

# Municipal Bankruptcy - Can an Illinois Municipality File for Bankruptcy Protection?

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## **Introduction**

The cities of Detroit, Michigan and Stockton, California recently grabbed headlines when they filed for bankruptcy protection under Chapter 9 of the U.S. Bankruptcy Code. What is Chapter 9? Most of us have only heard of *individuals* and *private companies* filing for bankruptcy protection under Chapter 7 (liquidation), Chapter 11 (business reorganization), or even Chapter 13 (individual reorganization). In short, Chapter 9 governs bankruptcy relief for municipalities.

While Chapter 9 petitions are extremely rare, the recent recession and resulting municipal budget imbalances have raised the question of whether bankruptcy is an option for cities and other local units of government across the country. In 2009, there were only 12 municipalities seeking reorganization under Chapter 9, while there were 819,000 Chapter 7 petitions and 11,700 Chapter 11 petitions in that year.

Can an Illinois municipality file for bankruptcy protection? The short answer is "maybe," but it is not easy.

## **Chapter 9 – Municipal Bankruptcy Protection**

Chapter 9 of the United States Bankruptcy Code provides for reorganization of municipalities, defined as a "political subdivision or public agency or instrumentality of a State" 11 U.S.C. § 101(40), such as cities, townships, villages, counties, school districts, taxing districts, municipal utilities, and revenue-producing bodies that provide services which are paid for by user fees rather than by general taxes, such as bridge and highway authorities.

There are four eligibility requirements for a municipality to file for Chapter 9 bankruptcy, found in Section 109(c) of the Bankruptcy Code. They are:

1. The municipality must be specifically authorized to be a debtor by state law or by a governmental officer or organization empowered by State law to authorize the municipality to be a debtor;
2. The municipality must be insolvent, as defined in 11 U.S.C. § 101(32)(C);
3. The municipality must desire to effect a plan to adjust its debts; and
4. The municipality must either:
  - obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan in a case under chapter 9
  - negotiate in good faith with creditors and fail to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan
  - be unable to negotiate with creditors because such negotiation is impracticable
  - reasonably believe that a creditor may attempt to obtain a preference.

## **Does Illinois law authorize a unit of government to file for Chapter 9?**

Under federal law, units of local government cannot petition for bankruptcy unless they have express and specific authority from the state to do so. The bankruptcy courts have strictly construed this to mean that authorization must be "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication." *In re County of Orange*, 183 B.R. 594, 604 (Bankr. C.D. Cal. 1995). Citing

this ruling, the U.S. Bankruptcy Court for the Northern District of Illinois dismissed the Slocum Lake [IL] Drainage District's petition for Chapter 9 bankruptcy since it could not point to any specific Illinois law that allowed it to directly petition for relief under Chapter 9. *In re Slocum Lake Drainage District of Lake County*, 336 B.R. 387, 390 (N.D. IL 2006). That court ruled:

The Debtor has the burden of proof to establish that it is eligible to be a debtor under Chapter 9. ...the Court finds that the Debtor has not met that burden. ... the Court finds that the general authority contained in the cited Illinois statutes is insufficient to meet the "specifically authorized" requirement of § 109(c)(2). The language utilized in the Illinois Drainage Code and the Illinois Public Water District Act constitutes general authorization to exercise the powers and manage and control the affairs of the municipal corporations subject to those statutes. However, neither statute contains specific authorization for entities to seek relief under Chapter 9 of the Bankruptcy Code. Moreover, under the Illinois Local Government Financial Planning and Supervision Act, there has not been a commission or financial advisor appointed to recommend that the Debtor file a Chapter 9 petition. ...**Had the Illinois General Assembly intended to specifically authorize this Debtor or other municipalities to seek relief under Chapter 9, it could have easily drafted appropriate legislation, but has not done so.**  
*In re Slocum Lake*, 333 B.R. at 390-391. (Emphasis added).

In Illinois, there is no specific statute authorizing any municipality to file for bankruptcy, **except for the Illinois Power Agency**, recently created in 2007 to, among other things, develop electricity procurement plans to ensure reliable and affordable environmentally sustainable electric service to customers, including municipalities. The Illinois Power Agency Act provides that the IPA is granted authority to "file a petition under Chapter 9 of Title 11 of the United States Bankruptcy Code or take other similar action for the adjustment of its debts." 20 ILCS 3855/1-20(b)(15).

The Village of Washington Park [IL] filed for Chapter 9 bankruptcy petition in 2009, citing assets of less than \$50,000 and debt of more than \$1 million, but that petition was dismissed after the presiding bankruptcy judge held that there was no state law enabling a municipality in Illinois to declare bankruptcy. (There have been a couple of "successful" bankruptcies in Illinois involving municipalities, including the Village of Brooklyn – filed in October 2003 – which apparently survived because no one objected to the filing of the petition or raised this issue.)

