

# Factors for a Public Retirement System to Consider if a Municipality Seeks Relief under Chapter 9 of the Bankruptcy Code

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In recent years, several municipalities have sought relief under Chapter 9 of the Bankruptcy Code.<sup>1</sup> This article will review some basic background concerning a municipality's ability to file for relief, and factors a public retirement system should consider in the event of a filing by a municipality that participates in the system.

## ELIGIBILITY TO FILE

A proceeding under Chapter 9 is very different than under other chapters of the Bankruptcy Code. The Bankruptcy Court's role in a Chapter 9 proceeding is more limited. The Court must determine whether the petition was properly filed, and then at the end of the case must determine whether a plan for adjustment of debts is confirmable. Between those two points, the Bankruptcy Court cannot require the sale of assets; does not oversee the use of funds; does not interfere with political or governmental powers; cannot require tax increases; and generally does not take an active role.

The first issue for the Bankruptcy Court is whether a municipality is eligible for relief under Chapter 9. Section 109(c) of the Bankruptcy Code contains five requirements for eligibility for relief<sup>2</sup> and a major fight in most cases is whether a municipality has met all the requirements.

### The Entity Must Be a Municipality.

The first requirement is that the entity must be a municipality.<sup>3</sup> A municipality is defined in the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State."<sup>4</sup> This excludes States themselves.

Disputes can arise over whether certain entities are municipalities.<sup>5</sup>

### Authorization to File.

The second requirement is that the municipality must be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under [Chapter 9] by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under [Chapter 9]."<sup>6</sup> A municipality cannot use Chapter 9 without specific State law authorization. This ensures that States retain some control over their municipalities.

### Insolvency.

The third requirement is that a municipality must be insolvent.<sup>7</sup> For a municipality, the Bankruptcy Code defines insolvency as a financial condition in which the municipality is "(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due"<sup>8</sup> on a cash flow basis.<sup>9</sup> This is a hotly contested issue in many Chapter 9 cases.

### Desire to Effect a Plan.

The fourth requirement is that the municipality "desires to effect a plan to adjust such debts."<sup>10</sup> A Chapter 9 case cannot be filed to evade creditors or as a negotiating ploy.<sup>11</sup> This is primarily a subjective inquiry, which can be satisfied by actions before filing, such as attempting to resolve claims; submitting a draft plan of adjustment; or other similar evidence.<sup>12</sup>

### Negotiation with Creditors.

The fifth and final requirement, which

can be met alternative ways, is that the municipality must: (a) have obtained the agreement of a majority of its creditors; (b) have negotiated with its creditors in good faith, but failed to obtain the agreement of a majority of its creditors; (c) be unable to negotiate with creditors because it would be impracticable; or (d) reasonably believed that a creditor may attempt to obtain a preferential transfer.<sup>13</sup>

### Determination of Eligibility.

Many of the reported cases concerning Chapter 9 deal with objections to eligibility for relief.<sup>14</sup> If any of the above requirements is not met, the Court may dismiss the petition.<sup>15</sup> If the petition is not dismissed, then the Court shall enter an order for relief under Chapter 9.<sup>16</sup>

## WHAT HAPPENS IF ELIGIBLE

If the Bankruptcy Court determines that a municipality is eligible for Chapter 9 relief, the municipality is given a period of time by the Court to formulate and file a plan for adjustment of its debts.<sup>17</sup> Only the municipality itself can submit a plan.<sup>18</sup> In very general terms, unless all creditors consent, a plan of adjustment must provide creditors with all they can reasonably expect under the circumstances.<sup>19</sup>

## ISSUES FOR PUBLIC RETIREMENT SYSTEMS TO CONSIDER

A municipality's liability to public retirement systems may well be the primary focus of a Chapter 9 case. However, there is little case law on these issues.

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The Florida case will also focus on collective bargaining. Florida is one of only three states where public employee collective bargaining is in the state constitution. This makes collective bargaining a fundamental right which cannot be altered except in the most compelling circumstances. A large number of unions have intervened in support of the trial court decision. While NCPERS supports the right of self determination for working Americans, NCPERS is an

advocate for the rights of retirement systems and their members. As a result, the NCPERS brief focuses solely on pension rights.

The Florida case will be the first of three favorable pension decisions by state trial level courts in 2011 to reach a state high court (the other cases being in Arizona and New Hampshire). The case is set for argument before the Florida Supreme Court in Tallahassee in September. A decision is expected by late December. To add further nuance to

the case, three of the seven justices must stand for merit retention in November. Organized efforts are underway to unseat those justices believed more favorable to the rights of workers.

NCPERS' brief was prepared by its longtime General Counsel, Robert Klausner and Adam Levinson of the firm Klausner, Kaufman, Jensen & Levinson of Plantation, Florida. A copy of the brief is available on the firm's website, [www.robertdklausner.com](http://www.robertdklausner.com) in the Legal Resources section. ❖

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**Trust Funds Held By a System.**

Trust funds actually held by a system, whether by previous contributions from the municipality or the employee, will not be part of the Chapter 9 proceeding because they are not the municipality's property. Trustees should make sure that the parties to the bankruptcy are aware of this important distinction.

**Benefits for Current Employees – Rejection of Collective Bargaining Agreement.**

Chapter 9 debtors (municipalities) have the power to assume or reject executory contracts.<sup>20</sup> Current collective bargaining agreements are considered to be executory contracts. Thus, municipalities can seek to reject their obligations for benefit payments and employer contributions under an existing collective bargaining agreement.<sup>21</sup> But, municipalities must first make reasonable efforts to negotiate a voluntary modification.<sup>22</sup>

If an executory contract is rejected, the non-debtor party (the union in the case of a collective bargaining agreement) can file a proof of claim for damages arising out of the rejection. In some cases, unions have tried to negotiate a long-term contract prior to a Chapter 9 filing so that, if approved but thereafter rejected in the Chapter 9 proceedings, the rejection damages will be higher.<sup>23</sup>

**Benefits to Existing Retirees.**

Existing retirees are often a major creditor constituency. As part of a plan of

adjustment, a municipality may seek to reduce contribution requirements and benefits as part of an overall cost savings plan. Pension benefits for existing retirees are often protected by the state's constitution or statutory authority. These protections<sup>24</sup> may be enough to prevent modifications of benefits of existing retirees.<sup>25</sup> In many states, however, health care benefits do not enjoy the same protections.

**What If There Is A Shortfall?**

When there are insufficient funds held by the retirement system to cover liabilities for current and future benefits the trustees should determine their contractual rights to seek contributions from the municipality. The trustees should then assert the system's rights as a creditor in the Chapter 9 bankruptcy.

**CONCLUSION**

Municipalities are facing a host of financial pressures. In many cases, retirement contributions and benefits are a municipality's largest expenditure.<sup>26</sup> In Chapter 9 a municipality may seek to alter those obligations. Retirement system trustees must be vigilant to protect the interests of plan participants, when that occurs. Each case will be unique and will require a careful analysis of the facts and applicable state law as they interact with the provisions of the Bankruptcy Code.

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