

## **Fiscal Stress and Municipal Bankruptcy: History and Implications for Rhode Island**

*Rhode Island has been cited as one of the weakest states in terms of economic growth and fiscal health in the nation and the economic crisis of the past several years has had a significant impact on cities and towns in the Ocean State. This Public Policy Issue Brief provides an overview of the fiscal challenges faced by communities across the state, as well as a description and summary of Chapter 9 (Municipal Bankruptcy) across the country and in Rhode Island.*

### **Introduction**

As the country emerges from the recent economic downturn, the fiscal health and stability of municipalities has attracted greater attention. State intervention, bankruptcy, and increasing levels of debt financing have become a reality for many localities. According to a December 2011 report by Moody's Investors Service, Inc., municipalities in Rhode Island have been subject to steeper declines in property values and sharper increases in pension liabilities than the nation as a whole, as well as lackluster economic growth. As a result, the company has given an A1 outlook for Rhode Island municipalities. This rating is a step below the national median of Aa3, and it is not anticipated the state will experience any rating upgrades in the coming fiscal year.

Municipal bankruptcy, frequently referred to by its chapter under the federal bankruptcy code – Chapter 9 – has garnered more attention in recent years. Confronted with the challenge of continuing basic operations during the economic downturn, coupled with various contractual obligations, such as pension payments to municipal retirees, some municipalities have started to consider Chapter 9 as a form of debt relief and restructuring. In 2011, 13 municipalities and

special-purpose districts or public-benefit corporations across the country filed for municipal bankruptcy, and others have seen the appointment of task forces or review teams.

In August 2011, Central Falls, Rhode Island sought bankruptcy protection in an effort to restore the city to fiscal solvency. Although no other Rhode Island community has filed for bankruptcy, a number of other municipalities face similar challenges. Moody's December 2011 downgrade of East Providence's bond rating to junk status was in response to the city's financial situation. The city is reported to have required state assistance to borrow funds to support operations through the end of the fiscal year. Currently a state-appointed, five-member budget commission is tasked with reorganizing the city's finances to avoid bankruptcy. In February, Providence Mayor Angel Taveras noted that Chapter 9 may be an option for the capital city, which faces a \$22.5 million budget deficit in the current fiscal year. Most recently, Woonsocket disclosed a \$10 million deficit and reported that bankruptcy also remains an option for the city.

Each successive filing raises the question of whether the stigma of municipal bankruptcy is lessening. Municipal fiscal stress – particularly insufficient cash flow to fund

current operations and municipal pension obligations – has made Chapter 9 a more attractive option for communities. Bankruptcy protection may aid municipalities who are having difficulties meeting their financial obligations by allowing greater flexibility with regard to contractual requirements and payments of other obligations. However, it often also results in greater borrowing costs for the municipality, and potentially for the state. Furthermore, the community may become less attractive to current and potential businesses and residents who, as a result, may choose not to locate in the municipality, further straining the community’s fiscal capacity.

**Local Finances**

**Revenue Overview**

Local governments in Rhode Island are supported by three primary sources of revenue: property taxes, state aid, and federal aid. In most cases, these governments are predominantly supported by property taxes and state aid (excluding federal and state education aid), although the extent to which communities rely on these revenue sources varies by community. Table 1 shows municipal general fund revenue by source for the state’s 39 cities and towns for FY 2010, the most recent year for which data was

**Table 1  
FY 2010 Municipal General Fund Revenue by Source\***

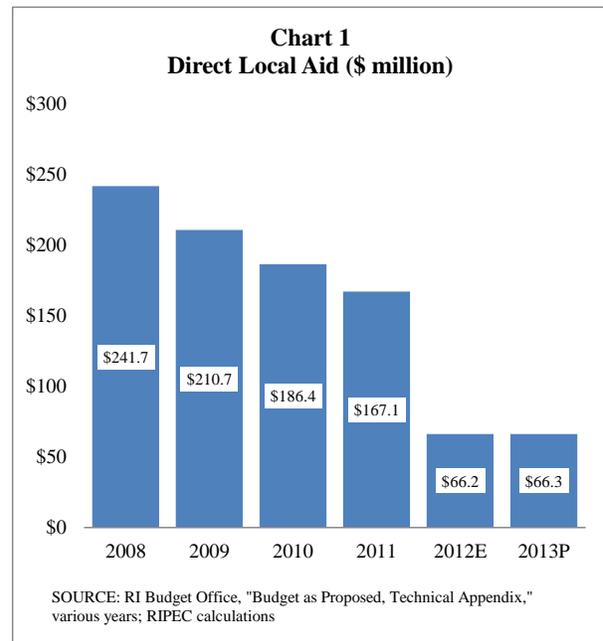
	Local		Federal	State
	Property	Other		
Urban Core	48.7%	9.5%	0.1%	41.8%
Urban Ring	68.9%	6.8%	0.7%	23.6%
Suburban	74.9%	8.0%	0.9%	16.2%
Emerging Suburban	73.0%	8.0%	0.4%	18.6%
<b>Total</b>	<b>64.5%</b>	<b>8.2%</b>	<b>0.5%</b>	<b>26.8%</b>

\* Excludes state and federal appropriations for education  
 SOURCE: Division of Municipal Finance; RIPEC calculations  
 See RIPEC "Results" appendix for definitions

available. According to the data, roughly 65 percent of municipal revenue is derived from the local property tax; however, property taxes only account for 48.7 percent of urban core revenues, compared to almost 75 percent of suburban revenues.

*State Aid*

In Rhode Island, direct state aid to municipalities includes payment in lieu of taxes (PILOT), distressed communities aid, the motor vehicle excise tax phase-out, state and reference library grants, library construction reimbursements, and funding for property revaluation. In response to shrinking state revenues, general revenue sharing was cut by approximately 50 percent in FY 2009, and the program was eliminated in FY 2010. The following year, in FY 2011, the state reimbursement for the motor vehicle excise tax phase-out was reduced slightly. The FY 2012 budget virtually eliminated the program, reducing payments to \$10.0 million from a peak of \$136.2 million in FY 2007.

