Public Finance

Options for Pennsylvania Cities and Municipalities in Financial Distress

provided by Ballard Spahr LLP

I. Introduction

In the wake of the global financial crisis of 2008, local governments continue to face significant budget imbalances created by high unemployment, escalating pension and other employment legacy costs, increased demand for public services, and reduced tax revenues. The financial crisis has worsened long-term structural budget imbalances in cities and municipalities, many of whom were struggling to meet their financial obligations before the recession.

The hardest-hit local governments are saddled with escalating operating expenses and high fixed costs driven by indebtedness, collective-bargaining agreements containing provisions that impose costly operational restrictions and remove flexibility to implement cost saving changes, and significant funding obligations relating to defined benefit pension plans and other post-employment benefits (OPEB). It is no coincidence that in many of these fiscally distressed cities and municipalities, the personnel costs for uniformed and other unionized personnel alone constitute more than 50 percent and sometimes as much as 60 percent or more of the community's general fund budget. As a result, the financial distress of many cities and municipalities is often directly related to existing contracts with public employees and retirees.

Distressed municipalities in Pennsylvania, if left to their own devices, typically have no effective tools to reverse fiscal distress and are unable to solve their fiscal crisis. Municipalities can raise taxes and cut government services to address short-term financial needs, however these measures are often insufficient to combat long-term structural budget deficits.[1] Raising taxes, borrowing, and deferring expenses are not viable or genuine solutions to the expenditure-driven budgetary imbalances that are at the core of the fiscal problem. The fiscal crisis among local governments is caused by structural budgetary imbalances, and the remedy must address those concerns.

This paper provides an overview of municipal debt relief options, including Act 47 and a bankruptcy filing under Chapter 9 of the Bankruptcy Code. The paper outlines the conditions imposed by Act 47 on a municipality contemplating a Chapter 9 filing, and then focuses on certain benefits and drawbacks of a Chapter 9 filing.

II. Act 111

In Pennsylvania, municipalities are often fiscally burdened by public employee obligations, pension obligations, bonded debt, bank loans, long-term leases, and a high portion of tax-exempt properties within their borders. The ability of municipalities to create a sustainable balance between revenues and personnel costs and obligations, is constrained by mandatory interest arbitration between the public employer and its uniformed employee unions. The Policemen and Firemen Collective Bargaining Act,[2] commonly referred to as Act 111, requires municipalities to participate in binding interest arbitration to resolve an impasse in collective bargaining between the public employer and its police and fire unions. The interest arbitration process consists of a tri-partite arbitration panel, and an arbitration award is issued by a majority of the arbitrators. As counter-intuitive as it may seem, that panel does not have to consider the ability of the municipal employer (i.e., the taxpayers) to pay for the existing contractual benefits or any new benefits that may be awarded. Act 111 does not require that the arbitration panel explain its reasoning for adding new costly benefits or refusing to cut existing wages or benefits, nor even explain the evidence on which it relies in issuing its award. In fact, rarely is such reasoning provided by an arbitration panel. As a result, interest arbitration awards in Pennsylvania often contain benefits that are unaffordable and unsustainable in today's economic climate, and the majority of arbitrators on the panel who are responsible for the award—who do not have to answer to the taxpayers or elected officials—simply leave it to the taxpayers to figure out how to pay for the costly new benefits.

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A recent study by the Pennsylvania Economy League ("PEL 5-City Study") concluded that state laws and mandatory arbitration awards have had "far reaching effects on the economic health of Pennsylvania's municipalities; therefore proving that these municipal fiscal problems are 'systemic' and not 'political'" in nature.[3] The *PEL 5-City Study* illustrates the severity and degree of fiscal distress that Pennsylvania's local governments are experiencing. The alarming fact is that at the time of the study, ***none*** of the cities were operating in a distressed status under the Pennsylvania Municipalities Financial Recovery Act,[4] commonly referred to as "Act 47,"[5] yet the study revealed two frightening facts:

- In all but one of those cities, "all the taxes levied within the city do not generate sufficient revenue to pay for public safety, let alone the other basic functions of the government such as general administration, public works, and debt service;" and
- Not one city in the case study could support public safety, general administration, public works, or debt service from its existing tax base.[6]

