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I. INTRODUCTION

The City of Detroit's bankruptcy filing has shined a bright light on Chapter 9 of the federal bankruptcy code. Since the Great Recession of 2008, subnational governments have operated with growing budgetary shortfalls and unfunded pension obligations. While all levels of government have felt the effects of a new financial reality, local governments have borne the brunt. Cities and counties provide the bulk of essential services to state residents. Demand for these services has spiked since the Great Recession, but funding is disappearing.[1] The vast majority of cities and counties are experiencing declining tax revenues coupled with increased costs related to debt financing, health care, and pension benefits for employees.[2]

In Oregon, the loss of timber subsidies has caused particular financial distress in certain counties, forcing these counties to cut back public safety and social services.[3] Local government has all but disappeared in these counties. In light of recent county and city bankruptcies throughout the country, many states are considering whether federal bankruptcy is an appropriate and effective mechanism for addressing local government distress.

Chapter 9 of the federal bankruptcy code addresses municipal bankruptcy. At its core, Chapter 9 is a collective debt-adjustment mechanism that enables a municipality to modify its debt obligations over the objections of recalcitrant creditors, including bondholders, current employees and retirees, and private companies that contract with the municipality. Chapter 9 offers distressed municipalities a

1. *See* RICHARD RAVITCH & PAUL A. VOLCKER, REPORT OF THE STATE BUDGET CRISIS TASK FORCE 53456 (July 17, 2012), *available at* http://www.statebudgetcrisis.org/wpcms/wp-conte nt/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

2. *See id.*

3. Vekshin, Alison, *Spotted Owl Listing Pushes Oregon County Near Insolvency*, BLOOMBERG, June 28, 2013, http://www.bloomberg.com/news/2013-06-28/spotted-owl-listin g-pushes-oregon-county-near-insolvency.html.

host of debt-relief mechanisms that can be employed with the ultimate goal of formulating a plan of adjustment that restructures existing and future debt obligations. In bankruptcy court, a municipality can disallow creditor claims and enter into new agreements with third parties on a prospective basis. The plan is adopted in federal bankruptcy court pursuant to federal law, and limitations imposed by

expenditures.[14] Eighteen Oregon counties have received federal timber payments.[15] The subsidies approximated $250 million per year from 2000 to 2007, but have been diminishing every year since.[16] The subsidies ended in 2013.[17] The loss of these payments has put additional pressure on these counties–especially those that relied heavily on the payments, including Josephine, Douglas, Curry, Coos, and Jackson counties.[18]

Declining intergovernmental aid has been coupled with declining property tax collections. Property tax revenue had been a stalwart for municipalities during previous economic downturns.[19] But the imploding housing market precipitated the Great Recession and an unprecedented fall in home prices decimated county coffers. Between 2007 and 2011, home prices fell almost 20% nationally, with states like Arizona and Nevada harder hit.[20]

Unfortunately, at a time where revenues are declining, costs are rising. In 2009, municipalities spent more than 35% of their budget expenditures on salaries and wages.[21] City and municipal budgets face rising labor costs in the form of salaries and wages, as well as pensions and daunting employee-related costs for long-term health care for retired employees. In fact, health benefit costs and pension costs have steadily increased for the vast majority of municipalities.[22] Meaningful reductions in these expenditures are elusive. In addition, as the Great Recession unfolded, demand for the free services that municipalities provide spiked, particularly health and human services and public safety. Indeed, municipalities fund public welfare programs that provide "cash or food assistance, healthcare, low-

14. *Id.*

15. These counties are Josephine, Douglas, Curry, Coos, Jackson, Lane, Polk, Benton, Columbia, Klamath, Linn, Clackamas, Tillamook, Yamhill, Marion, Lincoln, Washington, and Multnomah. *Id.*

16. *See id.*

17. Richard Lardner, *Forest Service to States: Give Timber Subsidies Back,* ASSOCIATED PRESS, May 3, 2013, *available at* http://news.yahoo.com/forest-states-subsidies-back-073739062.html.

18. *See* 2012 FINANCIAL CONDITION REVIEW, *supra* note 12, at 21–26, 31–36, 41. The numbers show that 24.2% of Josephine County's, 22.4% of Douglas County's, 17.7% of Curry County's, 15.1% of Coos County's, and 10.6% of Jackson County's 2011 budget was comprised of federal timber payments. *Id.* at 9.

19. *See* THE LOCAL SQUEEZE, *supra* note 8, at 8–9.