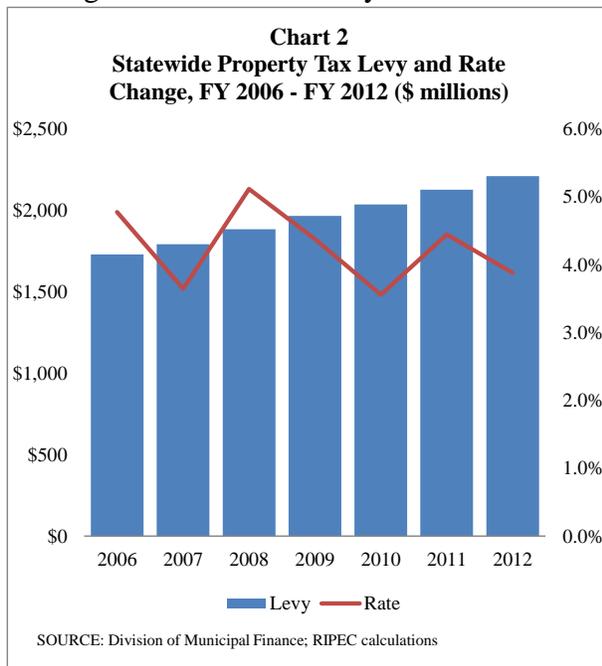


As shown in chart 1, between FY 2008 and the FY 2013 proposed budget, direct local aid, excluding education aid, declined from \$241.7 million to \$66.3 million, a decrease of 72.6

percent. When education aid is included, total state support for local government activities declined 20.4 percent over the five-year period.

*Local Revenues*

Despite the recent recession, property tax levies have steadily increased across Rhode Island. Between FY 2006 and FY 2012, the statewide levy increased by 33.9 percent, or \$559.5 million. Chart 2 shows the statewide levy and rate increase between FY 2006 and FY 2012. Of note, the statewide levy has not met nor exceeded the cap established under the state’s property tax cap legislation popularly referred to as S 3050. However, as of FY 2009, the most recent year for which nationally-comparable data are available, Rhode Island’s property tax burden as a share of personal income was the 4<sup>th</sup> highest in the country and 140.8 percent of the national average. Moreover, property taxes accounted for a greater share of the state’s total tax burden when compared to the national average (44.6 percent v. 33.4 percent). The state’s heavy reliance on the property tax, coupled with high property taxes, is a significant contributing factor to the state’s overall high rankings in national tax analyses.

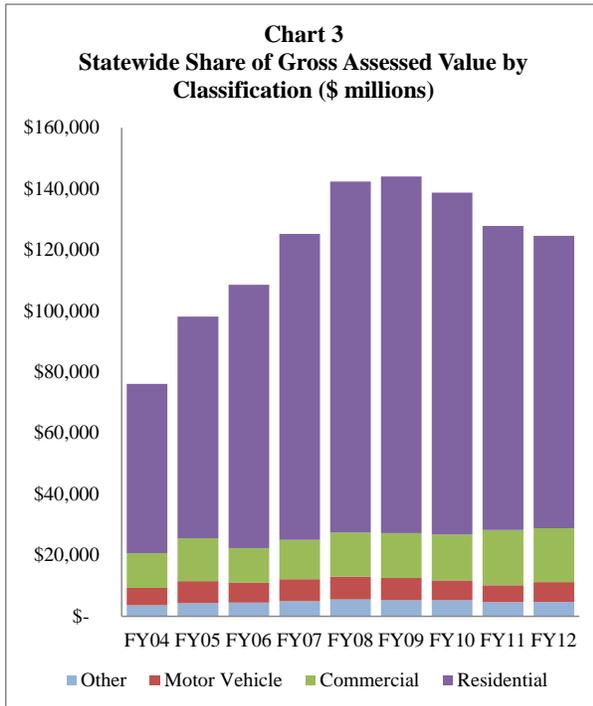


Although the state’s tax burden is high overall, the total levy does not take into account a number of factors that affect who bears the burden including:

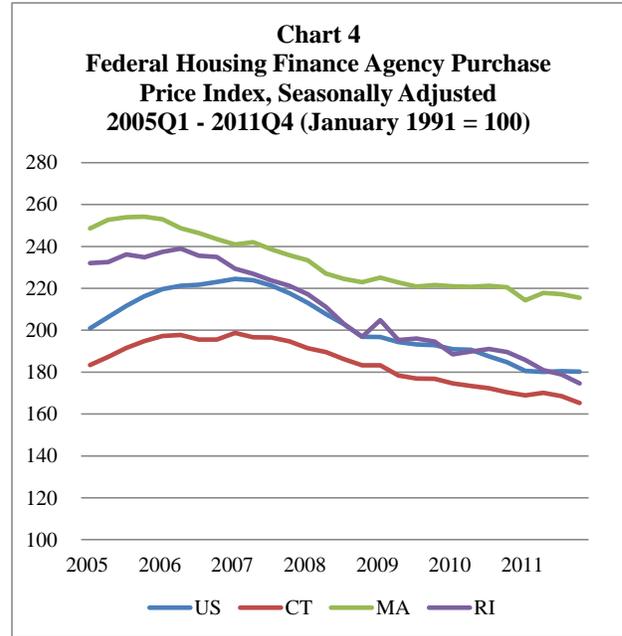
- *Rate by Community:* FY 2012, residential rates ranged from \$4.74 per \$1,000 of property value in New Shoreham, to \$31.89 per \$1,000 of property value in Providence.<sup>1</sup> However, communities with lower rates do not necessarily have a lower tax burden given that they tend to have higher property values per capita.
- *Exemptions:* Deductions from property tax owed, or on the assessed value, such as a homestead exemption, lower the individual taxpayer burden. As of FY 2012, eight communities had active homestead exemptions, while East Greenwich and Newport have enabling legislation. Although Providence has the highest property tax rate in the state, the city has a homestead exemption equal to 50.0 percent of the value of owner-occupied houses, effectively reducing the taxpayer burden by half.
- *Classification Structures:* Many communities have tax rates that vary by class of property (i.e. residential, commercial, motor vehicle and tangible). Classification structures, established under Rhode Island General Law 44-5-11.8, allow communities to shift the tax burden between the different classes of property. The law stipulates that the tax rate on a property classification cannot exceed the rate applied to any other class of property by more than 50 percent.<sup>2</sup> In Rhode Island, fluctuations in residential property values have resulted in comparatively stable commercial properties bearing a greater share of the overall property tax