To make matters worse, on the revenue side, the *PEL 5-City Study* noted:

Each city depends on the revenue collected primarily from real estate and Act 511 taxes, particularly the Earned Income tax. For the cities in these case studies, ***the real estate tax has become an essentially static revenue source. Property assessments, the basis for real estate taxation, have been slow to grow and reflect the limited ability of the cities to achieve significant property appreciation through new development.*** There is typically little room for new development on vacant land in these cities; for example, the most significant property development in these studies is being built upon the site of a bankrupt steel mill [Easton]. Politically, the cities must compete with the school districts and the counties for the real estate tax base, and as such cannot significantly compound the increased tax millage on the assessment base. For the 511 taxes, the cities must also share these revenue sources with their school districts.[7]

III. Act 47

Act 47 provides certain tools for a municipality that may allow the municipality to successfully address financial distress without filing for bankruptcy.[8] Act 47 was adopted in 1987 "to foster fiscal integrity of municipalities so that they provide for the health, safety and welfare of their citizens" and to ensure that municipalities "meet financial obligations."[9] Act 47 is often the only buffer that stands between local governments and Chapter 9.

Act 47 provides a number of short-term benefits to distressed municipalities. First, cities and municipalities determined to be distressed under Act 47 have access to administrative and financial consultants funded by the Pennsylvania Department of Community and Economic Development ("DCED"), and priority access to economic development programs funded by the Commonwealth. Second, distressed municipalities may request emergency loans or grants from DCED, and may qualify for certain extraordinary taxing authority not otherwise available to municipalities of the same classification. Third, Act 47 provides political cover by allowing elected officials to attribute unpopular measures to the recovery plan developed by a DCED-appointed Act 47 coordinator.

While these benefits provide some relief, they are not capable of correcting long-term structural budget imbalances. For cities struggling with overwhelming obligations and deteriorating revenues, two other potential solutions contemplated by Act 47 to address structural issues – consolidating or "regionalizing" municipal services and/or merging with neighboring municipalities – have almost always proven politically unpalatable and/or economically unfeasible. Although an Act 47 coordinator may conclude that the fiscal distress of a municipality is so severe that it should consider consolidation or merger,[10] the coordinator's recommendation is not binding, and adjacent municipalities historically have been unwilling to consolidate with their distressed neighbors.

More problematic, however, are the tools that Act 47 lacks. First, Act 47 does not provide a mechanism whereby distressed municipalities can compel a restructuring of existing obligations. Although creditors may negotiate an adjustment of their claims voluntarily, there is no statutory authority to force an involuntary restructuring.

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In addition, while § 252 of Act 47 originally provided that interest arbitration settlements and collective bargaining agreements involving fiscally distressed communities "shall not impair the implementation" of the recovery plan and had to comply with the terms of the recovery plan, the Pennsylvania Supreme Court ruled in October 2011 that the restrictive language of § 252 did not apply to interest arbitration awards involving uniformed personnel.[11] In early July 2012, the Pennsylvania legislature addressed the fiscal challenge created by the *City of Scranton* decision by amending Act 47 to expressly require interest arbitration *awards* to comply with the recovery plan, just as collective bargaining agreements are required to do. The amendment (Act 33 of 2012), however, also provides a process through which an arbitration panel can issue an award that exceeds a recovery plan.[12] It is hoped that the legislative "fix" within Act 33 will restore the prior effectiveness of Act 47 on interest arbitration awards. The provisions of Act 33 will no doubt be tested via the courts, and it remains to be seen if Act 33 will prove effective in causing adherence by arbitrators to Act 47 recovery plans.

Despite the limited effectiveness of Act 47 (even with the Act 33 amendments), an Act 47 designation may be viewed as a positive credit development by rating agencies and municipal bond investors. Some municipalities have successfully completed debt offerings with reasonable interest rate structures while under the Act 47 designation. Nevertheless, the relatively short-term benefits of Act 47 will not assist a financially distressed municipality when its distress is caused by (1) long-term structural budget imbalances, and/or (2) a single, overwhelming obligation, such as a substantial legal judgment or the failure of a municipal enterprise. In those circumstances in which Act 47 is insufficient to adequately address the financial situation, an insolvent municipality can consider Chapter 9, which has some of the tools that Act 47 lacks.

