Study D-1100 March 22, 1997

Memorandum 97-19

Bankruptcy Code: Chapter 9 Issues

The Commission decided at the November 1996 meeting to study some insolvency issues, including whether state law should be revised to increase the "options of state and local agencies and nonprofit corporations that administer government funded programs to elect Bankruptcy Code Chapter 9 (adjustment of debts of governmental entities) treatment." This memorandum gives a brief overview of the issues and raises several questions on the scope and timing of this study.

The following materials are attached for background information:

(For a general overview of municipal debt adjustment under Bankruptcy Code Chapter 9, you should review the first two exhibits.)

Statutory Framework

The general state statutes authorizing bankruptcy filings by local government were enacted in 1949 and have never been amended:

> **Gov't Code § 53760. Authorization for local government to file**
>
> 53760. Any taxing agency or instrumentality of this State, as defined in Section 81 of the act of Congress entitled "An act to establish a uniform system of bankruptcy throughout the United States," approved July 1, 1898, as amended, may file the petition mentioned in Section 83 of the act and prosecute to completion all proceedings permitted by Sections 81, 82, 83, and 84 of the act.
>
> **Note.** References are to 11 U.S.C.A. § 401 (repealed); 11 U.S.C.A. § 403 (repealed; see now 11 U.S.C.A. § 903); 11 U.S.C.A. §§ 401-403 (repealed; see now 11 U.S.C.A. §§ 101 *et seq.*, 901, 902 *et seq.*, 903, 904, 921(b)).

Gov't Code § 53761. State consent

53761. The State consents to the adoption of Sections 81, 82, 83, and 84 by Congress and consents to their application to the taxing agencies and instrumentalities of this State.

Note. References are to 11 U.S.C.A. §§ 401-403 (repealed; see now 11 U.S.C.A. §§ 101 *et seq.*, 901, 902 *et seq.*, 903, 904, 921(b)).

As indicated, the statutory references have become obsolete following enactment of the federal Bankruptcy Code, and the terminology is not consistent with 1994 amendments requiring that a "municipality" be "specifically authorized" to petition for debt adjustment under Chapter 9:

11 U.S.C. § 109. Who may be a debtor

….

(c) An entity may be a debtor under chapter 9 of this title if and only if such entity —

(1) is a municipality;

(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; **and**

(5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

….

[Emphasis added.]

A state may not expand the authority that may be granted pursuant to this section, but a state can limit the types of entities that can file, either by name or type, or by adopting a procedure for determining in each case whether the entity can file. This system reconciles the constitutional principles of federal bankruptcy authority and state sovereignty.

Updating State Law

The first issue and presumably the least controversial reform is the technical task of updating Government Code Section 53760 to refer correctly to the Bankruptcy Code. But can this be done without making any substantive changes, or raising a host of other issues?

Section 53761 should probably be repealed as unnecessary and redundant (see Kevane Memorandum, Exhibit p. 2 n.2); it would be difficult to figure out how to fix this section. We proceed on the assumption that Section 53761 serves no purpose and that there would be no objection to its repeal.

The "taxing agency or instrumentality" language of Section 53760 adopts a definition from the earlier Bankruptcy Act, which has been replaced by the "municipality" language in Bankruptcy Code Section 109(c)(1)-(2). A simple and mechanical updating of Section 53760 could read as follows:

> 53760. Any municipality in this state, as that term is defined in paragraph (40) of Section 101 of Title 11 of the United States Code, may file for adjustment of debts pursuant to Chapter 9 (commencing with Section 901) of Title 11 of the United States Code.

Bankruptcy Code Section 101(40) defines "municipality" as a "political subdivision or public agency or instrumentality of a State." The effect of this definition is that the federal courts will determine whether a local governmental entity is a "municipality." This was one of the issues faced by the court in the Orange County Investment Pool case — as it turns out, the determinative issue. In *In re* County of Orange, 183, B.R. 594, 600-06 (C.D. Cal. 1995), the court decided that OCIP's Chapter 9 petition could not be sustained because OCIP was not a "municipality" or an "instrumentality of a State," nor was it otherwise "specifically authorized" by the language of Section 53760 and the incorporated parts of the repealed bankruptcy act.

It is interesting to note, in passing, that the court did not discuss the issue of whether Government Code Section 53760 was obsolete or imposed additional restrictions that might prevent OCIP's filing, but instead concluded that OCIP did not meet the requisite standards of old or new law. Thus, we don't know whether the incongruity between the obsolete state authorization language and the new terms of the Bankruptcy Code might have any effect on the ability to file under Chapter 9. The OCIP court assumed that the municipality and state

instrumentality language of the Bankruptcy Code could be applied, but found that OCIP did not qualify.

Substantive Review of Authorization To File Under Chapter 9

With the proliferation of local government agencies — as many of 7000 of them who could claim municipality or instrumentality status — it is important to consider limitations on the authority to file for debt adjustment. As Mr. Kevane poses the question: "Should a 'citrus pest control district' or a 'storm drainage district' be permitted to seek Chapter 9 relief?" (See Exhibit 2, p. 2.) It cannot be assumed that simply updating language from the 1949 legislation to conform to the current language of the Bankruptcy Code, thereby giving the broadest authority to municipalities, is necessarily the most desirable approach. Conditions have changed dramatically since 1949.

Four bills before the Legislature during the 1995-96 session would have modernized Section 53760:

- Two bills granted the broadest authority permissible under federal law by adopting the federal definition of "municipality" in Section 101(40) — SB 1274 (Killea) and AB 2xx (Caldera). Neither bill made it out of committee.
- A third bill — AB 29xx (Archie-Hudson) — provided authority a for municipality as defined by federal law to file "with specific statutory approval of the Legislature" and required the plan for adjustment of debts under Bankruptcy Code Section 941 to be "submitted to the appropriate policy committees of the Legislature prior to being submitted to the United States Bankruptcy Code." This bill also died.
- A fourth bill — SB 349, authored by Senator Kopp — passed the Legislature, but was vetoed by the Governor. Like the other bills, SB 349 modernized the obsolete references and adopted the "municipality" language of the federal statute. Senate Bill 349 established a "Local Agency Bankruptcy Committee" (LABC) consisting of the Controller, Treasurer, and Director of Finance to determine whether to permit a municipality to file a Chapter 9 petition. It also contained provisions concerning appointment of a trustee by the Governor and time periods for various actions. The Governor's veto message (Sept. 30, 1996) stated that the bill "would inappropriately vest responsibility for local fiscal affairs at the state level, creating an instrument of state government to usurp the authority of local officials to decide the wisdom of a bankruptcy filing" and "could raise questions of the liability of the state to creditors of the public agency if eligibility for bankruptcy is denied."

Without getting into the merits of any of these proposals, it is clear that this is a subject that presents a number of controversial issues. The staff does not believe it is advisable to attempt to update Section 54760 without considering the many alternative approaches to authorizing Chapter 9 filings.

Possible Approaches to the Problems

What at first blush looked like a relatively simple task of updating obsolete statutory references now looks more complicated technically and politically. If the Commission decides to pursue this matter, the staff will do more research and seek involvement of experts in the field. That effort may lead to the conclusion that the Commission needs an expert consultant who already has the knowledge of the various approaches to the issue.

Perhaps as the Orange County bankruptcy recedes into the past, it will be possible to come to a general consensus on the proper approach to authorizing municipal debt adjustment. There were no bills in the 1993-94 legislative session amending Section 53760, and there are none in the current session. As we have seen, there were four in the 1995-96 session and a number of other bills dealing with other aspects of the Orange County problem. It is possible that further study might lead to a resolution of the issues addressed in SB 349 (which implemented a managed authority to file, instead of blanket authority) and in the Governor's veto message.

There are a number of possible approaches and various schemes have been adopted in other states. We understand that about half of the states have not responded to the need under the 1994 Bankruptcy Code amendments to "specifically authorize" municipalities to file. Two states specifically preclude Chapter 9 filings. (See Exhibit 2, p. 21.) It would be useful to survey the law of other states to find useful approaches. A number of options are summarized by Mr. Kevane and Ms. Chan. (See Exhibit 1, pp. 5-7; Exhibit 2, pp. 23-32.)

A revised Section 53760 could grant blanket authorization to certain types of municipalities, such as counties and charter cities, and apply conditions to other entities. There are any number of other combinations of authorizing standards that could be adopted.

There is some uncertainty inherent in relying on bankruptcy judges, as in the Orange County case, to determine whether an entity qualifies as a municipality. Enacting a list of entities that may file might help clarify the law, but it can be a cumbersome task. We are not certain the Commission would want to attempt to

pick and choose the appropriate qualifiers, whether described by class or in particular. Consider the list of entities in the First Validating Act of 1997 (SB 691):

> [A]ir pollution control districts of any kind, air quality management districts, airport districts, assessment districts, benefit assessment districts, and special assessment districts of any public body, bridge and highway districts, California water districts, citrus pest control districts, city maintenance districts, community college districts, community development commissions, community facilities districts, community redevelopment agencies, community rehabilitation districts, community services districts, conservancy districts, cotton pest abatement districts, county boards of education, county drainage districts, county flood control and water districts, county free library systems, county maintenance districts, county sanitation districts, county service areas, county transportation commissions, county water agencies, county water authorities, county water districts, county waterworks districts, … agencies acting pursuant to Part 3 (commencing with Section 11100) of Division 6 of the Water Code, distribution districts of any public body, drainage districts, fire protection districts, flood control and water conservation districts, flood control districts, garbage and refuse disposal districts, garbage disposal districts, geologic hazard abatement districts, harbor districts, harbor improvement districts, harbor, recreation, and conservation districts, health care authorities, highway districts, highway interchange districts, highway lighting districts, housing authorities, improvement districts or improvement areas of any public body, industrial development authorities, infrastructure financing districts, integrated financing districts, irrigation districts, joint highway districts, levee districts, library districts, library districts in unincorporated towns and villages, local agency formation commissions, local health care districts, local health districts, local hospital districts, local transportation authorities or commissions, maintenance districts, memorial districts, metropolitan transportation commissions, metropolitan water districts, mosquito abatement or vector control districts, municipal improvement districts, municipal utility districts, municipal water districts, nonprofit corporations, nonprofit public benefit corporations, open-space maintenance districts, parking authorities, parking districts, permanent road divisions, pest abatement districts, police protection districts, port districts, project areas of community redevelopment agencies, protection districts, public cemetery districts, public utility districts, rapid transit districts, reclamation districts, recreation and park districts, regional justice facility financing agencies, regional park and open-space districts, regional planning districts, regional transportation commissions, resort

> improvement districts, resource conservation districts, river port districts, road maintenance districts, sanitary districts, school districts of any kind or class, separation of grade districts, service authorities for freeway emergencies, sewer districts, sewer maintenance districts, small craft harbor districts, stone and pome fruit pest control districts, storm drain maintenance districts, storm drainage districts, storm drainage maintenance districts, storm water districts, toll tunnel authorities, traffic authorities, transit development boards, transit districts, unified and union school districts public libraries, vehicle parking districts, water agencies, water authorities, water conservation districts, water districts, water replenishment districts, water storage districts, wine grape pest and disease control districts, zones, improvement zones, or service zones of any public body.