20. *See id.* at 9.

21. *Id.* at 13.

22. *See* MICHAEL A. PAGANO & CHRISTIANA MCFARLAND, NAT'L LEAGUE OF CITIES, RESEARCH BRIEF ON AMERICA'S CITIES: CITY FISCAL CONDITIONS IN 2013, at 5–6 (2013).

income housing, and workforce development."[23] From 2007 to 2010, the number of Americans in poverty increased 14%, increasing the demands for municipality-provided services.[24]

Municipalities have tried a number of ways to strengthen their balance sheets but have found limited success. Municipalities are ill-equipped to create new revenue streams to combat these shifts. Forty-six states severely limit a municipality's ability to increase taxes.[25] There are also political obstacles. Elected officials are prone to eschew tax increases in favor of less controversial revenue-generating measures, such as raising fees that are applied to city services.[26] But these fee increases often fail to generate significant funds. Even in states that have the option of increasing taxes, the imposition of higher taxes may only serve to decimate the tax base. Indeed, macro migration trends demonstrate that the U.S. population is shifting out of large, northeast city centers, and migrating to southern and western areas.[27] These trends shrink tax bases in affected areas. Further, tax increases arguably accelerate these trends and eviscerate the benefit of a tax incred evm2oya.1(r)11Td[(areas)6.en

hall.[39] The sale yielded $74 million for the city, but leasing the buildings back will cost the city $125 million over the next twenty years.[40] Chicago leased its parking meter system to a consortium led by Morgan Stanley in order to balance its budget.[41] Chicago received $1.16 billion from its parking meter lease, but the consortium is now expected to make more than ten times that amount over the course of the seventy-five year deal.[42] Further, these one-time sales temporarily fill budgetary gaps but fail to produce any structural reform that improves the municipality's viability.

Against this backdrop, Oregon municipalities, as well as municipalities in other states, are forced to seek some mechanism that will allow for systemic debt restructuring. Unfortunately, state law offers few options.

III. MUNICIPAL DEBT ADJUSTMENT AND REORGANIZATION UNDER OREGON LAW

An Oregon municipality that cannot service its existing debt load has few meaningful options under state law. The municipality can (i) borrow its way out of its liquidity crisis, assuming it remains below debt caps under state law and has access to the capital markets, (ii) negotiate consensual concessions and compromises from its bondholders, trade vendors, current employees and retirees, among other creditors, which, in the absence of a binding mechanism, may be impossible, (iii) cut municipal operating expenses, which may compromise the municipality's mandate and impair its ability to function on behalf of the public's interest, and (iv) raise taxes. None of these options are necessarily easy to implement, and depending on a municipality's challenges, a number of them may need to be simultaneously employed. Increasing taxes may be politically impossible or prohibited by state law, and even where a tax increase is accomplished, revenues may continue to decline as the increase accelerates tax-payer flight to other localities. The obstacles to a consensual write-down of debts are self-evident. And borrowing

39. Michele Wilde Anderson, *The New Minimal Cities*, 123 YALE L.J. 1118, 1167–68 (2014).

40. *Id.*

41. *See* Darrell Preston, *Morgan Stanley Group'a lman Sta73n Str-.5(s m)6-13.776t2b.0412 T15an Stma(224.62.e3177.0012 Tm[(D*

money to fill budgetary gaps fails to address structural deficiencies.

And then there is the constitutional problem. Article 1, § 10 of the U.S. Constitution provides that "[n]o State shall . . . pass any . . .

Further complicating this problem is the fact that, as noted above, the state has not allowed its municipalities to seek protection in the federal bankruptcy courts.

A. Pension Obligations in Oregon

1. Public Pensions are Contracts Under Oregon Law

Since 1945, Oregon has provided its public employees with a host of retirement benefits.[49]

PERF.[60]

Ultimately, the promise of a public pension is binding at the time of the employee's acceptance, thereby imposing significant future and unliquidated, and most likely, unfunded, obligations on the state and its cities and municipalities.[61]