IV. The Origins of Chapter 9

While fiscally distressed corporations may turn to the well-established body of law under Chapters 7 (liquidation) and 11 (reorganization) of the Bankruptcy Code, municipalities are authorized to file for bankruptcy only under the rarely-used Chapter 9.[13] Municipalities have had the authority to file for bankruptcy since the 1930s, when Congress enacted the Municipal Bankruptcy Act in response to a rising number of municipalities defaulting on their obligations during the Great Depression. The Municipal Bankruptcy Act of 1934 was enacted under Article I, Section 8, Clause 4 of the U.S. Constitution, which authorizes Congress to enact "uniform Laws on the subject Bankruptcies throughout the United States." Although the legislation was adopted under an enumerated power of Congress, the Supreme Court held in *Ashton v. Cameron County Water Improvement District No. 1* that the Act improperly interfered with the sovereignty of the states.[14]

In 1937, Congress enacted a revised Municipal Bankruptcy Act[15] that expressly sought to preserve the sovereign powers of states guaranteed by the Tenth Amendment, and to affirm the power of local governments over day-to-day operations free of court control.[16] These principles have been carried over into Chapter 9, in Sections 903 and 904, which respectively provide that Chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality,"[17] and establish that a bankruptcy court may not interfere with the "political or governmental powers," "properties or revenues" of the debtor, or the "debtors use and enjoyment of any income-producing property."[18]

Because of the relative rarity of Chapter 9 filings, which represent a tiny fraction of bankruptcy filings in the United States each year, many principles that are well-established in the corporate bankruptcy setting remain open questions under Chapter 9. The potential legal outcomes in a Chapter 9 proceeding are, therefore, uncertain.

V. Legal Hurdles to Filing Under Chapter 9

To be eligible for Chapter 9, an entity must satisfy five requirements laid out in Section 109(c) of the Bankruptcy Code.[19]

A. Status as a Municipality

First, the entity must be a "municipality" within the meaning of the Bankruptcy Code. A municipality is defined for purposes of the Bankruptcy Code as "a political subdivision or public municipality or instrumentality of a state."[20] The scope of this definition encompasses traditional municipal entities, such as counties and cities, but certain public authorities and public benefit corporations may not be considered municipalities under Chapter 9. For example, the United States Bankruptcy Court for the District of Nevada concluded that the Las Vegas Monorail did not constitute a municipality under Chapter 9 because its operation more closely resembled a private company with state oversight, than an instrumentality of the state.[21]

B. State Authorization

Second, a municipality must have express state authorization to file for bankruptcy. In Pennsylvania, Act 47 provides the statutory authorization for a municipality to file under Chapter 9 if one of the following conditions is met:

- An Act 47 coordinator recommends the municipality file for an adjustment of its debts;
- The municipality faces an imminent threat of an action by a creditor that is likely to jeopardize its continued ability to provide health or safety services to its citizens;
- One or more creditors rejects an Act 47 plan, and efforts to negotiate a resolution of such creditors' claims are unsuccessful for a ten-day period;
- A condition substantially affecting the municipality's financial distress is potentially solvable only through a remedy exclusively available by filing for bankruptcy under Chapter 9; or
- A majority of the current or immediately preceding governing body of the municipality fails to adopt an Act 47 plan or carry out the recommendations of an Act 47 coordinator.[22]

In addition, the authority to file under Chapter 9 may only be exercised (i) upon the vote by a majority of the municipality's governing body, and (ii) with the consent of the Secretary of DCED.