Chapter 9 Filing by Nonprofits Administering Government Funds

As noted in the first paragraph, the Commission asked for an investigation of authorizing Chapter 9 filings by nonprofit corporations that administer government funded programs. Preliminary review of the language of Chapter 9 and the Orange County case suggests that it would not be possible to authorize such filings. See also *In re* Ellicott School Bldg. Authority, 150 B.R. 261 (D. Colo. 1992) (school building authority structured to qualify under tax code as nonprofit corporation so debt it issued could be treated as issued on behalf of a political subdivision did not constitute "municipality" for purposes of Chapter 9 eligibility). As in the OCIP case, an instrumentality of a municipality is not an instrumentality of the state qualified to petition under Chapter 9.

We could give this issue further study to confirm our initial impressions if the Commission decides to pursue revision of Government Code Section 53760.

Conclusion

The staff does not believe it is profitable for the Commission to simply recommend legislation to update Section 53760. The fate of two bills last session that would have updated the Section 53760 to provide blanket authority to file under Chapter 9 suggests that this is not an easy issue. Unless political conditions have changed significantly, or there is some other explanation for the failure of these bills, it looks like a waste of resources to repeat this effort. Apparently, the existing statute can be interpreted as providing blanket authority now (as in the Orange County case). This can support contrary conclusions: that there is no real

need for a technical updating of Section 53760 or that there should be no objection to making the statute say what it means in current terminology.

The staff believes that this law is seriously in need of review, both substantively and technically. There are obviously a number of significant issues that should be resolved in a thoughtful and comprehensive manner. This is clear from the exhibits attached to this memorandum. Our only hesitation, and it is a most serious one, is whether this area is too highly politicized to benefit from the Commission's involvement. It is always possible, however, that the Commission could supply the neutral forum, along with procedural and technical expertise, to accomplish what failed in the penumbra of the Orange County collapse. But based primarily on the legislative history of recent bills and the Governor's veto message, as well as the prospect of receiving letters from thousands of local government agencies, *the staff concludes that the prospect of achieving meaningful reform is too doubtful and we do not recommend that the Commission pursue this subject*.

If the Commission wishes to pursue this subject, however, the staff recommends serious consideration of contracting with an expert consultant to prepare a background study and to advise the Commission and staff.

Respectfully submitted,

Stan Ulrich
Assistant Executive Secretary

MEMORANDUM

TO: Randall Henry, Office of Senator Quentin L. Kopp

FROM: Henry C. Kevane

DATE: May 31, 1996

RE: SB 349 (as of February 26, 1996) -- Legislation Respecting State Authorization for Relief Under Chapter 9 of the Bankruptcy Code

I. Overview

Chapter 9 of the Bankruptcy Code was carefully crafted by Congress to accommodate the reserved sovereign rights of the states and the debt adjustment powers of federal law. On the one hand, as instrumentalities of a state, Chapter 9 debtors necessarily enjoy substantial freedom from federal interference. This freedom derives from the Tenth Amendment to the United States Constitution, which provides that "[t]he 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." U.S. Const., amend. X. On the other hand, only federal law can overcome the constitutional prohibition on the impairment by states of the obligation of contracts. U.S. Const., art. I, § 10, cl. 1. Thus, the powerful debt restructuring tools under the Bankruptcy Code--such as the automatic stay and the avoidance of preferential transfers--are available exclusively in federal court.

This balancing act is reflected in the stringent eligibility requirements for Chapter 9. The eligibility requirements are set forth in a five-prong test under section 109(c) of the Bankruptcy Code. One of the five eligibility requirements is specific, state-by-state authorization to file a Chapter 9 case. As a result, the ability of a municipality to seek federal relief is committed to the exclusive control of each state. Although approximately 20 states permit Chapter 9 cases, some with detailed pre-conditions or prior consent, the remaining states are silent on the subject and two states (Georgia and Iowa) expressly prohibit the bankruptcy option.

In 1994, Congress amended the Bankruptcy Code to require that municipalities be "specifically authorized" under state law to file a petition under Chapter 9. 11 U.S.C. § 109(c)(2) ("Section 109(c)"). Previously, a municipality was eligible if it was "generally authorized" to file for bankruptcy under state law. Case law was split over whether the authority to file could be inferred from the delegation by some states of traditional "home rule" powers to their municipalities (e.g., to issue debt, control finances or sue and be sued), or whether more detailed, express permission was necessary. The amendment was intended to clarify this uncertainty. By amending the eligibility statute, Congress has expressly invited each state to revisit the types of local agencies that may seek federal relief.

California law presently permits "any taxing agency or instrumentality" of the state to file a petition and "prosecute to completion all proceedings permitted" under the former Bankruptcy Act of 1898. Cal. Gov't Code § 53760 ("Section 53760").[1] The statute refers to the definition of "taxing agency or instrumentality" contained in the 1898 Act. Section 53760 has not been amended since it was enacted in 1949.

The existing statute is plainly outdated and, thus, merits amendment on purely technical grounds. Accordingly, the statute should be revised to conform to the current Bankruptcy Code and should contain a statement confirming that the statute reflects the intent of the state to permit Chapter 9 relief. In addition, responding to the invitation of Congress, it would also be worthwhile to re-examine the eligibility threshold for federal bankruptcy relief. Section 109(c) permits the threshold to be either (a) defined in the statute, or (b) delegated for case-by-case determination to a state official or agency.

Given the extraordinary proliferation of local agencies in California (according to the Constitution Revision Commission, there are over 7,000 special government agencies in California), the Legislature may wish to analyze whether certain special or limited purpose entities should be authorized to attempt to impair their contractual obligations in federal bankruptcy courts. Should a "citrus pest control district" or a "storm drainage district" be permitted to seek Chapter 9 relief?

II. Other Legislation

In addition to SB 349, other bills on this subject have been introduced following the Orange County case. They are: (a) AB 2XX (Caldera), (b) AB 29XX (Archie-Hudson), and (c) SB 1274 (Killea). Generally speaking, these bills propose to:

a. update the reference to the current Bankruptcy Code and incorporate the definition of "municipality" utilized in Section 101(40) of the Bankruptcy Code;

b. require some form of prior legislative approval before filing a Chapter 9 petition, or prior legislative review of a proposed plan of adjustment; and

c. permit the appointment of a state trustee to prosecute or supervise the Chapter 9 case.

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[1] Section 53761 of the Government Code provides that the "state consents to the adoption of [the applicable provisions of the Bankruptcy Act] and consents to their application to the taxing agencies and instrumentalities of this State." This "consent" provision is redundant to the "authorization" granted under Section 53760 and should probably be repealed or amended.

III. Comments

A. Use of Defined Term "Municipality"

As amended by SB 349, Section 53760 would permit "any municipality in this state" to file a petition under Chapter 9. The statute would incorporate the definition of "municipality" contained in Section 101(40) of the Bankruptcy Code. That term is defined to mean "political subdivision, public agency or instrumentality" of a state. But those three terms are not defined elsewhere in the Bankruptcy Code and, except for a recent decision by the bankruptcy court in the Orange County case, there are no reported bankruptcy court decisions construing these categories. See In re County of Orange, 183 B.R. 594, 601 n.14 (Bankr. C.D. Cal. 1995).

In Orange County, the bankruptcy court dismissed the filing by the County's commingled investment pool on the grounds that it did not qualify as a "municipality." The court's decision relied on a 1937 "laundry list" of entities that were previously permitted under the old Bankruptcy Act to file for municipal debt adjustment. Id. at 601 n.16 & 602-603. According to the court, a municipality includes only: (a) **a political subdivision of a state**, meaning an entity with the ability to exercise sovereign powers such as the police power, the power to tax or the power of eminent domain; (b) **a public agency of a state**, meaning an entity "organized for the purposes of maintaining or operating a revenue producing enterprise;" or (c) an **instrumentality of a state**, meaning a water, sewer, road, port, school or similar public improvement district. Since the investment pool did not qualify as one of these discrete entities, it was not a municipality and its bankruptcy case was therefore dismissed. The court also dismissed the case because the state had not specifically authorized an investment fund to file a petition under Chapter 9.

1. Potential Ambiguities

The issues raised by incorporating the federal definition of "municipality" in the state statute are whether (a) the definition adequately reflects the Legislature's views on the scope of eligibility, and (b) whether future federal judicial construction of the term might conflict with the Legislature's views. By incorporating the federal definition into the state statute, the state faces the principal risk that the term might be construed too narrowly (to exclude presumptively eligible entities). This problem would arise in each Chapter 9 case and might be subject to conflicting interpretations based on the venue of the case (there are four federal districts in California). If, on the other hand, the Legislature intends to restrict the "universe" of California public agencies that may file for bankruptcy, the opposite problem might arise. The federal definition might be construed over-inclusively, to permit Chapter 9 relief for entities that the state would prefer to exclude. To date, the state has not explicitly identified any entities for which access should be denied so this may be only a theoretical problem. (The only exception that I am aware of is SB 1993 (Calderon) which would prohibit the California Earthquake Authority from commencing a Chapter 9 bankruptcy case.) Under either scenario, by using the federal definition the state cedes some control over the eligibility threshold.