### **Illinois Local Government Financial Planning and Supervision Act**

Until such time as the State of Illinois legislature provides specific authority to units of local government to directly petition for bankruptcy protection under Chapter 9, the only opportunity for financial "relief" for small communities may be found in the Illinois "Local Government Financial Planning and Supervision Act." 50 ILCS 320/1 et seq. Moreover, that Act appears to set up a condition that certain units of government in Illinois should consider, and might even need to meet, before seeking authority to file for Chapter 9 protection.

The Illinois Local Government Financial Planning and Supervision Act allows for the establishment of a "financial planning and supervision commission" if the governing body of a unit of local government determines that a **fiscal emergency** exists. The Act provides:

Any unit of local government upon a 2/3 vote of the members of its governing body may petition the Governor for the establishment of a financial planning and supervision commission if the governing body of the unit of local government determines that a fiscal emergency, as defined in Section 3, exists or will exist within 60 days. A petition shall include the conditions of fiscal emergency and a list of all creditors of the unit of local government, which list shall indicate the names, addresses, amounts and types of indebtedness or claims of such creditors, and which of such creditors are subject to the stay provisions of Section 7 of this Act. 50 ILCS 320/4(b).

However, this only applies to municipalities that have a population *under 25,000*. 50 ILCS 320/3(d).

Upon receipt of a petition for establishment of a financial planning and supervision commission, the Illinois Governor then “*may* direct the establishment of such a commission if the Governor determines that a fiscal emergency exists.” 50 ILCS 320/5(a)(1). (Note that this statute does not *require* the Governor to establish a financial planning and supervision commission.)

Prior to making such a determination, the Governor is required to “give reasonable notice and opportunity for a hearing to all creditors of the petitioning unit of local government.” 50 ILCS 320/5(a)(2). Further, the Act provides that the Governor’s “determination shall be entered not less than 60 days after the filing of the petition” and that the “commission shall convene within 30 days of the entry by the Governor of his or her determination of the fiscal emergency.” *Id.*

The commission would consist of 11 members, including the Governor, the State Comptroller, the Director of Revenue, the Director of the Governor’s Office of Management and Budget, the State Treasurer, the Executive Director of the Illinois Finance Authority, the Director of the Department of Commerce and Economic Opportunity and the presiding officer of the governing body of the unit of local government, or their respective designees, *plus* three additional qualified members nominated by the governing body and chief governing officer of the unit of local government and appointed by the chairperson of the commission. 50 ILCS 320/5(b).

The financial planning and supervision commission has several powers, duties and functions to help the distressed municipality create a financial plan to overcome its debts and return to financial stability. However, in the event that the commission “determines that the proposed budget, tax levy, bond or note issuance or revenue estimates do not comply with the financial plan of the unit of local government,” *Id.*, the financial planning and supervision commission is authorized (among other things) to:

**Recommend** that the unit of local government file a petition under Chapter 9 of the United States Bankruptcy Code. Not later than 30 days after the conclusion of its investigation, the commission shall make a written report to the unit of local government of all findings, determinations and recommendations. 50 ILCS 320/9(b)(4). (Emphasis added).

Unfortunately, this statute is more than likely not going to be specific enough to satisfy the requirement in the U.S. Bankruptcy Code authorizing a municipality to actually file for Chapter 9 bankruptcy. Rather, the Illinois Local Government Financial Planning and Supervision Act only authorizes the “financial planning and supervision commission” to recommend that the municipality file a petition under Chapter 9. It has no specific power to authorize the municipality to file a Chapter 9 petition.

As noted above, the authorization to file a bankruptcy petition must be “exact, plain, and direct,” as held in the *County of Orange* and the *Slocum Lake* decisions. However, while the Illinois Local Government Financial Planning and Supervision Act does not provide the necessary authority, it is clear that before any municipality considers filing for Chapter 9 protection, it is recommended that it seek the recommendation to file under Chapter 9. It is important to point out that although the bankruptcy court in *Slocum Lake* held there was no Illinois state law that would allow Slocum Lake to seek reorganization under Chapter 9, the court also noted that Slocum Lake hadn’t sought to take advantage of the Illinois Local Government Financial Planning and Supervision Act. “Moreover,” the court stated, “under the Illinois Local Government Financial Planning and Supervision Act, there has not been a commission or financial advisor appointed to recommend that the Debtor file a Chapter 9 petition.”

## **Conclusion**

The U.S. Bankruptcy Code provides that a municipality may seek to reorganize its debts under Chapter 9 of the Code only if the municipality is specifically authorized to be a debtor by state law, or by a governmental officer or organization empowered by state law to authorize the municipality to be a debtor. In Illinois, there is no such statute that authorizes any municipality to seek protection under Chapter 9, unless it is the Illinois Power Agency.

Any municipality (with a population under 25,000) that has a "fiscal emergency" might want to seek assistance under the Illinois Local Government Financial Planning and Supervision Act. If relief is not likely under any financial plan, then the municipality should seek the recommendation from the Commission to file a petition under Chapter 9. Whether that recommendation is a prerequisite to filing under Chapter 9 is not clear. What is clear is that, at present, there is no law in the State of Illinois that authorizes **any** unit of government in Illinois to petition to reorganize under Chapter 9 of the U.S. Bankruptcy Code (again, except for the newly created Illinois Power Agency).