On June 30, 2011, the Pennsylvania General Assembly passed an additional limit on state authorization under Act 47 for cities of the third class.[23] This statute, commonly referred to as Act 26, provides that no city of the third class with a distressed determination may file for bankruptcy under Chapter 9.[24] In part as a result of Act 26, the United States Bankruptcy Court for the Middle District of Pennsylvania dismissed a bankruptcy petition by the City of Harrisburg, a city of the third class, on December 5, 2011.[25] Act 26 initially was set to expire on July 1, 2012. On July 29, 2012, the Pennsylvania General Assembly extended Act 26 for an additional five months.[26] The current restriction is set to expire on November 30, 2012, unless further extended by the General Assembly.[27]

C. Insolvency

Third, a municipality must be "insolvent." A municipality is considered insolvent under Chapter 9 if it is "(i) generally not paying its debts as they become due, unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due."[28] Bankruptcy courts determine insolvency through a prospective analysis that considers cash flows, available reserves, accumulated debt, and a municipality's ability to reduce expenditures and increase taxes.[29] With respect to taxation, a municipality must show that reasonable tax increases would not generate sufficient revenue to relieve existing financial distress.[30]

D. Desire to Adopt a Plan of Adjustment

Fourth, a municipality must demonstrate a desire to adopt a plan of adjustment of its debts.[31] This requirement is designed to ensure that a bankruptcy petition is not used for an improper purpose, such as to harass creditors or cause unnecessary delay. A municipality can satisfy the requirement by attempting to resolve claims with creditors, submitting a draft plan of adjustment, or submitting a statement under oath from a public official stating that the municipality desires to effect a plan of adjustment.[32]

E. Negotiations

Fifth, a municipality must demonstrate (1) it has reached agreement with a majority of the creditors it intends to impair under a plan; (2) it has negotiated in good faith with creditors and has failed to obtain the necessary level of agreement, (3) it is unable to negotiate with creditors due to impracticability, or (4) it reasonably believes a creditor may attempt to obtain a preferential transfer.[33]

Creditors have the right to object to municipal bankruptcy filings based on any of the five pre-petition requirements – and they frequently do. As a result,

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VI. The Limited Powers of the Bankruptcy Court and Creditors

As noted above, due to state sovereignty issues and sensitivities to federalism and the Constitution embedded in Chapter 9, the role of bankruptcy courts is limited as compared to their role in corporate and personal bankruptcies. Bankruptcy courts cannot impose a plan of adjustment, convert a case under Chapter 9 to a liquidation under Chapter 7, appoint a trustee to take over the municipality's assets, or dictate how a municipality spends its available funds.[34] Bankruptcy courts can dismiss a case for cause for unreasonable delay that is prejudicial to creditors, for failure to propose a plan of adjustment, or for want of prosecution.[35] Other than procedural dismissals, however, the principal power of the bankruptcy court is to approve or disapprove the plan of adjustment prepared by the municipal debtor.[36]

The role of creditors is also very limited under Chapter 9. As a threshold matter, municipalities are not subject to involuntary bankruptcy petitions.[37] In addition, although municipalities are required to adopt a plan that is "in the best interests of creditors and is feasible,"[38] creditors cannot file their own competing plans of adjustment with the court, and must instead negotiate with municipalities over the content of the municipality's own plan.[39] In short, the rights of creditors in a Chapter 9 case are limited to (1) contesting eligibility to file, (2) seeking dismissal for bad faith or want of prosecution, and (3) approving or rejecting a plan of adjustment proposed by the municipal debtor.

VII. The Benefits of Chapter 9

Local governments considering municipal bankruptcy should take into account the potential costs and benefits of filing under Chapter 9. There are a number of potential advantages, including (1) immediate breathing room under the "automatic stay," (2) local control, (3) the opportunity to restructure debts without securing unanimous agreement from creditors, and (4) the ability to reject burdensome contractual obligations.

A. Breathing Room

One of the principle benefits of Chapter 9 is that it buys time for a financially distressed municipality under siege from the remedial actions of creditors. A bankruptcy petition operates as an "automatic stay" of enforcement of claims against the debtor.[40] Without a Chapter 9 petition, distressed municipalities that default on their obligations to creditors may face debt acceleration, collection actions, writs, and other creditor remedies. In Pennsylvania, bondholders may seek a writ of mandamus pursuant to Section 8261 of the Pennsylvania Local Government Unit Debt Act,[41] or exercise other contractual and statutory rights to require a municipality's treasurer to apply the first available tax revenues to the repayment of creditors. The automatic stay will halt these actions, including mandamus actions.