The reason for potentially varying interpretations of the federal term is that Section 109(c) requires that each entity must individually qualify as a "municipality" under the federal definition to be eligible for Chapter 9. Unlike a Chapter 11 case, the bankruptcy court must independently examine the eligibility issue each time a Chapter 9 case is commenced. Other parties in interest have the opportunity to seek the dismissal of the case if the municipality does not qualify under the 5-prong eligibility test. As a result, bankruptcy courts will continue to construe the meaning of the term "municipality" in most filings, particularly those where creditors are seeking dismissal. The use of the federal term under state law, therefore, may generate unintended results depending on the Legislature's intent.

2. Narrow Interpretation of "Municipality"

Presently, the federal term "municipality" may not include various types of local government agencies or the instrumentalities of those agencies (as opposed to instrumentalities of the state). For instance, it is unclear whether the federal definition of "municipality" would include joint power arrangements under §§ 6500 of the Government Code. This is because federal law permits Chapter 9 only for instrumentalities of the state, not instrumentalities of local agencies. A JPA is formed by two or more local agencies and may not be considered an arm of the state. Other examples include non-profit corporations or trusts established by local agencies. Indeed, the Orange County court rejected the notion that an instrumentality of a municipality (as opposed to an instrumentality of the state) could qualify as a municipality. This interpretation may effectively excludes authorities and agencies created by municipal entities (including joint power authorities) from seeking Chapter 9 relief. Id. at 603.

3. Broad Interpretation of "Municipality"

California has experienced an explosion of local agencies, many with redundant service areas and overlapping bureaucracies. For instance, a bill that was chaptered into law last year provided certain benefits to over 100 separate and distinct types of "public bodies" created under California law, ranging from "A" (air pollution control districts) to "Z" (zones of any public body). Another bill introduced by Senator Kopp (SB 1474) would have permitted the consolidation of regional transit services in the Bay Area. Similarly, a bill introduced by Assembly Members Pringle and Baugh (AB 2109) would provide, subject to electoral approval, for the consolidation of twenty-five separate Orange County special water districts into a single entity--the "Orange County Water and Sanitation District." Should each of these many entities, if they qualify as municipalities, be permitted to file for Chapter 9 relief? One criticism of the Orange County case is that its decision to file was hasty and that the bankruptcy could have been avoided. The enormous expense and delays inherent in any bankruptcy case would probably merit some restriction on the ability of some special purpose districts to seek Chapter 9 relief.

I would suggest, therefore, that the Legislature consider using state, not federal, law as a reference point for determining the entities that are specifically authorized to file under Chapter 9. Although these entities would still need to separately qualify as "municipalities" under Section 109(c), the Legislative determination would be a persuasive starting point for defining the scope of that term in California. Moreover, the use of a state law definition would reduce the risk that certain entities might be permitted or precluded from filing based on shifting federal interpretations of the term "municipality."

B. Statement of Intent

It may be appropriate to include a brief statement of intent declaring that Section 53760, as amended, provides the "specific authorization" required by Congress under Section 109(c). See AB 29XX and AB 2XX. For example: "This subsection expresses the specific authorization of the state to permit a municipality to be a debtor under Chapter 9 of Title 11 of the United States Code."

C. Pre-Filing Approval

Under the amended version of Section 109(c), each state may now specifically authorize a local agency "in its capacity as a municipality or by name" to be a debtor under Chapter 9. The statute also permits the state to create a gatekeeper in the form of a "governmental officer or organization empowered by state law to authorize such entity to be a debtor." Various states currently use a gatekeeper to regulate entry to Chapter 9. Connecticut requires the prior written consent of the governor and New Jersey requires the prior approval of a municipal finance commission. Kentucky requires the pre-approval of a proposed plan by certain state officers before a county may file and Pennsylvania has a detailed list of bankruptcy triggers. Other groups considering reform of Chapter 9 in the wake of Orange County have suggested that Congress further amend Section 109(c) to require pre-filing approval by, or some form of prior notice to, the state.

SB 349 would (a) require the pre-filing written approval of the Local Agency Bankruptcy Committee ("Local Committee") before a municipality could file a petition, and (b) permit the imposition of additional "terms and conditions" for the petition.

There are various potential difficulties with this "gatekeeper" provision:

1. The bill does not contain any standards for admission to Chapter 9. The Local Committee is comprised of elected and appointed state officials. There is a risk that the approval process could become unduly politicized, possibly exacerbating a genuine fiscal emergency.

2. Although a five-day approval period is contemplated, this period may not accommodate a genuine emergency.

3. Are the decisions of the Local Committee reviewable? Are they permanent? May the public agency reapply immediately after denial of access or should there be a waiting period?

4. What "terms and conditions" are contemplated? Must the Legislature ratify such terms if they affect the privileges or powers of the public agency?

5. What responsibilities, if any, does the state assume if the Local Committee denies its consent to file a petition under Chapter 9? Does the state have any liability to creditors of the public agency if access is denied?

6. What are the contents of a municipality's request for consent to file? What evidence is contemplated, if any?

7. The public notice period may cause undue disruption in the public capital markets, perhaps precipitating collection measures that might heighten liquidity problems. If creditors have advance notice of a future filing, they would probably exercise setoff, withdrawal, foreclosure, and other enforcement remedies. Under Chapter 9, pre-petition payments on account of bonds or notes are not recoverable as preferences.

As drafted, the gatekeeper provisions of SB 349 have the advantage of flexibility. The price of this flexibility may be such a level of discretion in the approval process that it effectively limits access through sheer uncertainty. The gatekeeping function should be revised in favor of (i) a more thorough examination of the entities permitted to seek Chapter 9 relief, and (ii) creation a trusteeship mechanism capable of promptly dismissing the Chapter 9 case if it is inconsistent with the best interests of the state.

D. Trusteeship

Trusteeship provisions for local agencies, although controversial, are not unusual. It is a fundamental precept of municipal law that local agencies, created by the state, exist principally as instrumentalities for (a) the orderly exercise of state functions and (b) the convenient delivery of state services. Notwithstanding the growth of public agencies in California, the state retains plenary control over their duties and powers. For example, according to the California constitution, the "Legislature shall provide for county powers" and "shall prescribe uniform procedures for city formation and provide for city powers." Cal. Const. art. XI, § 1(b), § 2(a). Even charter cities and counties should remain subject to state control. Although a charter is deemed to supersede the general laws adopted by the Legislature, the "provisions of a charter are the law of the State and have the force and effect of legislative enactments." Cal. Const. art. XI, § 3(a).

Local agencies, thus, are creatures of only limited and enumerated powers. Based on this principle, it seems indisputable that the state may, at its pleasure, modify or withdraw any delegated powers and exercise them directly. Trusteeship provisions were signed into law for Orange County (SB 1276, Killea) and were proposed for Los Angeles County (AB 53, Bowen, et al.).

In addition, existing California law requires the appointment of a state administrator to exercise the powers and responsibilities of the governing board of an insolvent school district. This administrator has the authority to "implement substantial changes in the district's fiscal policies and practices, including, if necessary, the filing of a petition under Chapter 9 of the federal Bankruptcy Act for the adjustment of indebtedness." Cal. Educ. Code § 41325(c). See also In re Richmond Unified School Dist., 133 B.R. 221 (Bankr. N.D. Cal. 1991). A recent bill introduced by Assembly Member McDonald (AB 2415) would clarify the scope of the state administrator's authority.

Similar trusteeship provisions exist for health care districts whose indebtedness is insured under the Cal-Mortgage Loan Insurance Program. The Office of Statewide Health Planning and Development is authorized to request that the Secretary of the Health and Welfare Agency appoint a trustee capable of exercising "all the powers of the officers and directors of the borrower, including the filing of a petition for bankruptcy." Cal. Health & Safety Code § 129173. A recent bill introduced by Senator Wright (SB 1922) would clarify the scope of the trustee's liability for other debts of the health care agency.

Although the availability of a trusteeship is an excellent idea, because it would avoid a political dispute and possible legislative delays over whether a trustee should be authorized in a particular case, the provisions of SB 349 raise some concerns:

1. Immediate appointment of a trustee upon the filing of the petition would "bifurcate" the case into two forums, perhaps spurring creditors to ignore the bankruptcy forum in the hopes of seeking a more favorable resolution from the trustee; this could cause unnecessary delay and expense in the bankruptcy case. Although the potential for a trustee should probably exist in every case, the conditions for appointment should be tied to specific bankruptcy milestones that implicate the interests of the state, e.g., rejection of the plan, inability to timely confirm a plan, impairment of public debt, or misconduct by public officials.

2. The trustee qualifications should incorporate some of the provisions of SB 1276, particularly respecting the trustee's status as a public official.

3. When should the trusteeship expire?

4. The delegation of powers provision should (a) permit the trustee to assume all or only specified local powers, with the corresponding

authority to refer or withdraw specified powers to or from local officials as and when required or appropriate; and (b) expressly authorize the trustee in all instances to exercise any or all powers of the municipality with respect to the conduct of the Chapter 9 case (e.g., filing a plan, issuing debt on behalf of the municipality, dismissing the case).

5. Would the trusteeship apply to charter cities and counties? Although a duly adopted charter has the force and effect of a legislative enactment, and would thus seem capable of being superseded or amended by the Legislature, some charter cities and counties dispute the validity of a trustee.

6. Although some form of trustee oversight is probably appropriate, the requirement that all "significant actions" must be reported by the trustee to the Local Committee is vague and could impede the conduct of the case. Parties might rely to their detriment on actions of the trustee which could then be overruled by the Local Committee. This would exacerbate the "dual forum" problem mentioned above.

Attached to this memo is suggested language for a trusteeship mechanism that creates the potential for a trustee in every case yet ties the actual appointment to an event that affects the interests of the state. Also, a trustee could be appointed within a brief window at the commencement of the case for the sole purpose of dismissing the case. Thus, the state would retain the ability to act as a "gatekeeper" without creating undue barriers to entry in meritorious cases. I would expect that the appointment of a trustee for purposes of immediate dismissal should be accompanied by some form of state relief (equivalent to the tacit responsibilities of the Local Committee if consent to file is denied).