<sup>1</sup> NOTE: Scituate’s FY 2012 rate of \$32.73 was the highest in the state; however, the community assesses property at less than<sup>1</sup> Providence and Gloucester are excluded from this limitation. full value.

burden. Chart 3 shows gross assessed property value in the state by classification between FY 2004 and FY 2012. From FY 2009 to FY 2012, assessed residential property values declined by 17.9 percent, while commercial assessed values increased by 19.5 percent.



As evidenced by the data in chart 3, the housing market contraction has had a significant effect on residential property values in Rhode Island. Moreover, this deflation in housing prices was more severe in Rhode Island than it was nationally, or in either neighboring state. As measured by the Federal Housing Finance Agency Purchase Price Index, single-family housing prices in Rhode Island fell 27.0 percent between the market peak in the second quarter of 2006 and the last quarter of 2011 (chart 4). Moreover, housing prices are likely to continue to decline in Rhode Island. By contrast, peak-to-trough (or current) prices fell 19.8 percent nationally, 16.7 percent in Connecticut and 15.2 percent in Massachusetts. This erosion of municipal tax bases hit the state’s central cities – which



tend to have lower home values and higher rates of foreclosures – particularly hard.

### Municipal Fiscal Stress

In 1973, the U.S. Advisory Commission on Intergovernmental Relations (ACIR) identified eight warning signs that local governments may face fiscal stress:

- Operating fund where expenditures exceed revenues;
- Consistent overage of expenditures over revenues for several years;
- Excess of liabilities over current assets;
- Short-term operating loans outstanding at the end of the fiscal year;
- High property tax rates coupled with high delinquency in property tax collections;
- Sudden, unexpected, substantial decrease in assessed property values;
- Under-funded pension funds; and
- Poor budgeting, accounting, and reporting techniques.

The ACIR also found that “[u]nsound fiscal management stands out as one of the most important potential causes of financial emergencies in local governments.” The ACIR added defaulting on various notes and

bonds, municipal bankruptcy, and failure to meet financial obligations to the list of warning signs in 1985.

*Distressed & Fiscally-Stressed Communities*

Rhode Island has two designations for communities facing fiscal difficulties: distressed communities, a statutory definition that provides state aid, and fiscally stressed, developed by the “Task Force to Measure Fiscal Stress” in January 2010. The Distressed Communities Relief Program was established in 1990 to provide a measure of assistance to communities with the highest property tax burdens relative to taxpayer wealth. There are four indices that determine program eligibility:

- Percent of tax levy to the full value of property;
- Per capita income;
- Percent of personal income to full property value; and
- Per capita full property value.

	Distressed (1)	Fiscally Stressed (2)
Central Falls	*	*
Cranston	*	
East Providence		*
Johnston		*
North Providence	*	*
Pawtucket	*	*
Providence	*	*
Warwick		*
West Warwick	*	*
Woonsocket	*	*

(1) Communities receiving "Distressed Communities Aid" in FY 2013

(2) Based on Municipal Fiscal Stress Task Force report, January 28, 2010

Any community which falls into the lowest 20 percent of at least three of the four indicators is eligible for aid. In the report developed by the “Task Force to Measure Fiscal Stress”, fiscal stress is described as a combination of financial position, financial flexibility, and tax capacity indicators. The report takes a broad view of fiscal stress, incorporating such factors as unfunded pension liabilities, long-term debt, and reliance on state aid.

As shown on table 2, ten communities are either classified as distressed or fiscally stressed by the metrics outlined above. Cranston is the only community not designated as fiscally stressed in the 2010 report to receive distressed communities aid in FY 2013. However, three communities, East Providence, Johnston, and Warwick – all designated as fiscally stressed – do not receive any state aid based on this designation.

*Statewide Equity Index*

Another measure of municipal fiscal stress is the statewide “Equity Index”, which is based on relative property tax burden and effort. The Division of Municipal Finance considers the property tax base and levy of each municipality relative to the state average. The results produce an “Equity Index” for each municipality. The Index uses the adjusted weighted equalized assessed value (or EWAV), which includes an adjustment for the Median Family Income (MFI) of each community and the gross levy reported by each community. The Index calculates the average state property tax rate and uses the rate to generate a hypothetical per capita tax yield. This yield is then compared to the actual per capita property tax yield by community. The Index then estimates the gap between the actual and potential yield if the state average tax rate were used, based on each community’s tax base.

The composite equity index is calculated by dividing each community’s relative capacity

by its relative effort. In general, those communities that have an Equity Index of 1.00 or less are considered to evidence some level of fiscal stress relative to the rest of the state because of their relative fiscal capacity and tax effort. Table 3 shows the MFI, property tax capacity and effort, and Equity Index number for the five districts with the highest Equity Index and the ten districts with the lowest composite Equity Index<sup>3</sup>. Of note, of the ten districts with the lowest composite index number, nine are considered either fiscally stressed or distressed communities.