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There are two limits to the automatic stay in Chapter 9 cases. The first is the unique status afforded "special revenue bonds" – typically issued in connection with revenue generating municipal enterprises like water and sewer and parking systems, and secured by a pledge of net system revenues rather than taxes of general applicability. The automatic stay does not prevent the holders of special revenue bonds from enforcing their right to continue to receive net system revenues.[42] Section 902 of the Bankruptcy Code provides a list of municipal income that qualifies as "special revenues," including revenues from transportation and utility systems, and taxes specifically levied to finance municipality projects or systems.[43] Payments due under a municipal guaranty of special revenue bonds, however, are treated like general obligation bonds and are subject to the automatic stay.

The second limit to the automatic stay is that the Bankruptcy Court, on request of a creditor, can lift the automatic stay and allow such creditor to pursue its remedies for "cause," or for certain other enumerated reasons.[44]

B. Local Control

Another benefit of municipal bankruptcy is its preservation of local control. Chapter 9 explicitly protects the rights of states to control their political subdivisions, and the rights of municipalities to manage their internal affairs.[45] Unlike corporate bankruptcy proceedings, courts operating under Chapter 9 may not force a municipality to set aside funds or sell assets to satisfy its obligations. Moreover, municipalities do not need the approval of the bankruptcy court to buy or sell property or make capital improvements. During the pendency of a Chapter 9 case, the debtor municipality can pick and choose which obligations – and to what extent – it pays.

C. Dealing with the Recalcitrant Creditor

A key benefit of Chapter 9 is that it allows a municipality to adopt a restructuring plan that restructures its debt obligations without the unanimous consent of creditors, whose claims are being restructured. Like Chapter 11 corporate reorganizations, creditor classes vote on a plan, and a plan can be accepted by a class if approved by class creditors holding more than one-half of the class claims in number, and at least two-thirds of such claims in amount.[46] Moreover, Chapter 9 provides that a plan can bind even a non-consenting class of creditors if (1) at least one class of creditors accepts the plan, and (2) the bankruptcy court determines that all classes received equitable treatment.[47] The threat of a so-called "cram down" can result in favorable settlements for local governments, and ultimately provides a powerful tool to force a restructuring on creditors who refuse to negotiate. Perhaps most importantly, these two provisions make it possible to restructure bond debt in ways that, under the bond documents, would require the affirmative vote of all bondholders without attempting (and usually failing) to get such a unanimous affirmative vote.

Bankruptcy can offer a distressed municipality the ability to reject burdensome contracts.

D. The Power to Reject Contracts

Among the leading benefits of Chapter 9, is its incorporation of Bankruptcy Code provisions permitting the assumption or rejection of contracts. Section 365(a) of the Bankruptcy Code provides that a municipality, subject to a bankruptcy court's approval, may assume or reject "any executory contract or unexpired lease of the debtor."[48] Assumption allows a municipality to retain the benefits of favorable contracts despite filing for bankruptcy, while rejection can free a municipality from burdensome agreements.

The use of Chapter 9 to reject unsustainable collective-bargaining agreements is a key area of recent focus. Because employee compensation and benefits make up a significant portion of local government budgets, the power to reject collective-bargaining agreements could offer substantial relief to a distressed municipality.

In *N.L.R.B. v. Bildisco and Bildisco*,[49] the Supreme Court held that a debtor can reject a collective-bargaining agreement if it shows that (1) the collective-bargaining agreement burdens the debtor, (2) the equities balance in favor of rejecting the contract, and (3) reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution.[50] Although the *Bildisco* decision was superseded by statute for Chapter 11 cases,[51] the standard set forth therein remains the governing standard in Chapter 9. Moreover, although Chapter 9 cases applying the *Bildisco* standard are limited, recent authority suggests that courts will apply a deferential standard to the judgment of the municipality.[52]

The power to reject a collective bargaining agreement provides substantial and immediate leverage for municipalities to renegotiate burdensome collective-bargaining agreements. If a municipality ultimately decides to reject a collective bargaining agreement, the municipality is liable for breach of contract damages under Section 365(g) of the Bankruptcy

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Code.[53] That liability, however, constitutes a general unsecured claim in the bankruptcy proceedings that may be restructured, like any other debt obligation, by the plan.