IV. Conclusion

I believe the amendments proposed to Section 53760 under SB 349 would (i) update the statute to the current version of the Bankruptcy Code, (ii) clarify that "specific authorization" is being granted pursuant to Section 109(c), (iii) clarify the scope of eligible entities and, correspondingly, revise the ad hoc gatekeeper function, and (iv) create a flexible trusteeship mechanism for all municipalities which would be triggered based on specified criteria or time periods. The essential purpose of the trusteeship would be to enable the state to direct the conduct of the Chapter 9 case when it would serve the interests of other municipalities and the people of the state. The trusteeship mechanism would conform to provisions of the Bankruptcy Code which permit the state to "control" its municipalities and, correspondingly, prevent any bankruptcy court interference with the political or governmental powers of the municipality. 11 U.S.C. §§ 903, 904.

Suggested Language for Trusteeship Mechanism

Statement of Intent

It is intent of the Legislature to permit, under specified circumstances, the appointment of a trustee to manage the affairs of any public body that has commenced a case under Chapter 9 of Title 11 of the United States Code.

It is the further intent of the Legislature that the appointment of a trustee shall become effective when necessary to protect the health, safety and welfare of the residents of the state and the constituents of the public body, to foster the fiscal integrity of the state and its political subdivisions, to preserve access by the state and its political subdivisions to the public capital markets, or to otherwise expedite the timely confirmation of an acceptable plan of adjustment for the public body.

The trustee shall be vested with full and complete control over the public body and shall have the exclusive authority and discretion to direct the conduct of the Chapter 9 case and take any actions on behalf of the public body that are necessary and proper to formulate, confirm and implement an acceptable plan of adjustment.

It is the further intent of the Legislature that the trustee shall, to the extent practical depending on the circumstances of each case, defer to the officers or other governing board of the public body the principal responsibility to conduct the ordinary political and governmental functions of the public body.

Statute

(a) The Governor is authorized to appoint a trustee to oversee any public body that has commenced a case under Chapter 9 of Title 11 of the United States Code. The authority of the Governor may only be exercised upon the satisfaction of the conditions specified under subsection (c).

(b)(1) Upon the appointment of a trustee under subsection (a), all powers provided or granted by the Legislature to the public body, and all rights incident or essential to the exercise of those powers, shall be withdrawn and vested in the trustee. The trustee shall be immediately authorized to assume and exercise all powers of the public body, or direct the actions of the public body. Notwithstanding the foregoing, the trustee may at any time provide for the continued exercise by the officers and governing board of the public body of all or specified powers. The trustee shall attempt, to the extent practical depending on the circumstances of each case, to defer to the officers and governing board of the public body the principal responsibility for the conduct of the ordinary political and governmental functions of the public body. The trustee may reassume all or any powers of the public body whenever necessary or appropriate to the resolution of the Chapter 9 case.

(2) The trustee shall supervise the conduct of the Chapter 9 case and may, at any time, dismiss the Chapter 9 case. The trustee shall be exclusively authorized to take or prescribe such actions in the Chapter 9 case that are necessary to promote the timely confirmation of an acceptable plan of adjustment. In exercising the foregoing powers, the trustee shall be serving the public purpose of a speedy and just resolution to the Chapter 9 case and the restoration of the fiscal integrity of the public body.

(3) This subsection shall not be construed to expand the privileges or powers delegated to any public body by the Legislature. The trustee may only assume those powers of a public body granted under the existing and subsequently enacted laws of the state, and may only exercise such powers in a manner consistent with such laws.

(c) The Governor may appoint a trustee under subsection (a) under the following circumstances:

(i) within 30 days following the commencement of the Chapter 9 case for the purpose of causing the public body to voluntarily dismiss its Chapter 9 case; or

(ii) at any time during the Chapter 9 proceedings if the Governor or his or her designee determines that (1) the public body is or will be unable to provide essential health, safety or welfare services to its constituents, (2) the financial status of the public body may jeopardize the ability or increase the costs of the state or its political subdivisions to issue debt or borrow money, (3) the principal creditors in the Chapter 9 case have failed to reach substantial agreement on the terms of a plan of adjustment, (4) the timely confirmation of an acceptable plan of adjustment appears unlikely, or (5) the appointment of a trustee is otherwise in the interests of the state, its residents and other public bodies within the State.

(d) The trustee shall exercise the powers conferred under this section until the later of (i) the date the Chapter 9 case is dismissed, (ii) the date a plan of adjustment is consummated, or (iii) any other date fixed by the Governor to promote the satisfactory resolution of the Chapter 9 case. In fixing a date for the expiration of the trustee, the Governor or his or her designee shall consult with the officers and governing body of the municipality and the representatives of creditors in the Chapter 9 case. The Governor may also terminate the services of the trustee if the trustee is unable or unwilling to carry out his or her duties as specified in this section. Upon the termination of the trustee, all powers vested in the trustee shall revert to the public body.

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By

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Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code

By Amy Chang*

Abstract

Municipalities can seek protection from their creditors by filing for bankruptcy under Chapter 9 of the federal bankruptcy law, but only if state law authorizes them to file. Once the state has given its permission, federal bankruptcy law preempts any state action that would prevent the municipal debtor from enjoying the "breathing space" federal law creates in order to allow debtors to formulate a debt readjustment plan.

The state may, however, attach conditions to its permission to file for bankruptcy protection. For example, the state may require municipalities to seek the prior approval of some state body, to accept appointment of a state trustee, or to submit to state control over the municipal debt readjustment plan. The Constitution requires federal bankruptcy law to respect state sovereignty, such conditions are generally valid, at least so long as the primary benefits of bankruptcy protection -- the automatic stay of debt collection actions and the power to reorganize debt -- are not destroyed.

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I. INTRODUCTION

Federal municipal bankruptcy laws were first introduced in 1934 during the depths of the Great Depression as municipalities across the country struggled to provide necessary services while facing a dramatic drop in tax revenues. The enactment of federal bankruptcy laws allowing municipalities to impair debt was necessary because of the inadequacy of traditional state remedies.

Prior to the establishment of federal bankruptcy laws, the principal state remedy for creditors was an action for mandamus to compel increased taxes.[1] However, imposing new taxes was often counterproductive because of the inability or unwillingness of the citizenry to pay, the rush of individual creditors filing separate mandamus suits, and the "hold-out" problem among creditors.[2] Rather than enter a voluntary comprehensive agreement with the city and creditors, minority creditors often derailed efforts to reach voluntary agreements by "holding-out" to use the mandamus remedy to get a tax levy for full payment.[3]

At the same time, state law could not force an unwilling creditor to compromise his claim without violating the constitutional prohibition against state impairment of contracts.[4] Thus, without a federal bankruptcy law which permitted municipalities to scale down their indebtedness and bind all creditors, both creditors and debtors were "at an impasse to neither's advantage".[5]

The fundamental objective underlying the enactment of federal municipal bankruptcy law is to provide court protection for distressed municipalities, allowing them to adjust their debts in a manner which enables them to continue to provide essential public services.[6] Unlike private individuals or corporations, a municipality cannot liquidate all of its assets to satisfy creditors. Chapter 9 provides a municipal debtor with two primary benefits: (1) a breathing spell with the automatic stay; and (2) the power to readjust debts through a bankruptcy plan process.[7]

Federal law permits municipalities to seek protection from their creditors by filing for bankruptcy under chapter 9, but only if the state specifically authorizes its municipalities to file.

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[1] Michael McConnell and Randall C. Picker, When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy, 713 Practicing Law Institute 35, 12 (1995); 4 Collier on Bankruptcy, P 900.01 at 900-2 (L. King 1994).

[2] Id.

[3] McConnell and Picker, supra note 1, at 13.

[4] U.S. Const. art. I., § 10, cl. 1; See Appendix A.

[5] David L. Dubrow, Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?, 24 The Urban Lawyer 3, 548 (Summer 1992).

[6] House Report No. 95-595, 95th Cong., 1st Session 263 (1977), U.S. Code Cong. & Admin. News 1978 pp. 5787, 6221.

[7] In re County of Orange et al. v. County of Orange, 179 Bankr. 185, 191 (Bankr Ct. C.D. Cal. 1995).

States have approached the authorization requirement in a variety of ways: some grant or deny authorization by state statute, others attach preconditions to authorization, and still others do not have statutes on the subject.[8] Currently, the state of California authorizes its taxing agencies and instrumentalities to file for Chapter 9 pursuant to state statute, without attaching any preconditions or requirements to the filing.

This paper will focus on the issue of state consent under the federal bankruptcy code, examining whether a state may impose preconditions on a municipal-debtor subject to authorization. Typical requirements proposed by the California Legislature and already in use by other states include: approval by a state body prior to filing, state appointment of a trustee, and state control over the municipal debt readjustment plan.[9] The following pages will describe the federal bankruptcy statutory and constitutional framework for evaluating these state requirements.

[8] See Appendix B for Sample Survey of State Authorization Statutes.

[9] See Appendix C for Survey of California Legislative Proposals.

II. FEDERAL BANKRUPTCY LAW REQUIRES THAT THE STATE SPECIFICALLY AUTHORIZE A MUNICIPALITY TO FILE FOR CHAPTER 9.

Section 109 of Chapter 9, the federal bankruptcy statute, describes the requirements for filing for bankruptcy, including the requirement of specific, state authorization. The state of California grants specific authorization by statute in Cal Govt Code § 53760.

The absence of authorization would violate state sovereignty because the state has ultimate control over its municipalities. A state's power to grant or deny consent may also include the power to force a municipality to file for chapter 9.

Federal Bankruptcy Law

11 U.S.C. § 109. Who may be a debtor

(c) An entity may be a debtor under chapter 9 of this title if and only if such entity ---

(1) is a municipality;

(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; and

Federal Bankruptcy Law

11 U.S.C. § 109 (continued)

(c)(5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(c) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.[10]

California Authorization Statute

Cal Gov Code § 53760. Right to file proceedings in bankruptcy

Any taxing agency or instrumentality of this State, as defined in Section 81 of the act of Congress entitled "An act to establish a uniform system of bankruptcy throughout the United States," approved July 1, 1898, as amended, may file the petition mentioned in Section 83 of the act and prosecute to completion all proceedings permitted by Sections 81, 82, 83, and 84 of the act.[11]

A) State Consent is Critical to the Constitutionality of Chapter 9.

