000, the presiding bankruptcy judge closed the case by approving the distribution of $816 million in litigation proceeds.[45]

There are, of course, many lessons to be learned from the Orange County filing — and they encompass principles of municipal management, finance, and oversight, among others. But the State of California's policy allowing its municipalities to avail themselves of relief under chapter 9 appears to be a prudent one. And the Code itself, as applied by the bankruptcy court, appears to have been sufficiently flexible to accommodate the operational needs of the County and the interests of its creditors.

Conclusion

The paramount feature of a municipal reorganization is the requirement that the municipal debtor and a majority of its creditors reach an agreement on the plan to readjust the municipality's debts. The outcome of any reorganization cannot be predicted with certainty. Given the many variables, including applicable state law and the underlying reason for the insolvency, the parties involved, including the court, may take an expansive and dynamic approach to reorganization, or a narrow, more limited view of remedial possibilities. Several basic principles may provide guidance as one considers the likely course of a major municipal reorganization. First, the policy underlying chapter 9 is unlike that of other chapters: municipalities are not subject to liquidation or strict judicial control. Second, development of the reorganization plan is largely the initiative of municipal authorities, who do not need judicial permission to exercise governmental functions.

Conversely, even though the Code is designed to give the cash-strapped municipal debtor "breathing room" and an opportunity to marshal its assets, the Code does not relieve the debtor from the requirements of applicable nonbankruptcy law. Filing bankruptcy does not lift from the municipality the burdens imposed upon it by myriad state and federal laws. Reorganization and, ultimately, repudiation of debt may be facilitated by a chapter 9 filing. But the manner in which the municipal debtor reaches its goal for rehabilitation will still be shaped, in large part, by the constraints of federal and state law under which it operates.

In the Orange County financial crisis, the bankruptcy forum appears to have provided an appropriate and efficient judicial mechanism for its resolution. The County *qua* municipality remained in control of its "political" affairs, that is, the operation of government and the provision of public services, while the County *qua* debtor was free to pursue both litigation and negotiated settlement with its creditors. The uniquely binding effect of a chapter 9, federally-confirmed reorganization plan coupled with the inherent limitations creditors face in dealing with a municipal debtor may promote consensus towards an achievable composition of debt. Whether

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[45] Daniel Yi, *Judge OKs Payments Ending O.C. Bankruptcy,* L.A. TIMES, Feb. 3 2000, at B3. The distribution provided "near total" recovery for many of the agencies that lost money in the OCIP; schools recovered an average of 97.7%; cities and public agencies, 94.4%; and the County, 87 cents on the dollar.

chapter 9 will be called upon to aid municipalities grappling with pension and health-care related debt remains to be seen.