Another area of interest is the possible use of Chapter 9 to address unaffordable pension and OPEB obligations. A 2010 study by the Kellogg School of Management at Northwestern University, estimated that local governments have $574 billion in unfunded employee pension obligations.[54] Although unfunded pensions are among the largest financial obligations facing financially distressed cities, many efforts to reduce these obligations are unsuccessful. In December 2009, the city of Prichard, Alabama, became the first city to default on pension obligations when it faced a choice between paying current police officers and paying pensioners.[55] Prichard illustrates the potential conflict that can emerge between current public employees and retired public employees. As a city's financial distress grows, the two groups compete over portions of an increasingly smaller pie.

Where pension and OPEB obligations are part of the collective-bargaining agreement, such obligations are potentially another contract obligation that can be assumed or rejected along with the balance of the contract. When such obligations, and in particular, pension obligations, are not part of the collective bargaining agreement, as is often the case, and are part of a state-run public employee pension plan covering such employees state-wide, the question becomes murkier. There is little existing legal precedent with respect to whether and how Chapter 9 could be used to restructure the obligations of a municipality to a state-run pension plan. The issue in either situation, moreover, is complicated by the fact that some state constitutions provide strong legal protection against the impairment of pensions and retirement benefits. In Pennsylvania, there are strong arguments that the state constitution prohibits the revocation of pension benefits by statute or ordinance.[56] Because constitutional protections of public pension obligations vary by state, it is difficult to predict the outcome of a municipality's attempt to restructure pension obligations without analyzing the applicable state constitutional and statutory regime. Nevertheless, growing pension costs and the experience of cities like Prichard, Alabama, suggest that cities may be increasingly likely to consider bankruptcy to try to address burdensome pension and OPEB obligations.

Indeed, recent actions by the Government Accounting Standards Board ("GASB") and Moody's Investors Service may contribute to the likelihood that local governments will consider bankruptcy to address pension and OPEB obligations. Since the beginning of 2011, Moody's Investors Service and other rating agencies, have treated unfunded pension obligations as equivalent to bond indebtedness for ratings purposes. The Government Accounting Standards Board ("GASB") voted in June 2012 to require unfunded pension obligations to be included on the balance sheets of local governments, and Moody's proposed, in July 2012, new adjustments to the required pension funding reporting by local governments whose debt is rated by Moody's.[57] The proposed Moody's adjustments will (1) allocate multi-employer plans to specific governmental entities based upon proportionate shares of total contributions, (2) adjust accrued liabilities based upon a high-grade long-term corporate bond index discount rate, (3) replace asset smoothing techniques with reported market or fair market values, and (4) establish a common amortization period.[58] These actions are likely to enhance transparency and improve comparability of unfunded pension obligations, but they may further negatively impact the credit ratings of municipalities with large unfunded pension liabilities.

VIII. The Drawbacks of Chapter 9

Filing for bankruptcy under Chapter 9 comes with significant drawbacks. A filing can (1) impose significant litigation costs, (2) increase the cost of future borrowing, and (3) leave many of the same structural problems in place that led to the municipality's financial distress.

A. Costs

Limited case law and burdensome threshold requirements may result in drawn out litigation and lengthy eligibility factual discovery. Because municipal bankruptcy filings are rare and eligibility can be difficult to establish, there are many legal issues and objections for creditors to raise in a municipal bankruptcy case, and the outcome(s) may be unpredictable. Even when all eligibility issues are addressed, the bankruptcy process itself is expensive. For the City of Vallejo, California, for example, emerging from bankruptcy took three years and reportedly cost in excess of $10 million in legal fees.

Filing for bankruptcy also may increase the cost of future borrowing, or limit a municipality's access to capital markets. State governments often fear that the creditworthiness of its municipalities may be impaired if a state allows a municipality to file for bankruptcy. This fear of "credit contagion" may explain why many states do not authorize bankruptcy petitions or limit access to Chapter

Municipal bankruptcy cannot solve every cause of fiscal distress.