Much of the structure of Chapter 9 is shaped by two federal constitutional restraints: the Contracts Clause and the 10th Amendment.[12] On the one hand, the Contracts Clause prohibits the states from passing any law which impairs contracts,[13] and gives Congress the power to establish uniform bankruptcy laws.[14] Therefore, a state cannot pass laws which would relieve a municipality of its debts. (A more detailed treatment of the state's power to readjust debts will

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[10] 11 U.S.C. § 109© (1995).

[11] Cal. Gov Code § 53760 (1995).

[12] U.S. Const. art I, §§ 8, 10; See Appendix A.

[13] U.S. Cont. art. I., § 10; See Appendix A.

[14] U.S. Const., art. I, § 8, cl. 4; See Appendix A.

follow in Part III, Chapter II). On the other hand, the interest of protecting state sovereignty under the 10th Amendment overrides Congress' explicit federal bankruptcy and limits the degree of federal intrusion into municipal and state governance.[15]

In keeping with the deference to states under the 10th Amendment, federal bankruptcy law does not give municipalities powers independent of those granted by the state. Rather it is the state which must decide whether to empower its municipalities to utilize federal bankruptcy laws. The Supreme Court upheld the constitutionality of the 1937 Municipal Bankruptcy Act in Bekins v. Lindsay-Strathmore Irrigation District:

> The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by the state legislation. The bankruptcy power is competent to give relief to debtors in such a plight. . . . The state acts in aid, and not in derogation, of its sovereign powers. It invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue.[16]

In other words, federal bankruptcy law is a valid exercise of federal power and not an unconstitutional intrusion on state sovereignty insofar as it requires the municipal-debtor to obtain state consent, the filing is voluntary and not forced upon the municipality by the federal courts, and judicial control over state property and revenues is limited. This deference to state sovereignty is codified in the requirement for specific state authorization and other provisions of the federal bankruptcy code.

B) Under Federal Bankruptcy Law, the State Specifically Authorizes the State a Municipality To File For Chapter 9, and Consent May Not Be Implied.

After the 1994 Bankruptcy Reform Act, state consent cannot be implied or "generally authorized" but must be "specifically authorized".[17] This reaffirmation of state control over a

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[15] U.S. Const., amend. X; See Appendix A; Bekins v. Lindsay-Strathmore Irrigation District, 304, U.S. 27, 58 (1942).

[16] Id. at 53-54 (The Supreme Court struck down the first municipal bankruptcy statute enacted in 1934 as an unconstitutional infringement on state sovereignty in Ashton v. Cameron County Water Improvement District, 298 U.S. 513 (1936). Bekins overturned Ashton to uphold the constitutionality of federal bankruptcy protection for municipal debtors.)

[17] The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (Enacted on October 22, 1994 and effective in cases filed after that date.); See Collier, supra note 1, at 900-17; S. Rep. No. 989, 95th Cong., 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News 5787, 5896-5897. (According to the legislative history, the new language was intended to clarify the split in the courts over the interpretation of "generally authorized". The "generally authorized" language was itself a compromise between earlier House and Senate bills: the House bill provided that a municipality must not be prohibited from filing while the Senate bill required specific state authorization. The earlier Senate version appears to have eventually prevailed in the 1994 Bankruptcy Reform Act. According to those earlier Senate discussions, "[a]bsent . . . a requirement for affirmative action by the state, a serious constitutional question would be raised in connection with the

chapter 9 filing was prompted by the chapter 9 filing of Bridgeport, Connecticut. In 1991, Bridgeport, with a population of 140,000 and a $2 million dollar debt, became was the largest city at that time to have attempted to utilize federal bankruptcy protection.

In In re City of Bridgeport, the court found implied state consent from state home rule delegation despite the vigorous opposition to the filing by the state and a state-created Financial Review Board.[18] The court reasoned that the "or" language contained in § 109(c)(2) did not imply *exclusive* authorization from one source, but included the possibility of different sources of "general" authorization. Thus, the objections by an entity empowered to give authorization did not change the implied authorization which existed under home-rule delegation.[19]

In the only post-1994 Bankruptcy Reform Act case on the subject of "specific" authorization, the bankruptcy court in the Orange County bankruptcy has interpreted 109(c)(2) to require statutory consent that is "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication".[20] The court rejected the argument that the state of California intended to broadly authorize *an instrumentality of a county* to file to chapter 9, and dismissed the bankruptcy petition of the Orange County Investment Pool (OCIP) on the basis that it was not a "municipality" nor was it "specifically authorized" to file.[21]

The California statute specifically authorizes federal bankruptcy filing for "any taxing agency or instrumentality of the state" as defined by federal bankruptcy law.[22] In other words, California's determination of "who" can file is co-extensive with the federal bankruptcy code's definition of a "municipality". The federal bankruptcy code's definition of "municipality" was itself ambiguous, however, according to the bankruptcy court in the Orange County case.[23] The court ultimately concluded that an instrumentality of a county was not an instrumentality of the state authorized to file for chapter 9 under California statute, because a *narrow* interpretation of state authorization was necessary in order to maintain state control over municipalities and limit federal intrusion into state sovereignty:

10th Amendment.")

[18] In re City of Bridgeport, 128 B.R. 688, 688 (Bankr. Ct. D. Conn. 1991).

[19] Id. at 693.

[20] In re County of Orange; Orange County Investment Pools, 183 B.R. 594, 604 (Bankr. Ct. C.D. Cal. 1995).

[21] Id. at 605.

[22] Id.; Cal Govt. Code § 53760 (1995) (California's authorization statute was passed in 1949 and refers to the § 81 of an earlier bankruptcy code which was eventually included in the 1937 Bankruptcy Act. Section 81 provides a list of types of public entities that are authorized to file. Amendments to the 1976 bankruptcy code enacted § 84 intended to broadened the applicability of Chapter 9, by more generally categorizing the list of entities contained in § 81. (H.R. Rep. No. 686, 94th Cong., 2nd Sess. 20 (1975). § 84 is nearly identical to that of §101(4) of the federal bankruptcy code in defining a "municipality" as a "political subdivision or public agency or instrumentality of the State.").

[23] Id.

> First, Congress could easily have written Sec 101(4) to include instrumentalities of a County, public agency or political subdivision, but did not. . . . *Second, this leap of logic presents potential Constitutional problems because it would reduce state control over those entities entitled to file chapter 9.* Lastly, interpreting Sec. 101(4) this way would blur the boundaries surrounding the term "municipality" to the extent that any entity set up by a political subdivision or public agency would qualify for chapter 9.[24]

This interpretation of §109(c)(2) after the post-1994 Bankruptcy Reform Act emphasizes specificity and statutory authorization. The court in the Orange County bankruptcy, in dicta, suggested that the state could comply with the federal bankruptcy code's requirement for specific state authorization by identifying entities by specific category in the state statute.[25] For example, the state may authorize all "municipalities" to file as defined by the federal bankruptcy code, or the state could also name specific entities within certain categories or reference to the actual name of the municipality.[26]

C) A State May Deny a Municipality Authority to File For Chapter 9.

A state's power to grant consent to file also includes the converse authority to deny authorization.[27] A handful of states, such as Georgia and Iowa, directly prohibit filing.[28]

The 1994 Bankruptcy Reform Act's requirement of "specific" state authorization reaffirms state control over the chapter 9 filing and lends support to state authority to deny authorization.[29] Although the court in the pre-1994 Bridgeport case recognized Bridgeport's chapter 9 filing despite vigorous opposition from the state of Connecticut, Bridgeport does not support the view that the state may not deny authorization.[30] In Bridgeport, the court did not find that the city circumvented state authority denying authorization to file chapter 9, the court merely found that there was implied authorization from other sources. However, in practice, commentators have suggested that the city of Bridgeport was attempting to use federal bankruptcy as an "alternative (perhaps an escape) from the strictures of state supervision)".[31]

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[24] In re Orange County, 183 B.R. at 602 (emphasis added).

[25] Id. at 604.

[26] Id.

[27] Bekins, 304 U.S. at 58 (In dicta, the Supreme Court suggested that a potential constitutional obstacle to the 1937 Municipal Bankruptcy Act was the right of states to *prevent* their municipalities from seeking federal bankruptcy protection. The Court did not reach this issue, because the state of California had granted authorization in Bekins.)

[28] See Appendix B.

[29] 1994 Bankruptcy Reform Act, supra note 16.

[30] In re Bridgeport, 128 B.R. at 688.

[31] McDonnell and Picker, supra note 1, at 17.

D) Federal Bankruptcy Law Probably Does Not Prohibit the State From Forcing a Municipality to File for Chapter 9.

There is no case law on the issue of whether a state may force a municipality to file for chapter 9. The resolution of this issue probably pertains more to state constitutional issues regarding state governance of municipalities, rather than federal bankruptcy law. Federal bankruptcy law prohibits "involuntary" filings, *in deference to state sovereignty*.[32] Since a forced filing by the state would not implicate state sovereignty, federal bankruptcy law probably does not pose a constraint to state exercise of such power.

While the 1994 Bankruptcy Reform Act clarified that authorization must be "specific", the language of 109(c)(2) as highlighted in the earlier Bridgeport discussion allows authorization from different state sources "by State law, *or* by a governmental officer *or* organization empowered by State law to authorize such entity to be a debtor . . .."[33] For example, the state of New York provides that a municipality *or* its state-created financial review board may file for federal bankruptcy protection.[34] In the event that a municipality refuses to file for chapter 9, this conflict would most likely be governed by state law, rather than federal bankruptcy law because it involves two state bodies empowered to grant authorization.

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[32] Bekins, 304 U.S. at 58.

[33] 11 U.S.C. § 109(c)(2) (1995); In re Bridgeport, 128 B.R. at 693 (In Bridgeport, the court interpreted the "or" language as indicating that the power to grant authorization may exist in several sources, thus finding that a governmental body which denied authorization did not bar a finding of implied consent from state statute authorizing home rule. After the 1994 Bankruptcy Reform Act, authorization may not be implied, but must be specific.)

[34] NY CLS Loc Fin § 85,80 (1994); See Appendix B.

III. THE STATE MAY ATTACH PRECONDITIONS TO STATE AUTHORIZATION AS LONG AS SUCH REQUIREMENTS DO NOT UNDERCUT THE EFFICACY OF CHAPTER 9.