**Table 3**  
**Tax Capacity and Effort, FY 2009**

	MFI	Property Tax Capacity Effort		Equity Index
New Shoreham	\$59,844	\$4,258	\$95	44.82
Little Compton	\$62,750	\$455	\$29	15.69
Jamestown	\$77,990	\$388	\$41	9.46
Exeter-W. Greenwich	\$72,745	\$493	\$73	6.75
East Greenwich	\$90,221	\$247	\$71	3.48
Cranston	\$55,241	\$85	\$121	0.70
Johnston	\$54,837	\$86	\$131	0.66
North Providence	\$51,655	\$71	\$132	0.54
Westerly	\$53,165	\$76	\$148	0.51
East Providence	\$48,463	\$67	\$131	0.51
West Warwick	\$47,674	\$33	\$95	0.35
Woonsocket	\$38,353	\$30	\$95	0.32
Pawtucket	\$39,038	\$38	\$160	0.24
Providence	\$32,058	\$35	\$256	0.14
Central Falls	\$26,844	\$15	\$189	0.08

See <http://infoworks.ride.ri.gov/funding-and-resources/statewide-data> for all communities

**Municipal Bond Ratings**

Municipal bonds are issued by local governments, or agents thereof, in order to borrow money for public purposes. In general, municipal bonds are tax free for investors who reside in the state where the bond is issued. As a result, these bonds typically have low yields, allowing local governments to borrow funds at below-market

<sup>3</sup> NOTE: Equity Index data by municipality is not currently available.

rates. General obligation (GO) bonds are one of the common types of municipal bonds in the U.S. These bonds are backed by local resources, e.g., property taxes, and often have covenants attached to them that either restrict certain activities or require the issuer to meet certain requirements in order to maintain their tax-free status. Because GO bonds are backed by property taxpayers, they often have relatively high bond ratings.

**Table 4**  
**Municipal Bond Ratings**

Moody's	S&P	Fitch	Credit-Worthiness
Aaa	AAA	AAA	Investment Grade
Aa1	AA+	AA+	
Aa2	AA	AA	
Aa3	AA-	AA-	
A1	A+	A+	
A2	A	A	
A3	A-	A-	
Baa1	BBB+	BBB+	
Baa2	BBB	BBB	
Baa3	BBB-	BBB-	
Ba1	BB+	BB+	Below Investment Grade
Ba2	BB	BB	
Ba3	BB-	BB-	
B1	B+	B+	
B2	B	B	
B3	B-	B-	
Caa1	CCC+	CCC	
Caa2	CCC		
Caa3	CCC-		
Ca	-	-	
C	-	-	Default
-	-	DDD	
-	-	DD	
-	D	D	

Source: moody's.com, standardandpoors.com, and fitchratings.com

There are three major rating agencies for municipal bonds: Moody's Investors Service, Inc., Standard and Poor's and Fitch Ratings. In assigning a bond rating, the agencies consider the overall fiscal capacity of a municipal entity, taking into account the community's: economy; debt and debt structure; financial condition; demographics; and government management practices. Effectively, these factors together are intended

to provide a measure of the credit-worthiness of the issuing community. As shown on table 4, bond ratings vary by company. Moody's ratings range from Aaa to C, while bond ratings at S&P and Fitch range from AAA to D.<sup>4</sup> The higher the bond rating, generally, the lower the interest payments are for the community because of the lower level of risk involved in the investment.

As bond ratings fall, however, the cost of going to the market increases for communities. In the short run, lower bond ratings may also limit access to capital markets, even for borrowing for cash-flow purposes. Longer-term implications of low bond ratings – particularly bond ratings considered to be below investment grade – include increased project costs due to both delaying projects and increased borrowing costs, as well as opportunity costs related to foregoing a project.

Town	Date of Downgrade	Downgraded		Current Outlook
		From	To	
Pawtucket	2/11/2011	A1	Baa2	Negative
Providence	3/17/2011	A1	A3	Negative
Coventry	3/30/2011	Aa2	Aa3	Negative
Warwick	5/12/2011	Aa2	Aa3	NOO*
Central Falls	6/17/2011	B3	Caa1	Negative
West Warwick	8/5/2011	A1	Baa1	Negative
East Providence	8/11/2011	A1	Baa1	RUR**
Coventry	9/21/2011	Aa3	A1	Negative
North Providence	9/29/2011	Baa1	Baa2	Negative
East Providence	12/12/2011	Baa1	Ba1	RUR**
Woonsocket	1/17/2012	Ba1	Ba2	Negative
Cranston	2/24/2012	A1	A2	Negative
Providence	3/26/2012	A3	Baa1	Negative

\*NOO - No Outlook  
 \*\*RUR - Ratings Under Review  
 Source: Moody's Investors Service

Table 5 outlines the 10 Rhode Island communities who have had a ratings downgrade by Moody's since the beginning of 2011. Of the 10, Central Falls, East Providence and Woonsocket are the only communities with a rating below investment grade (Ba1 or lower). However, the majority of the municipalities face a negative outlook and two, Coventry and East Providence, have seen two downgrades in less than one year. Recently, Woonsocket's bond rating was downgraded to below investment grade by Fitch. Fitch also downgraded Providence's bond rating, from A to BBB.

## Chapter 9 Background and History

Municipal bankruptcy, frequently referred to by its chapter under the U.S. Bankruptcy Code – Chapter 9 – provides municipalities with relief such as an automatic stay on debt repayments and the ability to bind creditors to a debt restructuring plan. This section of the report provides an overview of the mechanics and history of bankruptcy and Chapter 9, across the country and in Rhode Island.