2. Legislative Reform Has Been Drawn-Out and Difficult

Oregon political leaders have been able to circumvent the Oregon Contracts Clause by making prospective adjustments to the PERS contract.[62] These changes have been largely limited to modifications affecting new employees.[63] In 2003, the state legislature passed the PERS Reform and Stabilization Act of 2003 ("2003 Reform Act"). The 2003 Reform Act made significant changes to PERS by: (i) directing all employee-member salary contributions after January 1, 2004, to an individual account program, (ii) altering how PERS credited earnings to Tier 1 members, (iii) prohibiting members from making further contributions to the variable annuity account program, (iv) temporarily suspending COLAs for Tier 1 members, and (v) permitting erroneously paid benefits to be recouped from future PERS earnings as administrative expenses. But the Oregon Supreme Court voided the provision in the 2003 Reform Act that eliminated the annual assumed earnings rate credit to Tier 1 members' regular accounts on the grounds that the change reflected an impairment of the obligations of the statutory

60. OR. REV. STAT. §§ 238.655, 238.705, 238.710.

61. The fact that there is no separate pension clause in the Oregon Constitution that protects the impairment of municipal pension obligations should not, in and of itself, entitle retirees to any less protection under the Oregon Contracts Clause than if there was a separate pension clause. The Bankruptcy Court for the Eastern District of Michigan recently opined on the effect of the Michigan Constitution's pension clause in *In re City of Detroit*, 504 B.R. 97 (Bankr. E.D. Mich. 2013). The Court stated that the separate pension clause in the Michigan Constitution offered employees no additional protections from those protections already provided by the Michigan Constitution's contracts clause. *Id.* at 118–27. The pension obligations of Michigan's municipalities were constitutionally protected by the contracts clause in the Michigan Constitution, and the existence of a separate pension clause did not entitle pension benefits to heightened protections from contract benefits. *Id.*

62. Most recently, the Oregon legislature passed Senate Bill 861, which modified cost-of-living adjustments (COLAs) for retirees under PERS, and Senate Bill 862, which modified the calculation of the final average salary for PERS members and removed future legislators from PERS.

63. The Oregon Supreme Court has, in fact, invalidated parts of passed legislation that modified existing benefits for employees.

PERS contract in violation of the Oregon Contracts Clause.[64] Furthermore, in *Strunk*, the Oregon Supreme Court ruled that the suspension of the COLAs to retirees' fixed serviced retirement allowances violated the PERS statutory contract.[65]

The existing case law on the 2003 Reform Act demonstrates that any meaningful reform analysis requires a comprehensive understanding of the contours of the PERS contract and contractual impairment.[66] But the scope and force of the PERS contract is not entirely clear. The legal analysis is nuanced and further complicated by temporal issues such as when certain benefits accrue and the permanence of the statutory promises that comprise PERS.[67] We believe that any discussion of contractual impairment must distinguish not only between future promises with respect to new employees and existing obligations relating to retirees and existing employees that may extend into the future, but also between future liabilities that have been funded and future liabilities that remain unfunded.[68] The executive and legislative bodies cannot be certain

64. Strunk v. PERB, 108 P.3d 1058 (Or. 2005).

65. *Id.* at 1064. At the same time, in 2006, the Ninth Circuit Court of Appeals rejected

that proposed legislative reform is constitutional without further highway or bridge tolls, (iii) user fees, (iv) special excise taxes, including hotel/motel taxes, alcoholic beverage taxes, meal taxes and license fees, and (v) proceeds from other project financing. As discussed in further detail below, special revenue bondholders are secured creditors in a Chapter 9 bankruptcy case and are entitled to continue receiving payments on their bonds from the pledge of income during the postpetition period. In other words, the income constitutes the collateral of the bondholders notwithstanding the filing of the Chapter 9 case.

In addition to general obligation and revenue bonds, Oregon's municipalities are authorized to issue refunding bonds, which pay off existing bonded indebtedness.[72] The issuance of these bonds gives municipalities the ability to refinance existing bonded indebtedness.[73] Along with the statutory caps on permitted bonded indebtedness, which ensure that municipalities do not overleverage their balance sheets and tie up significant amounts of taxing and other revenues servicing bonded debt, refunding bonds give the municipality the ability to ensure sufficient liquidity to rollover existing indebtedness.