States have a strong interest in preventing their municipalities from filing bankruptcy, in order to protect the credit of all municipalities in the state. By imposing preconditions prior to granting authorization to file, the state may be able to discourage frivolous filings, and maintain control of the municipal-debtor during bankruptcy. However, the gate-keeper function appears to be less critical in light of the actual dearth of frivolous chapter 9 filings: over the entire history of chapter 9 through 1991, a total of 452 chapter 9 cases were filed, mostly among special purpose districts.[35]

Typically, states have focused on the following requirements in exercising control over municipal-debtors: a) the state serves as a gate-keeper by requiring prior approval before filing; b) the state controls the debtor during bankruptcy through the appointment of a trustee who acts on behalf of the municipal-debtor and proposes a plan of readjustment; and c) the state enacts state "bankruptcy" procedures in the form of municipal-distress statutes which may run concurrently with federal bankruptcy laws.

The state's authority to control the municipal debtor is independent of federal bankruptcy law. A municipality may file for chapter 9 only with state consent. In other words, since municipalities do not have any federal bankruptcy powers independent of those granted by the state, and what power the municipality has under state law is delegated by the state, the state is free to attach requirements to its authorization statute.

The only apparent limitation imposed by federal bankruptcy law is that the state may not impose requirements which undercut the efficacy of chapter 9.

Thus, federal bankruptcy law does not dictate that state control over the municipal-debtor must be enacted as a *precondition* to filing, because such requirements may be imposed at *anytime* by the state. For example, the state of Pennsylvania liberally grants authorization to file chapter 9, but the *effect* of filing chapter 9 automatically triggers the appointment of a state plan coordinator, and subjects the municipality to state procedures which act concurrently with the federal bankruptcy laws.[36] The Pennsylvania authorization statute has the advantage of flexibility

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[35] McDonnell and Picker, supra note 1, at 22 (There have been a total of 452 chapter 9 filings over the history of federal bankruptcy statute through 1991: 362 municipal bankruptcy cases were filed between 1938 and 1972 and of that number 95% were filed before 1952; from 1972 to 1991, there were an additional 90 chapter 9 filings. Excluding the special purpose districts, which are the large majority of insolvent municipal debtors, *there have been only three Chapter 9 filings by general municipalities between 1972 and 1984,* and none of these were related to the long-term financial health of the cities. In 1991, Bridgeport, Connecticut with a population of 140,000 and a $2 million dollar debt was the largest city at that time to have *attempted* to utilize Chapter 9; the case was eventually dismissed for not meeting the "insolvency" requirement. In 1994, Orange County of California became the largest municipality to file for Chapter 9 reporting a $1.7 billion loss on a $7.4 billion dollar investment pool.)

[36] 53 P.S. §§ 11701.261-11701.263 (1995); See Appendix B. for language of statute; Ronald K. Snell and Scott Makey, "Locals in Distress: What Can States Do?" the Fiscal Letter - A Bimonthly Report on Government Finance

in both retaining state control over the municipality while not unduly delaying or preventing a bankruptcy filing.

The structure of the Pennsylvania statute is itself also shaped by state constitutional constraints. For example, Pennsylvania's constitution prohibits state interference into local government and enactment of special legislation affecting only one or a few local governments.[37] Under the authorization statute, compliance with state aid procedures are voluntary rather than mandatory, and the municipal-debtor has the option of rejecting any readjustment plan proposed by the state appointed fiscal coordinator. If the municipal-debtor rejects the state proposed readjustment plan, it then runs the risk of losing state grants and funding.[38]

Although this paper does not explore California's state constitutional constraints, it underscores the importance of the state constitution and state law in shaping the state's control of a municipal-debtor. The focus on the remaining analysis will be on how federal bankruptcy law effects the types of requirements which a state may impose on a municipal-debtor.

A) Federal Bankruptcy Law Limits Judicial Interference into State and Municipal Governance Thereby Allowing the Municipal-Debtor to Maintain Control of Its Fiscal Affairs During Bankruptcy.

Together, sections 903 and 904 preserve the constitutionality of the federal bankruptcy laws by severely curtailing the power of the federal court's interference into municipal affairs.[39]

The hands-off policy reflected in these sections preserve the state's authority to control the municipal-debtor.

§ 903 Reservation of State Power to Control Municipalities

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but ---

(1) a state law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and

(2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

Issues in the State, Vol. XIII, No. 3 p. 7-8 (Published by National Conference of State Legislatures, May/June 1991).

[37] Id.

[38] Id.

[39] Id. at 904-2; B.R. Rep. No. 94-686, 94th Cong., 1st Sess. 18 (1975).

§ 904. Limitations on jurisdiction of the powers of the court.

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court, may not, by any stay, order, or decree, in the case or otherwise, interfere with —

(1) any of the political or governmental powers of the debtor;

(2) any of the property or revenues of the debtor; or

(3) the debtor's use or enjoyment of any income-producing property.[40]

The purpose of the unequivocal language protecting state sovereignty in § 903 is "to remove any inference that the legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness."[41] Because a municipality's level of expenditures is viewed as an inherently political issue, federal courts are not allowed to interfere with democratic decision-making by appointing a trustee to manage or control the municipal-debtor.[42]

According to critics, the freedom to set spending priorities removes "one of the principal disincentives to fiscal irresponsibility" and is the chief difference between municipal and private bankruptcy.[43] Creditors cannot force an involuntary filing, submit their own plan of reorganization, move for the appointment of a trustee, or contest decisions of the municipality regarding its property and revenues.[44] Instead, the creditor's primary tools are to object to the bankruptcy filing or the plan of confirmation, while the court's sole remedy when a debtor fails to propose a plan on a timely basis or a plan which cannot be confirmed is to dismiss the case.[45]

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[40] 11 U.S.C. §§ 903, 904 (1995).

[41] Collier, supra note 1, P 903.02. at 903-3.

[42] In re Richmond Unified School District, 133 B.R. 221, 224 (Bankr. Ct. N. Dt. 1991) (The court may appoint a trustee pursuant to § 926 for the limited purpose of prosecuting avoidance actions.); See also John Jacobs, "Orange County's Leadership Crisis," Sacramento Bee, June 25, 1995 (Although municipal bankruptcy law prevents court intervention into the governmental affairs of the city, critics note that the problem of financial distress may indeed reflect a failure in the democratic political process. According to an analyst with the Moody Investors of New York, "This event in Orange County (bankruptcy) is indicative of risk, the breakdown of local governance and the inability to find a solution. We view the passive approach the state has taken to his problem pretty negatively."); "A Trustee for Orange County," Sacramento Bee, June 30, 1995 (The recent defeat of the sales tax measure prompted another commentator to write: "Orange County is not broke; it is unable, or unwilling, to govern itself and take responsibility for its debt.")

[43] McConnell and Picker, supra note 1, at 12.

[44] Dubrow, supra note 5, at 552.

[45] Id.; In re Richmond Unified School District, 133 B.R. at 221.

B) The State May Appoint a Trustee At Anytime.

While *the court* is prohibited from appointing a trustee to manage the affairs of the municipal-debtor after a chapter 9 is filed pursuant to § 904,[46] the statute is silent on whether and when a state may appoint a trustee. The likely interpretation of the federal bankruptcy code is that a state appointment of a trustee as a precondition to filing or as an effect of filing or even during bankruptcy is valid, because such state authority would exist independent of federal bankruptcy law. A hands-off policy is further supported by § 903 which denies federal bankruptcy power to "limit or impair the power for the State to control, by legislation or otherwise, a municipality".[47]

In In re Richmond Unified School District, the bankruptcy court held that the debtor-school district was entitled to dismiss its chapter 9 case, even though there was an alleged conflict of interest between the state and the school district.[48] While this case pertains to a dismissal of a chapter 9 case, the court's rationale explaining the lack of bankruptcy court authority to dismiss a state-appointed Administrator is applicable to the present issue of the state's discretion to appoint a trustee:

> In the first place, unless the Administrator is divested of authority for reasons unrelated to the matters now before the court, he will retain control of the District, whether or not the court dismisses the case, because, as previously mentioned, the court may not interfere with the District's management, section 904. . . . Secondly, and more significantly, Chapter 9 was drafted to assure that application of federal bankruptcy power would not infringe upon the sovereignty, powers and rights of the states, including, presumably, states alleged to have a conflict of interest.[49]

As a state matter, states vary as to the degree of authority delegated to a trustee. For example, New Jersey, Connecticut, and Kentucky simply give a state appointed official or body the power to approve a filing.[50] On the other hand, after Richmond School District filed for bankruptcy, the state of California appointed a trustee to assume all the legal rights and duties of the District's governing board as consideration for an agreement to loan the school district $19 million dollars.[51] The California State Legislature has recently gone even further by appointing a

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[46] Id. at 224 (The court may appoint a trustee for the limited purpose of prosecuting avoidance actions pursuant to § 926.).

[47] 11 U.S.C. § 903 (1995).

[48] In re Richmond Unified School District, 133 B.R. at 221 (Creditors argued in opposing the motion by the state and debtor-school district to dismiss the bankruptcy case, that the school district had a conflict of interest as the largest creditor (owed $36 million dollars) and as the Administrator of the school-district.)

[49] Id.

[50] See Appendix B.

[51] In re Richmond, 133 B.R. at 222.

trustee who will assume all powers granted to the Orange County Board of Supervisors if a readjustment plan is not filed by the County by January 1, 1996, *and* the voting power of the public creditors in order to prevent a denial of a confirmation plan.[52] If a trustee and a plan are approved, the Orange County Transportation Authority will receive $1.917 million dollars annually from 1997 to 2013.[53]

C) A State May Control the Formulation of the Debt Readjustment Plan.

Under Chapter 9, the imposition of a binding readjustment plan allows a municipality to resolve the hold-out problem among creditors. The power to "impair contracts" or scale down debts is unique to federal bankruptcy law; states are prohibited from "impairing contracts" under the Contracts Clause of the Constitution.[54]

1) The "Debtor" has the Exclusive Right to Propose a Debt Readjustment Plan In Chapter 9.