### Bankruptcy Code

Broadly, bankruptcy is the legal status of an insolvent entity, and may refer to the legal proceedings to restructure debt or liquidate assets in order to resolve the insolvency. Bankruptcy in the United States is governed by Congress with authorization under the Article 1 of the Constitution. The article empowers Congress to establish procedural bankruptcy law throughout the country. In addition to federal law, state law plays a role in bankruptcy filings, often in relation to property rights issues. There are multiple chapters of the United States Bankruptcy Code permitting various entities a mechanism for debt restructuring during times of financial distress. The most common chapters refer to the filings of individuals (Chapters 7 and 13),

<sup>4</sup> For both S&P and Fitch, a rating of "D" indicates the bond is in default due to non-payment.

**Table 6**  
**Select Chapters of U.S. Bankruptcy Code**

Chapter	Eligible	Description
Chapter 7	Individual, Partnership, Corporation, or Other Business Entity	Provides for liquidation, sale of the debtor's nonexempt assets, in order to repay creditors.
Chapter 9	Municipalities	Provides protection for financially-distressed local government entities from creditors while the governmental entities establish a plan to restructure their debt.
Chapter 11	Corporation, Partnership, or Sole Proprietorship	Commonly referred to as "reorganization" it provides insolvent business entities the opportunity to develop a reorganization plan.
Chapter 12	Family Farmers or Family Fishermen	Provides for family farmers and fishermen with "regular annual income" to establish a plan to repay all or part of their debts to creditors over a 3-5 year period. Chapter 12 is a hybrid of Chapters 11 and 13.
Chapter 13	Individuals	Provides for individuals with regular income to establish a plan to repay all or part of their debts to creditors over a 3-5 year period.
Chapter 15	Corporation, Partnership, or Sole Proprietorship	Provides for cross-border insolvency proceedings involving debtors, assets, and parties of interest in more than one country.

Source: United States Courts

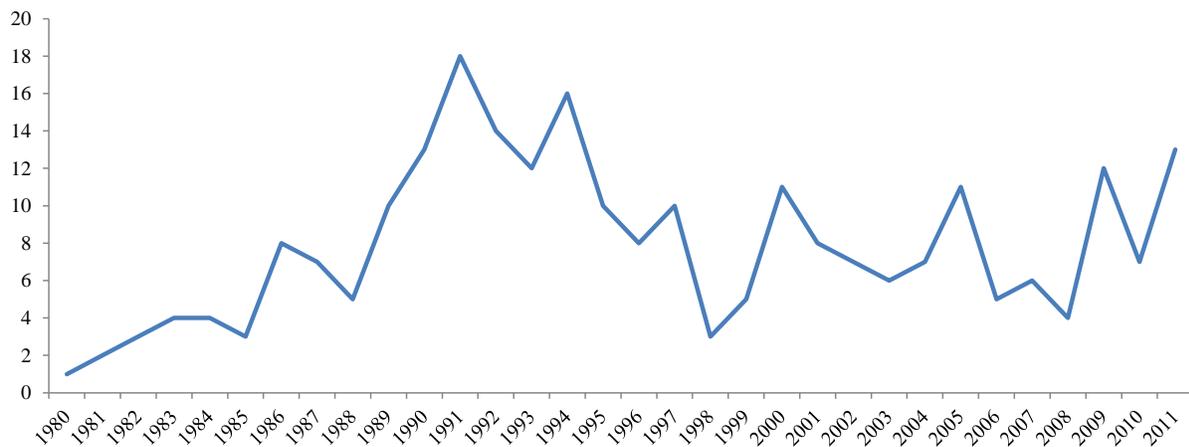
the filings of businesses (Chapters 7 and 11), and the filings of municipalities (Chapter 9).

Chapters 9, 11 and 13 provide restructuring and debt relief to municipal entities, businesses, and individuals, respectively. By contrast, Chapter 7 provides for the liquidation of the debtor's non-exempt property in order to repay creditors and is applicable only to individuals and business entities, not municipalities: entities eligible to file under Chapter 9 cannot be liquidated through a bankruptcy filing due to the provisions in the 10<sup>th</sup> Amendment to the Constitution relating to state sovereignty. Chapter 12 relates specifically to "family fishermen" or "family farmers" and is effectively a hybrid of Chapters 11 and 13, while eliminating some of

the barriers contained in those two chapters in recognition of the unique nature of the businesses. Chapter 15 is a more recent addition to the federal Bankruptcy Code and relates to cross-border (international) insolvency. Table 6 outlines some of the more prevalent forms of bankruptcy.

A relatively new addition to U.S. Bankruptcy Code, the first municipal bankruptcy legislation was passed in 1937 as local governments faced economic crises across the country, necessitating debt restructuring. Since 1937, fewer than 650 U.S. cities, counties, towns, political subdivisions, public agencies, or other qualifying entities have filed for Chapter 9, with just over 250 filings occurring in the last three decades. These filings are infrequent occurrences, generally

**Chart 5**  
**Chapter 9 Bankruptcy Filings Per Year: 1980-2011**



Source: American Bankruptcy Institute and RIPEC calculations.

because states tend to assist struggling cities, towns, and other Chapter 9 eligible entities before they resort to bankruptcy or may not allow these entities to file. Chart 5 displays the number of Chapter 9 bankruptcy filings from 1980 to 2011. Despite the attention the likes of Central Falls, Rhode Island and Harrisburg, Pennsylvania have garnered, Chapter 9 filings remain rare among the majority of municipal entities.

According to the federal Bankruptcy Code, only municipalities, which are a “political subdivision or public agency or instrumentality of a state,” are eligible for this form of relief. Rarely has Chapter 9 been implemented by an entire city or county. More often than not, “special purpose municipal taxing vehicles,” i.e., school districts, water districts, and hospital authorities, have made the most frequent use of Chapter 9. As noted above, state law also governs some aspects of filing, including, but not limited to, establishing guidelines on that its municipalities must satisfy in order to be authorized by the state to file.

