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Chapter 9 Bankruptcy Protection: The Final Option for Municipalities?

Many municipalities are facing strained budgets, or possibly worse, in light of severely reduced sales tax income and aggravated further by actions or inaction of the state legislature. It is difficult to predict with all the variables in play where municipalities' revenues are going to be in the next six months or longer. This may result in a municipality being figuratively put "out of business." If a municipality cannot pay its bills or bond obligations, there is a little known and seldom used provision in the Bankruptcy Code that should be explored — Chapter 9.

Chapter 9 of the Bankruptcy Code provides struggling municipalities with protection from creditors while they reorganize and renegotiate debt. Cities, counties, townships, school districts, public improvement districts, and other tax-funded entities — such as bridge, highway and gas authorities — are eligible for bankruptcy protection under Chapter 9.

Municipalities may obtain protection and relief by filing a petition and providing a list of their creditors, either with the petition or shortly afterward. Notice of the bankruptcy proceeding will then be sent to known creditors and other potentially interested parties. Creditors might challenge the petition and try to deny relief to the municipality. Experienced bankruptcy counsel can defend against such challenges, however, and show that the municipality is entitled to protection and relief under Chapter 9.

Chapter 9 municipalities are entitled to an automatic stay on all debts. This means that any collection efforts, including lawsuits and judgments, must immediately stop against a municipality in bankruptcy and are immediately suspended once a petition is filed. Municipalities are also excused from making principal or interest payments on general obligation bonds during the case. However, the bankruptcy does not operate as a stay for the application of pledged special revenues for payment of the indebtedness secured by those special revenues. In other words, a holder of a claim payable solely from special revenues can get paid during the bankruptcy from those special revenues.

Bankruptcy proceedings do not prevent municipalities from conducting normal operations or from using their property and revenue, as needed. Municipalities remain free to continue their typical day-to-day activities — and may even obtain credit and borrow money — throughout the bankruptcy process.

Municipalities are also permitted to renegotiate or reject certain contracts, including collective bargaining agreements, retiree benefit plans, and leases, subject to court approval, while the case is ongoing. Notably, municipalities in bankruptcy cannot be forced to liquidate assets to pay creditors. This provides them with greater protection than businesses pursuing bankruptcy and ensures that municipalities keep the resources they need to serve residents.

A key component of a Chapter 9 proceeding is filing a plan to adjust municipal debts and ensure long-term solvency. It is the municipality's responsibility to propose a viable and fair plan that

conforms with the Bankruptcy Code and other laws, covers reasonable costs related to the case, and pays creditors their original or renegotiated sums owed. Experienced bankruptcy attorneys can draft such a plan, and renegotiate and restructure debt obligations prior to its filing, to ensure that the plan survives any objections and is approved. Given the current situation with COVID-19, we would expect the income of the municipality to resume to prior levels before the pandemic at some point, thereby allowing the municipality to submit a workable plan to pay off its debts or a portion of them.

A Chapter 9 bankruptcy case ends once the plan is approved and the municipality properly deposits any funds that are meant to be distributed under the plan. The bankruptcy court will retain jurisdiction over certain aspects of the approved plan if there are disputes or issues.

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April 30 2020

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