Under § 942, the "Debtor" has the exclusive right to propose a readjustment plan either with the filing of the petition or within such a time as the court directs.[55] This rule is dictated by the 10th Amendment of the Constitution which requires that a municipality, as a political subdivision of a state, be left in complete control over the political and governmental affairs even during a municipal bankruptcy.[56]

However, state sovereignty is not implicated when it is the state which attempts to control the municipal-debtor by approving or proposing a plan. Consequently, while the state is not the "debtor" per se, federal bankruptcy law does not appear to prohibit the state from acting on behalf of the municipal-debtor through an appointed trustee.[57] The primary constraints on state actions under the federal bankruptcy code regarding the validity of state requirements are: a) federal

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[52] Cal SB 1276, Chapter 747, Approved by the Governor October 9, 1995; Interview with Henry Kevane, Esq. and David Konig, Esq. of Murphy, Weir and Butler of San Francisco.

[53] Id.

[54] U.S. Const. art. I., § 10, cl. 1; See Chapter I; Appendix A.

[55] 11 U.S.C. § 941 (1995) (Chapter 9 creditors may not submit a plan but may vote on the plan or object to the confirmation. This stands in direct contrast to chapter 11 which allows a debtor an exclusive period to file a plan after which any party in interest may file a plan. A court will confirm a plan in chapter 9 if it is "in the best interest of creditors and is feasible" and meets with other requirements set out in § 943. However, a bankruptcy court may still confirm a plan over such a vote if the court believes the plan to be "fair and equitable" and does not discriminate against the objecting class of creditors.")

[56] Bekins, 304, U.S. at 58.

[57] See also 11 U.S.C. §§ 943(b)(4), 943(b)(6) (1995) (The state's authority to propose a readjustment plan as a trustee in a bankruptcy case is further supported by provisions reinforcing state sovereignty in the plan confirmation. For example, § 943(b)(4) prohibits confirmation if the plan proposes any state action that the debtor is prohibited from taking under applicable law, and § 943(b)(6) stipulates that the court's power to confirm a plan does not override the power of the electorate to veto an action proposed under the plan if the electorate had such power outside of Chapter 9.)

pre-emption of state policies which undercut the efficacy of chapter 9; and b) uncertainty regarding whether federal bankruptcy law pre-empts all other independent state efforts to adjust debt, including state "bankruptcy" laws.

a) Courts Have Construed State Authorization to File for Chapter 9 As State Policy Favoring the Pre-emption of Federal Bankruptcy Law over State Policies Which Undercut the Efficacy of Chapter 9.

Although § 903 reserves state power to control municipalities, the federal bankruptcy courts have not interpreted this provision to limit the application of *substantive* provisions of Chapter 9.[58] In Alliance Capital Management L.P. v. County of Orange, movants brought a motion for relief from stay in order to file a writ of mandate in state court to force the County to set aside certain revenues to pay noteholders. Movants argued that relief was necessary because state court provided the only forum to adequately protect movants' interests (the only forum to compel the County to make set-asides), and granting relief from the stay would further the Congressional policy of providing "maximum flexibility to states in solving the debt problems of municipalities."[59] The bankruptcy court rejected both arguments reasoning that by filing Chapter 9, the County has consented to the bankruptcy court's jurisdiction and the court's power to order adequate protection as a condition for continuance of the automatic stay.[60] More importantly, the bankruptcy court also rejected the argument that § 903 intended "maximum flexibility for the states" to solve municipal debt problems on the basis that "§ 903 will should not be interpreted to undercut the efficacy of Chapter 9".[61]

In other words, the court refused to lift the stay so that a creditor could pursue a writ of mandamus in state court, because the main benefits of chapter 9, which include the "breathing spell" provided by an automatic stay and the power to adjust debts through a binding plan process, would be lost.[62] Moreover, the court reasoned that removing these primary benefits could not be the intent of Congress in enacting federal bankruptcy law, nor of the State of California in authorizing its municipalities to use chapter 9.[63]

Similar reasoning was applied in In re City of Columbia Falls, Montana, Special Improvement District No. 25 where the court rejected state efforts to prevent a municipal-debtor from impairing their obligations to bondholders *after* the state had already authorized the chapter

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[58] Collier, supra note 1, P 903.02 at 903-4 to 903-5; Alliance Capital Management L.P. v. County of Orange, 179 Bankr. 185 (Bankr. Ct., C.D. Cal. 1995); In re City of Columbia Falls, Montana, Special Improvement Dist., No. 25, 143 B.R. 750 (Bankr. Ct., D. Mont. 1992).

[59] Alliance, 179 Bankr. at 191.

[60] Id. at 189.

[61] Id.

[62] Id.

[63] Id.

9 filing.[64] Under state law, the City of Columbia was required to fund a revolving fund until all bonds and interests were "fully paid and discharged".[65] The court concluded that federal bankruptcy law superseded these state law requirements to allow the municipal-debtor to modify or extinguish the municipality's obligations to bondholders.[66] The court reasoned that the federal bankruptcy pre-emption of state law in this case was not an unconstitutional interference with state powers in violation of the 10th Amendment of the Constitution and § 903 of the federal bankruptcy statute:

> Far from interfering with the ability of the state of Montana to control its municipalities, it is concluded that Montana has affirmed that its municipalities may avail themselves of the benefits of the federal bankruptcy process, including the modification and termination of these sorts of debts, and as such does not interfere with the power of the State of Montana to control a municipality or in the exercise of the political or governmental powers of such municipality.[67]

In Bridgeport, the bankruptcy court went even further than Alliance or Columbia Falls to narrowly construe the power of the state to control the municipal-debtor during bankruptcy. The Bridgeport court denied the state the authority to approve a plan of readjustment.[68] Although the state of Connecticut had created a Financial Review Board with authority to approve Bridgeport's budget and all borrowing, the court held that a "budget" was conceptually different from a (readjustment) "plan".[69] This distinction appears rather superficial.

As discussed earlier in Chapter I, Bridgeport may be distinguished on the narrow ground that the court found implied state consent to file for bankruptcy.[70] The 1994 Bankruptcy Reform Act overturned the implied consent concept and reaffirmed state control of the chapter 9 filing by requiring "specific" authorization.[71] Nevertheless, a reaffirmation of state control over the filing of the bankruptcy may not be equivalent to reaffirmation of state control of the municipal-debtor during the bankruptcy *after* the state has granted authorization.

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[64] In re City of Columbia Falls, 143 B.R. at 759.

[65] Id. at 757.

[66] Id. at 758.

[67] Id. at 759.

[68] Bridgeport, 128 B.R. at 699.

[69] Id. (A "plan" involved a readjustment of pre-petition obligations, while a "budget" pertained to future expenditures.)

[70] Id.

[71] 1994 Bankruptcy Reform Act, supra note 16.

However, the better view following Alliance and Columbia Falls, is that state actions which do not undercut the efficacy of Chapter 9 are valid. The courts have construed state consent as a state policy to avail municipalities of the primary benefits of the automatic stay and debt readjustment provisions of the federal bankruptcy code. Thus, federal bankruptcy appears to pre-empt state law that prevents the municipal-debtor from exercising the opportunity to readjust debt. To the extent that chapter 9 is applied in such a manner as to impair or limit state control of the municipality beyond the automatic stay and debt readjustment provisions, the state would have standing to challenge this under § 903.[72]

The precise balance between federal bankruptcy law and state law remains an open question.[73] Federal bankruptcy law does not provide definitive limits on state authority, short of state actions which deny a municipality the opportunity to impair debt. The courts have construed state consent to file for chapter 9 as consent to allow federal pre-emption of state policies which undercut the efficacy of chapter 9. To the extent that courts are examining state intent as instructive on federal pre-emption, a state authorization statute subject to preconditions expresses a conditional grant of state authorization and may deny federal pre-emption in those areas specified. On the other hand, federal bankruptcy law's deference to state sovereignty already suggests a narrow scope for federal pre-emption limited to creating "breathing space" for the Debtor to formulate a readjustment plan.

b) The State May Enact State "Bankruptcy" Procedures Which Do Not Impair Contracts In Violation of the Contracts Clause of the U.S. Constitution.

As discussed earlier, states may appoint a trustee who assumes the duties and legal rights of the municipal-debtor *within* the federal bankruptcy framework. Alternatively, numerous states have enacted the equivalent of state bankruptcy procedures through municipal distress statutes such a those found in New York and Pennsylvania, which may act concurrently with federal bankruptcy laws.[74] The latter approach, while not the focus of this paper, raises questions concerning the constitutionality of state "bankruptcy" procedures, as well as pre-emption issues when federal and state laws conflict.

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[72] Collier, supra note 1, P 903.02 at 903-5.

[73] See also Laura Jereski, "Who Bears the Loss Becomes Critical Orange County Issue," The Wall Street Journal, January 10, 1995; Interview with Henry Kevane, Esq. and David Konig, Esq. of Murphy, Weir and Butler of San Francisco; In re Orange County, Response to Official Committee of Unsecured Creditors of the County of Orange to Various Objections to the Motions for Dismissal of Chapter 9 Petitions Filed by Orange County Investment Pools and County of Orange, Case No. SA 94-222272-JR, p. 6, March 28, 1995 (In the dismissal of the investment fund (OCIP) bankruptcy petition in Orange County, an unresolved issue was whether federal bankruptcy law's goal of equality in distribution among creditors would override state trust law. If a trust was not recognized, then Investment Pool participants would be general unsecured creditors, and would share pro rata in the distribution of funds. The dismissal of the OCIP's bankruptcy petition prevented a resolution of this issue.)

[74] NY Stats, Title 6-A, commencing § 85.00 (1995); Penn Code, Chapter 30, Financially Distressed Municipalities Act; See Appendix B; Snell and Mackey, supra note 35.

Conceptually, federal bankruptcy laws were enacted by Congress and made available to states to get around the U.S. Constitutional prohibition against state impairment of contracts.[75] § 903(1) of the federal bankruptcy code attempts to codify this principle by prohibiting state law from prescribing a "method of composition of indebtedness" without the consent of creditors, However, as Collier points out, it is not clear whether § 903(1) is co-extensive with the Contracts Clause.[76] In other words, a state law that adjust debts but complies with the Contracts Clause may be a valid exercise of state authority, thereby making §903(1) an unconstitutional intrusion on state sovereignty.