As with pension obligations, the Oregon Contracts Clause protects bonds and other types of debt instruments. Bonded indebtedness cannot be written down under state law without the express consent of the holders in accordance with the terms of the loan documents. As described below, this is not true in bankruptcy. If a municipal borrower filed for Chapter 9 protection, that municipality would be able to compromise existing unsecured bond debt on new payment terms. Further, a municipal debtor would only be required to pay holders of secured bond debt the value of their lien (rather than the face amount of the debt) on new payment and performance terms approved by the bankruptcy court.[74]

C. Absence of Debt Adjustment Mechanism Under Oregon Law

Oregon law does not provide a collective mechanism that enables cities and counties to adjust their existing debt load. Instead of focusing on debt deleveraging and operational reorganization, Oregon law has created a system of public borrowing caps and limitations on creditor attempts to enforce judgments.[75] These

72. *Id.* § 287A.360.
73. *See id.*
74. 11 U.S.C. § 1129(b)(2)(A).
75. OR. REV. STAT. §§ 30.260–300 (2013).

provisions ideally afford a distressed municipality additional time to address its financial difficulties. To that end, Oregon law exempts public property from execution to pay a debt or judgment.[76] A judgment creditor cannot execute on public property in Oregon. Consequently, judgment creditors' primary option is to file a mandamus action seeking to compel municipal officers to levy sufficient taxes to satisfy the judgment.[77] In the event the levy fails, the municipality can petition a court for an order requiring installment payments for a period of up to ten years, depending on the ability of the municipality to pay its debt and still carry out its essential governmental responsibilities.[78] If the municipality cannot pay within the ten-year period, there is no provision for extension or for forgiveness of the debt. In other words, a county facing a significant judgment may evade full satisfaction of the judgment by pleading insolvency. But the judgment cannot be written off.

In 2012, the Oregon legislature enacted legislation that addressed financial distress among its counties.[79] The legislature sought to assist troubled counties impacted by the recent loss of federal timber revenue. In particular, the law authorizes counties to declare a public safety services emergency by requesting in writing that the Oregon Criminal Justice Commission review and analyze the public safety services provided in the county.[80] If the Governor issues a public safety emergency, he or she must then establish a Fiscal Assistance

76. *See id.* § 18.345(1)(g); Eldredge v. Mill Ditch Co., 177 P. 939, 940 (Or. 1919); First Nat'l Bank of Idaho v. Malheur Cnty., 45 P. 781 (Or. 1896); Portland Lumbering & Mfg. Co. v. Sch. Dist. No. 1, 10 P. 350 (Or. 1886). Public property is generally not lienable.

77. Under Oregon law, to the extent a creditor obtains a judgment against or settlement with a municipality, payment must be made by the municipality and can be funded through a tax levy if the following conditions exist: (i) the judgment exceeds the funds available in the municipality's budget; (ii) the judgment exceeds 10% of the total unrestricted revenues in the municipal budget for the coming year; (iii) payment would impair the municipality; and (iv) the municipality has called an election to submit a special levy. OR. REV. STAT. § 30.295. The problem with an action in mandamus is a collection problem. Ultimately, a municipality will not be able to service its bondholder debt if it does not have the funds available to satisfy the indebtedness or even to cure the default and is unable to raises taxes or raise sufficient revenue from a tax increase to satisfy the indebtedness. Oregon state law does allow holders of special revenue bonds issued by county pollution control facility and public housing projects to seek the appointment of a receiver and to foreclose upon default. However, it appears that foreclosure is strictly limited under Oregon law to these issuers. *See id.* §§ 468.268, 456.210.

78. *Id.* § 30.295.

79. *See id.* §§ 203.095, 203.100.

80. *Id.* § 203.095(1).

Board ("FAB") for the distressed county.[81] The board must devise a recovery plan.[82] The plan may, among other things, recommend that the county renegotiate payment terms of the county's legal and moral indebtedness, as well as cut services, lay off employees, reduce costs, and sell or lease real or personal county property.[83]

This law is limited in two material respects. First, the ability for the county to renegotiate payment terms of existing indebtedness is wholly dependent on achieving a consensual agreement with its creditors. While forbearance is certainly possible, creditors maintain a disproportionate amount of leverage

Ultimately, many Oregon municipalities face a Hobson's choice: utilize a more aggressive debt adjustment mechanism than currently offered under state law or face ruin.