As opposed to the other forms of insolvency proceedings, in a Chapter 9 bankruptcy case

the U.S. Bankruptcy Court performs only a limited role, which is generally limited to the following:

- Determining the “eligibility” of a municipality to file at the outset of the bankruptcy proceedings;
- Addressing disputes over control of municipal assets, the effect of the automatic stay, assumption or rejection of executory contracts, preferences, fraudulent conveyances and claims; and
- Determining whether the plan of adjustment proposed by the debtor may be confirmed.

### **Chapter 9 Requirements**

In accordance with U.S. Bankruptcy Code, municipalities must meet several requirements that differ from other forms of bankruptcy in order to be “eligible”. First, the municipality must be authorized by the state to be a debtor. Twelve states currently permit municipalities to file for Chapter 9 bankruptcy protection without prior approval of the state, including Alabama, Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas and Washington. California belonged to this group until late 2011 when the state instituted

a law requiring municipalities to participate in a neutral evaluation process. Eleven states, in addition to California, require state authorization before a municipality can file for Chapter 9.<sup>5</sup> Colorado, Oregon, and Illinois allow their municipalities limited authorization to become a debtor under Chapter 9. Georgia and Iowa have laws explicitly barring municipalities from declaring bankruptcy, though Iowa's law makes an exception for bankruptcy filings if the municipality's insolvency is due to involuntarily incurred debt. The remaining 21 states do not have clear legislation authorizing or banning Chapter 9 filings.

A number of states require municipalities to take certain actions before they are allowed to file for bankruptcy. For example, under California's pre-filing neutral evaluation mandate, municipalities are given a process through which they can negotiate readjustment of their debts without having to resort to bankruptcy. In Rhode Island there is a three-step intervention process in which municipalities must participate before they are allowed to file, except in extraordinary circumstances. In some states, municipalities are empowered to make changes to their financial structure or are afforded relief from some state mandates.

Another eligibility requirement is that the municipality must be insolvent. According to the federal Bankruptcy Code, a municipality is deemed "insolvent" when it is generally not paying its debts when due or if it is unable to pay its debts as they become due. Often, communities that are denied bankruptcy protection, such as Bridgeport, Connecticut in the early 1990s, are unable to meet this requirement. Furthermore, the filing municipality must have satisfied at least one of the following actions:

- Obtained 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;
- Been unable to negotiate with creditors because such a negotiation is unrealistic;
- Engaged in negotiations in good faith with creditors and failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class the debtor intends to impair under a plan; or
- Reasonably believed that a creditor may obtain a preference.

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#### *U.S. Bankruptcy Code Highlights*

- § 362 grants an automatic stay, upon filing, which prevents most creditors from collecting on debts and bringing legal action against the debtor;*
  - § 365 gives the debtor the power to assume or reject executory contracts, which are contracts that have obligations yet to be fulfilled by both parties;*
  - § 502 allows for the claims process under which creditors can file for proof of what is owed;*
  - § 507 establishes priority among claims; and*
  - § 943 lays out the plan on adjustment process under which the debtor can reorganize.*
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Once it has been established that the municipality is authorized to be a debtor and is insolvent, it must then determine a course of action to address its debts. For those entities that are deemed "eligible" according to the aforementioned standards, public employee obligations and bond debts are the two most common forms of debt. Moreover, they are the most likely to be the focus of the restructuring process. Other forms of debt, such as trade and vendor liabilities, rarely contribute to a municipality's debt restructuring effort as they are commonly limited in amount by state debt limitation provisions. There are some forms of municipal bond debt that are not affected by Chapter 9 filings. These include industrial revenue bonds, which are tax-exempt bonds,

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<sup>5</sup> These states are CT, FL, KY, LA, MI, NC, NJ, NY, OH, PA, and RI.

frequently used to finance private, corporate infrastructure projects as a means of economic development.

*Collective Bargaining and Rejection of Labor Contracts under Chapter 9*

As with other forms of reorganization bankruptcy, under § 365 of the U.S. Bankruptcy Code, entities deemed eligible to file under Chapter 9 are empowered to reject collective bargaining agreements (CBAs), as long as certain conditions are met. In *NLRB v Bildisco & Bildisco*, the U.S. Supreme Court held that companies may void labor contracts as long as they are able to demonstrate that “equities balance in favor of rejecting the labor contract” and that they may reject the CBA as soon as they file a petition, as opposed to waiting for a hearing in bankruptcy court.<sup>6</sup> The Bankruptcy Amendment Act of 1984, however, limited the right of companies to terminate labor contracts and, in 1994, Congress enacted Section 1113(b), which expressly forbids unilateral modification of CBAs unless a Chapter 11 debtor:

- makes a proposal to employees, or the authorized representative of employees, covered by such an agreement that outlines the terms of the modifications and that such modifications are necessary to permit reorganization, based on the most complete information available at the time;
- provides the employees, or representative thereof, all the necessary and relevant information needed to evaluate such a proposal; and
- meets, and confers in good faith, with the authorized representative in order to reach mutually satisfactory modifications.<sup>7</sup>

In determining whether to approve the application, the court, under the provisions of Section 1113, must find that the debtor has

fulfilled the requirements outlined above, that the refusal to accept said proposal was without good cause, and the “balance of equities *clearly* favor rejection of such agreement” (emphasis added).

Although the above governs the rejection of CBAs in the context of a Chapter 11 filing, in the case of Chapter 9 filings, it is noticeably absent from Bankruptcy Code provisions incorporated into Chapter 9. Moreover, in 1991, a proposed bill that would have required municipal debtors to “exhaust state labor law procedures before rejecting a collective bargaining agreement” did not make it out of committee.<sup>8</sup>

California courts in both the Orange County and Vallejo filings upheld modified forms of *Bildisco*. In the case of Orange County, the Court held that *Bildisco* applies under Chapter 9, but that it does not allow entities to unilaterally modify CBAs unless the entity has fully complied with state labor law. Effectively, the Court held that state labor law continued to affect issues related to CBAs even in the case of a Chapter 9 filing. In the case of Vallejo, the Court found that, although the determination as to whether municipal entities are eligible to file is left to a state, they have no basis for restricting the application of the provisions of Chapter 9 once the filing is authorized and that *Bildisco* applies. Specifically, the Court found that “Congress, not the Court ... should decide whether to incorporate Section 1113-like provisions into Chapter 9 ... in the absence of such legislation ... [t]he Court finds *Bildisco* and *In re County of Orange* to be persuasive authorities for analyzing and determining the appropriate standard for municipalities to reject a CBA during Chapter 9 bankruptcy.”<sup>9</sup>

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<sup>6</sup> *Bildisco* (465 U.S. at p. 526).