There are two cases suggesting that state *extension* of municipal debt with no reduction in principal payments is not an impairment of contracts in violation of the Contracts Clause. In Faitoute Iron & Steel Co. v. City of Asbury, the U.S. Supreme Court upheld a 1933 New Jersey law that permitted a state plan of adjustment of municipal debt over the objection of minority creditors if the city and 85% of the creditors agreed.[77] However, in 1946 Congress reacted to Faitoute by adding the amendment prohibiting state composition of debt which is reflected today in § 903(1). According to the legislative history, the amendment was intended to pre-empt state bankruptcy law and provide uniform federal law for the adjustment to municipal debt.[78]

In more recent history, the bankruptcy court in Ropico, Inc. v. City of New York upheld the New York State Emergency Moratorium Act for the City of New York as an extension of debt, and not an impairment of contract in violation of both the Contracts Clause of the Constitution and the jurisdiction by the federal bankruptcy court over impairment of contracts.[79] Technically, the City of New York did not utilize federal bankruptcy protection, but relied upon remedies provided by the state municipal-distress statute. The New York Moratorium Act suspended payment of principal on the city's short-term notes for three years and reduced the interest after maturity to 6%.[80] According to the Ropico majority: as long as the contract rate of interest on the notes was paid until the original maturity date, the fact that a Moratorium Act provided for lower interest payment post-maturity did not render the Emergency Moratorium Act a "composition".[81]

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[75] Bekins, 304 U.S. at 51.

[76] Collier, supra note 1, at 903-9; (See Appendix B).

[77] Faitoute Iron & Steel v. City of Asbury, 316 U.S. 502, 502 (1942).

[78] H.R. Rep. No. 2246, 79th cong., 2d Sess. 4 (1946) ("State adjustment acts have been held to be valid, but a bankruptcy law under which the bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the United States, as the bonds of almost every municipality are widely held. Only under a Federal law should a creditor be forced to accept such an adjustment without his consent.")

[79] Ropico, Inc. v. City of New York, 425 F.Supp. 970, 977 (S.D. New York, 1976).

[80] Id.

[81] Id.; Under the U.S. Constitution, article I, § 8, the state may not impair contracts. (See Appendix A). 11 U.S.C. § 903(1) prohibits "state law prescribing a method of composition of indebtedness" which binds any creditor that does

In Ropico, a federal pre-emption issue was not addressed, because the court interpreted the Contracts Clause and the federal bankruptcy clause prohibiting impairment of contracts to be co-extensive and not violated by the New York State Moratorium Act for the City of New York.[82] However, in a related case of Subway-Surface Supervisors Assoc. v. New York City Transit Authority, involving suspension of wage increases in a collective bargaining agreement and preference payments to bondholders in response to the New York City fiscal crisis, the court held that the state's exercise of police powers overrode the Contracts Clause where such impairment was "reasonable and necessary to serve an important public purpose."[83] The court further held that such state actions were not deemed to be a "plan" of readjustment in violation of jurisdiction under the federal bankruptcy law.[84]

The New York experience reflects the court's flexibility in interpreting the state municipal distress statutes and the Contracts Clause to allow for state remedies outside of federal bankruptcy. State municipal distress statutes allow states to comprehensively and pro-actively assist municipalities in preventing default. For most municipalities, filing for federal bankruptcy is typically a last resort. The U.S. constitutional authority of states to enact parallel state bankruptcy procedures remains unclear given the limited case law on the subject.

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not consent to such composition.

[82] Id. at 977.

[83] Id.; See also Subway-Surface Supervisors Assoc. v. New York City Transit Authority, 44 N.Y.2d 101, 109 (1978).

[84] Id.

IV. CONCLUSION

A state has the power to grant or deny "specific" authorization for its municipalities to file for federal bankruptcy protection under 11 U.S.C. § 109(c)(2). The requirement of state consent protects state sovereignty from federal intrusion, and has been critical to the constitutionality of the federal bankruptcy law.

Since federal bankruptcy law does not grant the municipalities power independent of that delegated by the states, federal bankruptcy law does not bar state actions to control municipal debtors. Deference to state sovereignty is reflected in federal bankruptcy law under sections 903 and 904 which severely curtail the interference of federal courts and creditors in the governance of the municipality and the state. The unequivocal language of § 903's reservation of state power is "to remove any inference that the (municipal bankruptcy) legislation itself accomplishes anything more than providing a procedure under which municipalities may adjust their indebtedness."[85]

While the court and creditors cannot appoint a trustee or propose a plan of confirmation, this paper concludes that the state may take such actions at anytime. Where the state acts to control the debtor, state sovereignty is not implicated. The state may, in effect, assign powers from the municipality to a trustee who acts on behalf of the municipal-debtor, if such state authority is valid under state law.

State imposition of preconditions to filing a chapter 9 provides both a gate-keeper function to discourage frivolous filings and a mechanism to maintain state control over the municipal-debtor during bankruptcy. Generally, states have a strong interest in preventing a municipal bankruptcy filing in order to protect the credit of all municipalities in the state. However, federal bankruptcy law does not dictate that state measures to control the municipal debtor must be imposed *prior* to filing. The state could conceivably attach the requirements as a precondition, or as an effect of filing, or even enact *ad hoc* legislation during the bankruptcy case, because such state authority exists outside of federal bankruptcy.

Various factors may shape the structure of the state authorization statute, including the need for flexibility to prevent delays in emergency filings and the relationship between states and municipalities under the state constitution. As a subject for another paper, the analysis provided underscores the importance of state constitution and state law in defining the scope of state authority to control a municipal-debtor.

The effect of state consent has been construed by the bankruptcy courts as an expression of the state's willingness to allow federal bankruptcy laws to pre-empt state policies which undercut the efficacy of chapter 9. For example, since the primary benefits of chapter 9 are the automatic stays which allow municipalities "breathing space" to develop a plan and the power to readjust debts, the courts have denied creditors relief from stay to file writ of mandamus in state courts and also rejected state polices prohibiting a municipal-debtor from impairing debt. The

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[85] Collier, supra note 1, at 903-3.

court has reasoned that removing these benefits from a municipal-debtor is simply inconsistent with the state's authorization to file for chapter 9 in the first place.

Short of destroying the primary benefits of chapter 9 of an opportunity to readjust debt, federal bankruptcy law does not provide definitive limits on state actions. State requirements that do not undercut the efficacy of municipal bankruptcy would appear to be valid. To the extent that the courts construe state intent in ascertaining federal pre-emption, a conditional grant of authorization subject to state requirements would be evidence of the state's intent not to relinquish control over particular issues. However, the strong deference to state sovereignty under federal bankruptcy law suggests that the scope of federal pre-emption may already be narrowly limited to readjustment of debt.

Several cases have even suggested that the state may have the authority to enact state "bankruptcy" procedures through municipal distress statutes which extend debt. Numerous states such as New York and Pennsylvania have enacted municipal distress statutes providing for comprehensive state remedies which kick-in before chapter 9 and run concurrently with federal bankruptcy law. The limited case law in this area leaves open the question of whether states may enact state "bankruptcy" statutes which run concurrently with the federal bankruptcy law or pre-empt federal bankruptcy laws, yet not constitute a violation of the Contracts Clause of the Constitution.

CHAPTER ____

An act to repeal Sections 43739 and 53761 of, and to repeal and add Section 53760 of, the Government Code, relating to local agencies.

LEGISLATIVE COUNSEL'S DIGEST

SB 349, Kopp. Local agencies: bankruptcy.

Under existing law, any taxing agency or instrumentality of the state may file a petition and prosecute to completion bankruptcy proceedings permitted under the laws of the United States.

This bill would provide that a municipality may only file under federal bankruptcy law with the approval of the Local Agency Bankruptcy Committee that would consist of the Controller, the Treasurer, and the Director of Finance. The committee would be required to respond to a request for approval within 5 days or the request would be considered as approved.

The bill would authorize a county that has requested approval to file under federal bankruptcy law to require local agencies with funds invested in the county treasury to provide a 5-day notice of withdrawal before the county is required to comply with a request for withdrawal of funds by a local agency.

The bill would specify that it only applies to a municipality that files under federal bankruptcy law on or after the date that the bill becomes effective.

Existing law requires state agencies to provide notice of a meeting at least 10 days in advance of the meeting.

This bill would authorize the committee to provide notice of its meetings at least 24 hours in advance and would specify the manner in which notice shall be provided.

The people of the State of California do enact as follows:

SECTION 1. Section 43739 of the Government Code is repealed.

SEC. 2. Section 53760 of the Government Code is repealed.

SEC. 3. Section 53760 is added to the Government Code, to read:

53760. (a) Any municipality in this state, as that term is defined in paragraph (40) of Section 101 of Title 11 of the United States Code, may, with the written approval of the Local Agency Bankruptcy Committee, under the terms and conditions that the committee may impose, file for adjustment of debts pursuant to Chapter 9 (commencing with Section 901) of Title 11 of the United States Code.

(b) As used in this section, "committee" means the Local Agency Bankruptcy Committee consisting of the Treasurer, the Controller, and the Director of Finance.

(c) The committee shall provide its written response of consent or denial of consent to file for adjustment of debts under federal bankruptcy law not later than five calendar days from receipt of the request of a municipality.

(d) If the committee does not respond to the request within five days after receipt of the request, the request shall be considered approved.

(e) A county that has requested approval to file under subdivision (a) may require local agencies with funds invested in the county treasury to provide a five-day notice of withdrawal before the county is required to comply with a request for withdrawal of funds by a local agency.

(f) Notwithstanding subdivision (a) of Section 11125, the committee may provide notice of its meeting at least 24 hours in advance of the meeting. The notice shall be posted in a location in the municipality that is freely accessible to members of the public. The notice shall be delivered personally, by the United States mail, or by facsimile transmission to each local newspaper of general circulation whose circulation area reasonably includes the municipality and shall similarly be delivered to each radio or television station that has requested notice in writing. The notice shall be received by the newspaper,

radio, or television station at least 24 hours prior to the date of the meeting specified in the notice. In addition, if the Legislature is in session, the committee shall request that the meeting notice be published in the daily file of each house at least 24 hours prior to the date of the meeting.

(g) If the committee approves a filing under this section, that approval does not obligate the state, in any manner, regarding financing a plan for adjustment of the municipality's debts or any act relating to that financing.

(h) This section shall only apply to a municipality that files as a debtor, as specified in subdivision (a), on or after the effective date of this section.

SEC. 4. Section 53761 of the Government Code is repealed.