IV. CHAPTER 9—THE FEDERAL DEBT ADJUSTMENT AND REORGANIZATION OPTION[85]

A. *Overview of Federal Municipal Bankruptcy Laws*

Prior to 1934, municipalities were expressly excluded from seeking protection under federal bankruptcy law.[86] But the Great Depression precipitated a wave of small town defaults. The prospect of widespread municipal financial collapse gained attention within the national consciousness. Distressed municipalities had few options and faced the prospect that spurned bondholders would attemptcipreow 110.008 o1t.3(ine0o0o0c endowment funds, pension funds, and other major holders of municipal bonds.[90]

The constitutionality of the new law was immediately contested. In *Ashton v. Cameron County Water Improvement District*,[91] the Supreme Court struck down the 1934 Municipal Bankruptcy Act. By a 5-4 vote, the Court held that the new law allowed for an unconstitutional level of federal interference with states' rights to manage their own affairs.[92] Undeterred, Congress promptly enacted another municipal bankruptcy law in 1937, which ultimately became Chapter IX under the Chandler Act of 1938 ("Original Chapter IX"). Original Chapter IX was only nominally different than its predecessor.[93] Nevertheless, the Court upheld the new law in *United States v. Bekins*.[94]

Original Chapter IX proved to be quite durable, but it became ineffective as the size and complexity of municipal distress grew over time. The law had a number of idiosyncratic provisions, including the requirement that the municipality had to formulate a plan of adjustment and have that plan approved by 51% of its creditors *prior to the filing of a bankruptcy petition*.[95] Further, the law did not provide for an automatic stay of all creditor collection actions or a mechanism for raising funds to pay ongoing expenses during the bankruptcy case.[96] By 1975, Congress recognized that Original Chapter IX was "hopelessly archaic and unworkable for all but the smallest entities."[97] At that time, a number of municipalities were experiencing financial distress on a scale that the nation had not seen since the Great Depression. Most notably, New York City was facing financial demise, and state officials were aggressively lobbying Congress to pass a new municipal bankruptcy law to accommodate a

90. *See id.* at 451.

91. Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513 (1936).

92. *See id.* at 530–31.

93. *See* McConnell & Picker, *supra* note 89, at 453 ("The only changes of constitutional interest between the [1934 Municipal Bankruptcy] Act and the [new Chapter IX] were that the [new law] (1) omitted the express provision of [its predecessor] requiring the approval of the bankruptcy petition by the State, replacing it with the requirement that a petitioning municipality show that it 'is authorized by law to take all action necessary to be taken by it to carry out the plan,' and (2) excluded counties from the Act." (footnote omitted)).

94. United States v. Bekins, 304 U.S. 27 (1938).

95. *See* Kenneth W. Ellison, *The Recent Revision of the Federal Municipal Bankruptcy Statute: A Potential Reprieve for Insolvent Cities?* 13 HARV. J. ON LEGIS. 549, 556–57 (1976).

96. *See id.*

97. H.R. REP. NO. 94-686, at 4 (1975).

filing by a municipality of its size.[98] New York City ultimately resolved its financial crisis without resorting to a bankruptcy filing, but the result of the city's near calamity was a new municipal bankruptcy law.[99] Original Chapter IX was amended "to provide a workable procedure so that a municipality of any size that . . . encountered financial difficulty [could] work with its creditors to adjust its debts."[100] The amendments allowed for a federal court to supervise a consensual settlement between a municipality and a majority of its creditors.[101] The primary purpose of the new law ("Chapter 9") was to "allow the municipal unit to continue operating while it adjust[ed] or refinance[d] creditor claims with minimum (and in many cases, no) loss to its creditors."[102] Aside from some relatively minor subsequent amendments, the federal bankruptcy laws today bear a striking resemblance to those passed in 1976 with respect to municipal bankruptcy.

B. Chapter 9's Dimensions

Municipal debtor cases generally implicate a handful of discrete issues. The most frequently reoccurring issues in municipal cases are (i) the debtor's eligibility to file a bankruptcy petition; (ii) the scope of federal judicial involvement vis-à-vis state sovereignty; (iii) rejection of collective bargaining agreements and adjustment of pensions and health care benefits; and (iv) guidelines for formulating and confirming a plan for adjustment.

1. Eligibility

Section 109(c) delineates the requirements that an entity must satisfy before it may file a petition under Chapter 9. Unfortunately, the criteria are invariably subjective and fact-specific, leading to contentious litigation and a depletion of the municipal debtor's scarce financial resources.

Primarily, the entity must qualify as a "municipality"[103]—

98. *See* SEYMOUR P. LACHMAN & ROBERT POLNER, THE MAN WHO SAVED NEW YORK: HUGH CAREY AND THE GREAT FISCAL CRISIS OF 1975, at 147–66 (2010).

99. *See* H.R. REP. NO. 94-686, at 61 ("[I]n further view of the fact that the legislation which we have before us was created and tailored for the one purpose of protecting the City of New York . . . .").

100. *Id.* at 6.

101. *See id.*

102. *Id.*

103. 11 U.S.C. § 109(c)(1) (2012).