<sup>7</sup> 11 USC § 1113 – Rejection of Collective Bargaining Agreements

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<sup>8</sup> Ryland EM, Douglas MG, “Municipal Bankruptcies: A Horse of a Different Color”, September/October 2010

<sup>9</sup> *In re City of Vallejo*, 403 B.R.

In Rhode Island, § 45-9-9 requires a fiscal overseer, budget commission or receiver to approve or reject new CBAs and requires that they participate in the negotiation of said CBA. If the CBA is approved, they must provide written certification to the director of revenue that they have evaluated the financial impact of the CBA. In the event that they do not approve of the CBA, they must specify the parts of the agreement that they reject and the reasons for the rejection. The section expressly provides that, absent agreement between the parties, the fiscal overseer, budget commission or receiver does not have the authority to alter any CBA as long as the CBA is in effect. In light of the absence of the express inclusion of Section 1113 in Chapter 9, along with the precedent set in both *County of Orange* and *City of Vallejo*, it appears that the *Bildisco* standard for the unilateral rejection of a CBA applies after an entity files a Chapter 9 petition.

### **2011 Chapter 9 Filings**

Nationally, 13 municipal entities sought financial relief and protection from creditors through Chapter 9 in 2011, one of which, Jefferson County, Alabama, was the largest municipal bankruptcy in US history. Stockton, California is currently in a state-mandated form of mediation that municipalities in the state must participate in before filing for bankruptcy, except in cases of imminent fiscal emergencies. If Stockton declares bankruptcy, it will become the most populous city to ever file.

Chapter 9 filings are frequently the result of either one-time events or more persistent structural budget problems. Regardless of the motivation to file, Chapter 9 is an expensive endeavor for municipal entities in both the short- and long-run. In the case of Vallejo, California, which filed in 2008 after three consecutive annual budget deficits, it is estimated that its Chapter 9 filing came at a

cost of approximately \$12 million to the city. Although no two bankruptcies are exactly alike, most cases can take years to emerge from bankruptcy and at a considerable cost to the municipal entity.

### **March: Boise County, Idaho Filing**

On March 1, 2011, Boise County, Idaho became the first county in 17 years to file for Chapter 9. The county stated it was unable to meet its financial obligations following a \$4 million judgment, with an additional \$1.4 million in attorney fees against the county for violating the Fair Housing Act. The case was dismissed on the grounds that, although the county met a number of the prerequisites for filing, the county did not prove it was, in fact, insolvent at the time of the filing.

The county claimed it was unable to raise sufficient funds to pay its current and future debts while meeting its obligations to residents because of how municipal accounts were structured under Idaho State Law. Similarly, the county argued it was unable to raise additional funds through property tax increases or bonding. The Court ruled that the county was able to meet both its current and future obligations through the transfer of funds into the county's unrestricted fund per their interpretation of Idaho State Law.

### **August: Central Falls, Rhode Island Bankruptcy**

In May 2010, Central Falls leadership voted to declare the city insolvent. At the time, the city faced a projected deficit of over \$3 million on an operating budget of approximately \$16 million. The projected shortfall for FY 2011 was over \$6 million, or roughly 35 percent of the city's operating budget. In addition to the current year and projected deficits, in FY 2010 the city had a combined unfunded pension liability and unfunded other post-employment benefits (OPEB) liability of approximately

**Table 7**  
**2011 City & County Chapter 9 Bankruptcy Filings\***

<b>Municipality</b>	<b>Month Filed</b>	<b>Catalysts</b>	<b>Outcome</b>
Boise County, ID	March	Lost a \$4M Fair Housing Act case plus legal fees of \$1.4M	Rejected by US Bankruptcy Court
Central Falls, RI	August	Pension costs, small tax base, and high unemployment	Approved and currently in Chapter 9 proceedings
Harrisburg, PA	October	Continuous budget shortfalls and waste incinerator debt.	Rejected by US Bankruptcy Court
Jefferson County, AL	November	\$3 billion in debt on failed bond financing for sewer construction	Approved March 5, 2012 and currently in Chapter 9 proceedings

\* NOTE: Of the 13 entities that filed for Chapter 9 in 2011, nine were special-purpose entities, e.g. Suffolk Downs OTB  
Source: reuters.com, businessweek.com, idahostatesman.com, bloomberg.com, and npr.org

\$80 million. In August 2011, the City of Central Falls, Rhode Island was the second city in the country to be declared eligible for Chapter 9 since 2000. The city declared bankruptcy after it failed to come to an agreement with its retirees that would have reduced retiree pensions. The Central Falls bankruptcy is discussed in detail in the following section.

### **October: Harrisburg, Pennsylvania Filing**

Pennsylvania’s capitol city, Harrisburg, filed for bankruptcy protection on October 15, 2011, following an attempt by state lawmakers to institute a three-member receivership panel that would have been responsible for the city’s finances. In addition to continuing budget shortfalls, the city faced a \$300 million in debt owed on a waste incinerator. In 2010, Harrisburg failed to make more than \$3.5 million in debt service payments, and it is anticipated the city will face a \$164 million deficit over the next five years.