9. It may also account for Act 26 in Pennsylvania, as well as Connecticut's strong opposition to the City of Bridgeport's 1991 bankruptcy filing. Yet some evidence suggests that municipal bankruptcy may improve a municipality's access to credit over the long term. Following Orange County, California's 1994 bankruptcy, the county's bond rating improved from non-investment grade "junk" status to investment grade, in three years.[59] Orange County's experience suggests that damage to a municipality's creditworthiness following a bankruptcy petition may be limited in duration.

B. Limited Solution

The most important drawback of municipal bankruptcy is that it is not tailored to solve all of the long-term demographic, financial, and political problems that lead to municipal financial distress. The municipal debtor will likely emerge from bankruptcy a leaner entity, but long-term demographic and economic conditions will likely not change. Moreover, municipal bankruptcy also is not a complete solution even to the problems that it can address. For example, although municipal debtors may reject burdensome collective-bargaining agreements, new agreements must be eventually negotiated or arbitrated. As a result, the same structural problems that led to financial difficulties in the first place, may lead municipal debtors back into financial distress after they emerge from bankruptcy.

IX. Avoiding Bankruptcy

Often, the best option for distressed municipalities may be to consensually restructure unsustainable obligations, where that is possible. Good faith negotiation is not only economical, it is legally required as a condition to the relief afforded under Chapter 9. Although elected officials (and voters) may be willing to confront unsustainable financial obligations, even severe budget cuts may be insufficient to combat long-term structural budget imbalances. Local governments must provide a consistent level of public safety and infrastructure, regardless of revenue and other obligations.

The best option for distressed municipalities may be to consensually restructure unsustainable obligations.

X. Conclusion

Municipalities have various tools available to them when in a distressed situation. In Pennsylvania, Act 47 is one option (and for third class cities, currently the only option). With proper DCED approval, Chapter 9 offers options to financially distressed cities that are not available under Act 47 or other applicable laws. In fact, Chapter 9 may be the best alternative for municipalities that are insolvent due to (1) long-term structural budget imbalances and burdensome financial obligations, or (2) a single, overwhelming financial obligation. But Chapter 9 is expensive and its outcomes are not certain. A municipality considering how to address a fiscal crisis must review and consider all of its options, and be sure to understand the true costs and benefits of each.

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Endnotes

1 When taxes rise above a certain level, taxable income decreases because residents move to municipalities with lower tax rates. Economists use the Laffer Curve to illustrate the hypothetical point at which an increase in the rate of taxation will decrease tax revenue.

2 43 Pa. Stat. Ann. § 217.1.

3 Pennsylvania Economy League, *Structuring Healthy Communities Municipal Case Studies*, at 1-3, (March 31, 2009) (hereinafter the "PEL 5-City Study"). *See also* The Pew Charitable Trusts Philadelphia Research Initiative, *Tough Decisions and Limited Options: How Philadelphia and Other Cities are Balancing Budget in a Time of Recession*, at 3-4 (May 18, 2009).

4 53 Pa. Stat. Ann. § 11701.

5 Since the Study, the City of Reading has entered Act 47 as of June 2010. In addition to Reading, Lancaster, York, and Easton have also participated in the Department of Community and Economic Development's Early Intervention Program, a step intended to avoid having to enter Act 47.

6 *See PEL 5-City Study*, at 9-2 (March 31, 2009).

7 *Id.* at 9-2, 9-3 (emphasis added).

8 Although Act 47 is designed to help municipalities avoid bankruptcy, one way to gain a distressed municipality designation under the Act is by filing a municipal debt readjustment plan under Chapter 9 of the Bankruptcy Code. 53 Pa. Stat. Ann. § 11701.201.

9 53 Pa. Stat. Ann. § 11701.102.

10 53 Pa. Stat. Ann. § 11701.241(7).

11 53 Pa. Stat. Ann. § 11701.408(a).