Colorado, and Illinois allow only certain types of localities to file a Chapter 9 petition.[113] In Oregon, only irrigation and drainage districts are allowed to file a Chapter 9 petition.[114]

Section 109(c)(3) requires that the municipality be "insolvent"—a requirement not imposed on debtors who file under other Code Chapters. The solvency determination must consider a municipality's condition at the time the bankruptcy petition was filed. However, a municipality is not required to be delinquent in paying its bills in order to seek bankruptcy protection. Section 101(32)(C) defines the term "insolvent" to mean a "financial condition such that 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."

The definition of "insolvent" affords a municipality two means to satisfy section 109(c)(3). Under section 101(32)(C)(i), the municipality can demonstrate that on the petition date it was not

invariably demand some proof of negotiations that include a good faith effort to compromise and avoid bankruptcy.[130] Multiple rounds of negotiations may be necessary. However, the Code recognizes the potential futility in forcing a municipality to negotiate with creditors to the point of impasse in all instances.[131] Creditors may be hostile to any attempt to adjust obligations. Further, the sheer number of creditors may preclude negotiations. In some instances, the need to

circuit split in *NLRB v. Bildisco & Bildisco.*[138] In that case, the debtor sought bankruptcy protection under Chapter 11.[139] At the time, approximately 40% to 45% of the debtor's labor force was fail.[148]

The Supreme Court affirmed the circuit court's ruling.[149] The Supreme Court explained that all collective bargaining agreements, except those subject to the Railway Labor Act, were subject to rejection under section 365.[150] However, the Court agreed that collective bargaining agreements are of a special nature and that "a somewhat stricter standard should govern the decision of the [b]ankruptcy [c]ourt to allow rejection of a collective-bargaining agreement."[151] Ultimately, the Court adopted the circuit court's proposed standard, but it provided additional guidance as well.[152] The Court explained that before determining whether to allow rejection of a collective bargaining agreement, "the [b]ankruptcy [c]ourt should be persuaded that reasonable efforts to negotiate a voluntary modification had been made and [were] not likely to produce a prompt and satisfactory solution."[153] Once the bankruptcy court made such a determination, it was obligated to balance the equities and consider the interests of the affected parties, including the debtor, creditors and employees.[154] Further,

> [t]he bankruptcy court must consider the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors' claims that would follow from affirmance and the hardship that would impose on them, and the impact of rejection on the employees. In striking the balance, the bankruptcy court must consider not only the degree of hardship faced by each party, but also any qualitative differences between the types of hardship each may face.
>
> . . . [T]he bankruptcy court must focus on the ultimate goal of Chapter 11 when considering these equities. The E[(of 4 4932(ees. 10015zoer th)11 do2.4(btTJ0s)2.8(0.7(lap)12(t)thor)-2.5(ze li)8

reorganization.[155]

In response to the *Bildisco* ruling, union leaders called upon Congress to pass legislation addressing the ruling's perceived inequities.[156] They argued that "unless [the] disgraceful and unfair situation [the ruling created was] corrected, unscrupulous employers [would] increasingly begin to use the threat of bankruptcy to force workers to accept rewriting of their contracts to incorporate concessions in their wage levels and working conditions."[157]

Congress addressed this issue by drafting a new section, 1113, as part of the 1984 amendments to the Bankruptcy Code.[158] The new section established a detailed three-stage process that directs the debtor and any union affected by a labor contract that the debtor seeks to reject to engage in collective bargaining. Section 1113's main purpose is to encourage a solution of the employer's labor problems through collective bargaining rather than by means of the debtor's unilateral action and recourse to the bankruptcy court.[159]

Chapter 9 does not incorporate section 1113.[160] Consequently, bankruptcy courts have reasoned that the approach propounded in *Bildisco* applies in Chapter 9 cases. Arguably, Chapter 9 debtors face fewer obstacles in rejecting a collective bargaining agreement because the negotiation procedures found in section 1113 are inapplicable. However, municipal debtors face a different challenge in rejecting collective bargaining agreements. In many states, pension and related labor benefits are controlled and protected by contract, state statutes

155. *Id.*

156. *See* Rosalind Rosenberg, *Bankruptcy and the Collective Bargaining Agreement–A Brief Lesson in the Use of the Constitutional System of Checks and Balances*, 58 AM. BANKR. L.J. 293, 312 (1984).

