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Municipal Bankruptcy, Atlantic City and Other Games of Chance

Atlantic City, N.J., is in the midst of a financial crisis that has been in the making for years. Increased competition and a host of unfortunate spending and hiring decisions have led to a state of affairs that currently features the nation's highest home foreclosure rate, junk bond credit status and an alarmingly large budget deficit. More recently, public officials have fought over whether schools should be funded at the expense of shutting down city government, or vice versa, as if either would be an acceptable outcome.

How to fix Atlantic City? That question is now being bitterly debated at all levels of government in an unusual combination of bipartisanship and acrimony that pits the Republican governor and the Democratic senate president against the Republican mayor and the Democratic assembly speaker. Gov. Chris Christie proposes a state takeover of nearly all of the city's operations, including the right to deal directly with municipal employee labor unions, dissolve city agencies and sell off the city's assets. The mayor, who earlier supported a similar version of the governor's plan, now opposes it and prefers an alternate plan from the assembly speaker that would allow the city to retain control, at least for now.

Significantly, neither of the plans contemplate bankruptcy, despite the potential for comprehensive adjustment of debt provided under chapter 9 of the bankruptcy code. The consensus is that an Atlantic City bankruptcy would be a bad thing not just for Atlantic City but for all New Jersey municipalities because it will raise their borrowing costs going forward. Recent history supports this view–in the wake of Detroit's chapter 9 filing, local government borrowing costs in Michigan have increased substantially.

In the private sector, the markets routinely discount troubled companies' debt while preserving historically low borrowing costs for investment-grade companies, even within the same industries or sectors as other companies that have filed for chapter 11 protection. So why is it different in the municipal sector?

A variety of factors may account for this discrepancy, but one important factor may be the way bondholders and other financial creditors are treated in chapter 9. Unlike chapter 11, where expectations are settled, there is a trust deficit in chapter 9 that runs throughout the process for reasons endemic to chapter 9 itself, as well as the way chapter 9 cases are adjudicated.

There is a perception that judges have their thumbs on the scale of chapter 9 proceedings in a way that favors local creditors and pension claimants at the expense of financial creditors. That perception may have some basis, given the way recent chapter 9 cases have played out. In Detroit, holders of pension claims received treatment perceived to be substantially superior to that of bondholders with identical entitlements. And in that same case, the presiding judge disregarded the emergency manager's business judgment and rejected a settlement with financial creditors holding quasi-liens because he believed the settlement paid them too much. When the city then negotiated a new, more favorable settlement, with the help of another federal judge acting as a mediator, the presiding judge again rejected the settlement despite the mediator's endorsement. The settlement ultimately approved by the court was for an amount that was far less than the creditors actually were owed.

With respect to chapter 9 itself, although it largely tries to mimic chapter 11, there are key differences that don't work in creditors' favor. First, for reasons grounded in federalism, a chapter 9 debtor doesn't need court approval to conduct its affairs or even to take extraordinary actions that could be value-degrading. Second, dissenting creditors in chapter 9 cases lack a backstop that exists in chapter 11. Under chapter 11, regardless of how popular a reorganization plan might be, any creditor can successfully object to confirmation if it demonstrates that it is receiving less than it would if the debtor was liquidated under chapter 7. This important component of chapter 11 prevents the debtor from reorganizing on the backs of those creditors who would do better if the debtor was simply liquidated. Chapter 9, on the other hand, lacks that protective backstop because the concept of a city being "liquidated" under chapter 7 simply doesn't apply, as cities are not even eligible for chapter 7 relief.

Although bankruptcy isn't an avenue of first recourse in almost any context, neither should cities be deprived of it as an efficacious remedy of last resort. For chapter 9 to fully accomplish its purpose, however, it must earn the buy-in of its largest creditor constituents. That may ultimately require reparative legislation. In any event, the credibility of the process demands that claims with similar legal entitlements be treated similarly under debt-adjustment plans without regard as to who the holders of those claims happen to be.

How Can Chapman Help

Clients frequently turn to Chapman in times of crisis. Our dedication to the capital markets and in-depth understanding of participant concerns in such matters has earned Chapman's Bankruptcy and Restructuring Group a distinct presence and reputation for both its strategic advice and creative approach to sophisticated, out-of-court restructurings. If a situation cannot be resolved consensually, we offer skilled representation to creditors, committees (formal and informal), bondholders and others in bankruptcy court and other forums across the nation.

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Steve is a member of the firm's Bankruptcy and Restructuring Group. He regularly represents investors, creditors, and lenders in complex restructurings, in and out of bankruptcy court.

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