12 The new amendment to Act 47 makes it essential for Act 47 communities to effectively litigate all interest arbitration proceedings, and to have labor counsel experienced in Act 111 and Act 47 involved in the preparation of the Recovery Plan, as well as the preparation for the Act 111 proceeding.

13 11 U.S.C. § 101 *et seq*.

14 298 U.S. 513 (1936).

15 The Supreme Court upheld the revised Municipal Bankruptcy Act the following year in *U.S. v. Bekins*, 304 U.S. 27 (1938).

16 The Tenth Amendment provides that "powers not delegated to the United States by the Constitution . . . are reserved to the States." U.S. Const. amend. X.

17 11 U.S.C. § 903.

18 11 U.S.C. § 904.

19 11 U.S.C. § 109(c).

20 11 U.S.C. § 101(40).

21 *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Bankr. D. Nev. 2010).

22 53 Pa. Stat. Ann. § 11701.261(a).

23 72 Pa. Stat. Ann. § 1601-D.1.

24 *d.*

25 *In re City of Harrisburg, PA*, 465 B.R. 744 (Bankr. M.D. Pa. 2011).

26 S.B. 1263, 196th Gen. Assemb., 2011-2012 Reg. Sess. (Pa. 2012).

27 *Id.*

28 11 U.S.C. § 101(32)(C).

29 *In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn. 1991) ("[T]o be found insolvent a city must prove that it will be unable to pay its debts as they become due in its current fiscal year or, based on an adopted budget, in its next fiscal year.").

30 *Id.*

31 11 U.S.C. § 109(c)(4).

32 *See, e.g., In re City of Vallejo*, 408 B.R. 280, 295 (Bankr. App. 9th Cir. 2009).

33 11 U.S.C. § 109(c).

34 *See* 11 U.S.C. §§ 109(b), 901(a), 903, 904, and 941.

35 11 U.S.C. § 930.

36 11 U.S.C. § 943.

37 11 U.S.C. § 303(a).

38 11 U.S.C. § 943.

39 11 U.S.C. § 941.

40 11 U.S.C. § § 362(a); 922.

41 53 Pa. Stat. Ann. § 8001.

42 11 U.S.C. § 922(d).

43 11 U.S.C. § 902(2).

44 11 U.S.C. § § 362(a); 922(b).

45 11 U.S.C. § § 903; 904.

46 11 U.S.C. §§ 901(a); 1126(c).

47 11 U.S.C. §§ 901(a); 1129(b).

48 11 U.S.C. §§ 901(a); 365(a).

49 465 U.S. 513 (1984).

50 *Id.* at 519-527.

51 *See* 11 U.S.C. §1113.

52 *See In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009).

53 11 U.S.C. § 365(g).

54 Joshua Rauh & Robert Novy-Marx, *The Crisis in Local Government Pensions in the United States,* Northwestern University Kellogg School of Management, 49, http://www.kellogg.northwestern.edu/faculty/rauh/research/NMRLocal20101011.pdf.

55 Michael Cooper & Mary Williams Walsh, *Alabama Town's Failed Pension Is a Warning,* N.Y. Times, Dec. 23, 2010, http://www.nytimes.com/2010/12/23/business/23prichard.html; *see also In re City of Prichard, Alabama,* No. 09-15000-WSS (Bankr. S.D. Ala., March 10, 2010) (granting motion to dismiss bankruptcy filing on other grounds).

56 Pa. Const. art. I, § 17 ("No ex post facto law, nor any law impairing the obligation of contracts, or making irrevocable any grant of special privileges or immunities, shall be passed."); *See, e*.g., Wright v. Ret. Bd. of Allegheny County, 134 A.2d 231, 233 (Pa. 1957) ("a public employee has a contract right to continued membership in a retirement fund, under the same rules and regulations prevailing at the time of his employment, which may not be qualified or altered by subsequent legislative enactment").

57 *Adjustments to US State and Local Government Reported Pension Data*, Moody's Investor Service, July 2, 2012, at 1.

58 *Id.*

59 Shelby Grad, *Moody's Boosts Orange County Bond*, L.A. Times, Dec. 18, 1997, http://articles.latimes.com/1997/dec/18/news/mn-65476.