157. *Id.* at 313 (quoting Letter from Legislative Director of the United Automobile, Aerospace & Agricultural Implement Workers of America to Members of Congress (Mar. 9, 1984)).

158. *See* 130 CONG. REC. H7489 (daily ed. June 29, 1984) (statement by the Hon. Peter W. Rodino Jr., Chairman of the House Committee on the Judiciary, upon the consideration of the Conference Report on H.R. 5174) ("[Drafting section 1113] was the most serious matter that the conference had to deal with and we dealt with it over a long period of time and it was only after much deliberation and much exchange that we finally came to what we believe to be a very balanced provision . . . .").

159. *See, e.g.*, *In re* K & B Mounting, Inc., 50 B.R. 460, 464–65 (Bankr. N.D. Ind. 1985).

160. Chapter 9 was amended in 1994, and Congress considered a proposal to add to Chapter 9 a provision similar to section 1113. But the proposal was never enacted into law. *See In re* Cnty. of Orange, 179 B.R. 177, 183 n.15 (Bankr. C.D. Cal. 1995).

and the state constitution. Significant constitutional issues are implicated when federal law grants a municipal debtor the ability to take action that is prohibited by a governing state constitution or statute. Though a detailed discussion of these constitutional issues is beyond the scope of this paper, a general discussion is necessary in order to understand the nature of this issue in Chapter 9.

b. Rejection of Collective Bargaining Agreements Under Chapter 9: Analysis and Implcations.

Chapter 9 enables municipal debtors to unilaterally reject collective bargaining agreements and other employment contracts. Rejection constitutes breach of the contract or lease, thereby entitling the counterparty to damages. The Bankruptcy Code categorizes these damage claims as prepetition, unsecured non-priority claims subject to significant write-down. The ability to write-down existing liabilities extends to pension liabilities, but probably only to the unfunded portion of the liability. The funded obligation is most likely property of employee accounts belonging to employees and retirees, and thus not subject to material adjustment in Chapter 9.

to a *state-run* pension system. Historically, Chapter 9 municipal debtors have worked with their pension plans, including state-run pension plans to avoid an impairment.[163]

Complicating this analysis is the fact that PERS is codified by statute, and Chapter 9 does not allow a debtor to propose and confirm a plan of adjustment that violates state law prospectively.[164] So, while the rejection of an employee obligation could affect the municipality's obligations to PERS, it is unlikely that a Chapter 9 filing, in and of itself, automatically severs the municipal employer from its relationship as a PERS employer. For example, if the municipality is a school district, state law mandates that all public school districts participate in PERS, which means any plan of adjustment the municipal school district proposed would have to incorporate PERS prospectively. That does not mean that the school district cannot suspend pension contributions to PERS during the bankruptcy case, and thereby increase its leverage with the teachers' union, or reject the collective bargaining agreements. However, the school district could not retain

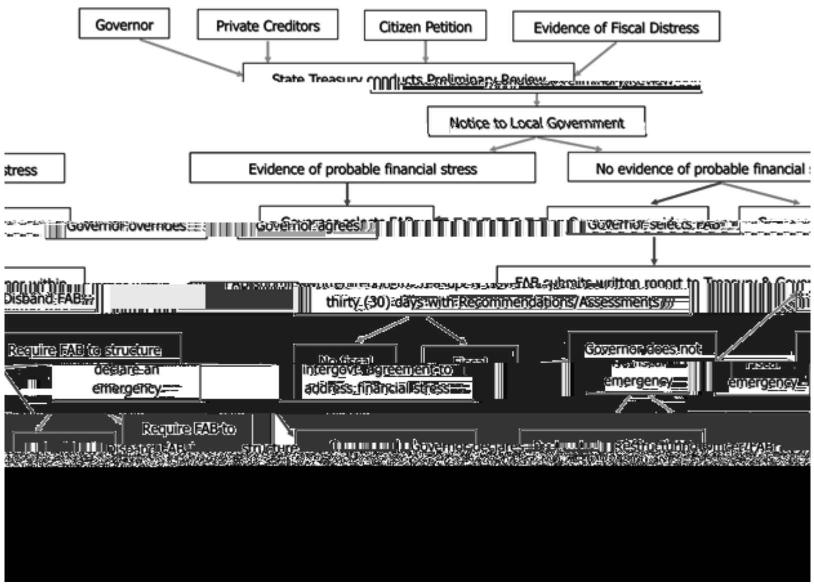
PERS as a participating member. At the very least, we could imagine that a municipality seeking to terminate its relationship with PERS would seek a comfort order from the bankruptcy court that addresses its ongoing obligations under the PERS statutes. Again, this issue would be heavily litigated.

and a Chapter 7 trustee will manage the debtor's liquidation.[170] The debtor can also be liquidated in Chapter 11.[171] In the alternative, substantially all of the debtor's assets can be sold through section 363 or a plan of reorganization, and the remaining shell entity can be liquidated immediately or allowed to emerge from bankruptcy in order to carry out some ministerial tasks.[172] Finally, the Chapter 11 debtor can formulate and confirm a plan of reorganization that allows the company to emerge from bankruptcy as a viable going concern.[173] Unlike in Chapter 11, there are only two potential outcomes in Chapter 9. The court can dismiss the municipal debtor's case or the debtor can propose, and the court can confirm, a plan of debt is far more textured then just securing the necessary votes from each class of creditor. Indeed, the system is not characterized by consensual agreements; rather, "the critical question is what the debtor can do over the objection of creditors."[176]

In the plan confirmation process, municipal debtors hold many of the same powers and obligations held by Chapter 11 debtors. Most importantly, section 901 adopts key provisions from subsections 1129(a) and (b). Section 1129(a) delineates the requirements for plan confirmation, including the requirement under section 1129(a)(8) that each creditor class must vote to approve a proposed plan. However, section 901 also adopts the "cramdown" exception to 1129(a)(8). Pursuant to section 1129(b), a nonconsenting class of creditors (i.e., a class of creditors in which the majority in number vote to reject the plan or holders of claims that exceed one-third of the total amount of claims in that certain class of creditors vote to reject the plan) can be crammed down in certain instances. Primarily, at least one impaired class of claims must approve the plan, and the plan must be fair and equitable with respect to each impaired class that has not accepted the plan.[177] The definition of "fair and equitable" varies depending on whether the class is composed of secured or unsecured creditors.

Classes of secured creditors in Chapter 9 are frequently composed of bondholders secured by the revenu1.4(e)-2.8(r0.001ecured by)13(irer is d)3(p)279

Due to the uncertainty surrounding the fair and equitable nature of a cramdown, unsecured creditors will often resort to other Code provisions in attempting to ensure favorable treatment. More specifically, creditors have relied on section 943(b)(7)'s requirement that the plan be in the best interests of creditors and feasible. In Chapter 11, the best interests test requires that an impaired creditor receive or retain under the plan interests or property that is not less than the amount it would receive if the debtor were liquidated under Chapter 7.[185] A municipality cannot be liquidated, so courts have construed the test under Chapter 9 to require that the proposed plan treatment for an unsecured creditor is better than realistic alternatives, such as dismissal of the case.[186] A plan that fails to repay creditors an amount that even remotely approximates their claims may not necessarily be in the best interest of those creditors. However, a



VI. CONCLUSION

Across the nation, subnational governments' financial distress has approached a crisis level. Currently, Oregon has cities and counties that are precariously close to service-level insolvency. But state law offers few restructuring options. This article encourages the Oregon legislature to create a framework that will facilitate negotiation among key constituencies and allow Oregon municipalities to file for Chapter 9 upon satisfaction of certain prerequisites. This process should give the municipality and its creditors every opportunity to reach consensual agreements that allow the municipality to enjoy sustainable viability. But there should be no illusions. The alternative to a consensual workout must be Chapter 9. Chapter 9 offers municipalities a host of measures to aggressively reduce debt obligations. A debtor's ability to file for bankruptcy incentivizes creditors to consider meaningful out-of-court concessions that can allow a municipality to avoid federal bankruptcy court altogether.

Oregon does not allow its cities and counties to file a Chapter 9 petition. This restriction is harmful in two significant ways. Primarily, a truly distressed municipality lacks a mechanism to address its financial troubles. Further, since Chapter 9 is not an option, troubled municipalities lack bargaining leverage in out-of-court negotiations. By creating the framework advocated by this article, Oregon would give its municipalities meaningful restructuring options and the necessary leverage to explore them.

Ultimately, the process set forth herein is not one that mandates Chapter 9 bankruptcy as a one-size-fits-all solution. Rather, Chapter 9 is merely the last door at the end of a long hallway. Prior to arriving at this point, a distressed municipality should engage state and local leaders, and its residents, to determine whether a consensual collective adjustment plan is possible. If so, an out-of-court solution is always preferable to one that is mandated in court. We do believe,