On November 23, 2011, Harrisburg’s bankruptcy filing was rejected by the U.S. Bankruptcy Court, which ruled that the filing was not authorized by Pennsylvania law. Pennsylvania recently enacted legislation that prohibits municipalities of a certain size to file

for bankruptcy until July 1, 2012. Similar to Central Falls, the State of Pennsylvania appointed a receiver responsible for managing the city’s finances in October 2011.

### **November: Jefferson County, Alabama Bankruptcy**

Most recently, Jefferson County, Alabama filed for bankruptcy protection on November 10, 2011. The filing was the largest Chapter 9 bankruptcy in U.S. history, exceeding the \$1.7 billion in debt that led to the filing of Orange County, California in 1994<sup>10</sup>. Jefferson County had been struggling with how to reconcile more than \$3 billion in debt on failed bond financing relating to a new sewer system. However, municipal bond default is rare – less than one-third of one percent of municipal bonds default. The compounding effects of both the failed bond financing and the lack of resolution with smaller, individual creditors spurred bankruptcy proceedings in Jefferson County.

Creditors argued that the county carried the wrong kind of debt under Alabama law to qualify for Chapter 9. At issue was whether a

<sup>10</sup> The county has yet to exit bankruptcy protection and is not anticipated to do so until 2017.

municipal entity must have bond debt to qualify. However, a federal judge issued an order March 5, 2012 that allowed the county to move forward with bankruptcy proceedings. The judge noted that any form of stated debt may be the basis for a bankruptcy filing. At the time of the order, Jefferson County's debt totaled \$4.2 billion.

### **Fiscal Stress and Chapter 9 in Rhode Island**

The Fiscal Stability Act (FSA) provides a mechanism for state assistance for municipalities under fiscal distress established in Chapter 9 of Title 45 of the General Laws of the State of Rhode Island. The law creates a three-step process that provides increasing levels of state intervention and support based on a community's fiscal situation. The Fiscal Stability Act applied retroactively to Central Falls, which had been placed under judicial receivership less than a month prior, and transitioned the city into state receivership. After a period of just over 13 months, the state-appointed receiver filed for bankruptcy on behalf of the city, making Central Falls the first municipal bankruptcy filing in Rhode Island's history.

#### **Process**

##### *Step One: Fiscal Overseer*

The first step is the appointment of a fiscal overseer by the state director of revenue. This appointment can be brought about either by a municipality submitting a joint request from the council and its elected chief executive officer, or at the discretion of the director of revenue if they find that any two of the following events have occurred:

- The city or town projects a deficit in its municipal budget for the current fiscal year and in the upcoming fiscal year;
- The municipality has failed to file audits by legal deadlines, absent extensions, with

the auditor general for two successive fiscal years;

- The municipality has been downgraded by one of the nationally recognized statistical rating organizations;
- The city or town is unable to access credit markets on reasonable terms; or
- The municipality fails to respond to requests for financial information and operating data made by the director of revenue, the auditor general, or the chairpersons of the house or senate finance committees.

The director of revenue may also appoint a fiscal overseer if a municipality has failed to comply with certain state debt management requirements under RIGL § 45-12.

Once appointed, the fiscal overseer has 120 days to develop a three-year operating and capital financial plan that will successfully stabilize the finances of the municipality. The fiscal overseer is also tasked with recommending sound fiscal policy, supervising and monitoring financial activities, reviewing all proposed contracts and obligations, assisting in the negotiation of collective bargaining agreements, and providing assistance in all matters relating to the financial affairs of the city or town, among other responsibilities. The fiscal overseer is required to report the progress made toward financial stability to the governor, director of revenue, auditor general, and the chairs of the house and senate finance committees on a monthly basis. All budgets and transfer requests are subject to approval by the fiscal overseer as well. The powers of the fiscal overseer are outlined in table 8.

If the municipality under the fiscal overseer is able to demonstrate to the Division of Municipal Finance that it has taken the necessary action to achieve long-term fiscal stability, the director of revenue can remove

**Table 8**  
**Powers of Fiscal Overseer, Budget Commission and Receiver**

Agent	Powers
<b>Fiscal Overseer</b>	Compel operational performance or forensic audits, or any other similar studies; Approve collective bargaining agreements; and Employ, retain, and supervise professional, clerical, and managerial staff required to carry out his/her responsibilities at the expense of the city/town.
<b>Budget Commission</b>	All powers of a fiscal overseer; Approval of all municipal spending and borrowing; Issue debts including, but not limited to, bonds and notes: Ability to levy taxes; Formulate, amend, and execute municipal and capital budgets including matters relating to personnel, contracts for goods and services, purchasing, leasing or sale of property, and issuance of budget guidelines for departments; Finance or refinance any debt, including amortization of operational debt for a term no longer than 5 years, and amend borrowing authorizations; Personnel authority including ability to hire, fire, alter compensation, and make appointments; and Ability to create or suspend any rules and regulations of the municipality.
<b>Receiver</b>	All powers of a financial overseer and budget commission; All powers granted any city/town official, employee, authority, or commission relating to financial issues under the law, including education; and The power to declare bankruptcy.

SOURCE: RIGL §45-9

the fiscal overseer, thereby ending active state fiscal oversight. However, if the overseer concludes that the municipality will be unable to present a balanced budget, or that it will not achieve fiscal stability without the services of a budget commission, the director of revenue will proceed to step two of process and will replace the fiscal overseer with a budget commission.

*Step Two: Budget Commission*

The five-member budget commission is composed of three designees of the director of revenue, the current elected chief executive officer of the municipality, and the president of the city or town council. If the chief elected official of the municipality is the president of the city or town council, the municipality’s manager/administrator will be named the fifth member. In the event that no

manager/administrator is currently employed by the municipality, the chief financial officer will fill the fifth seat on the commission. In addition to the powers and duties of the fiscal overseer, the commission is granted other powers as outlined in table 8.

The budget commission acts by majority vote, and is charged with implementing appropriate measures to stabilize the municipality’s finances. A community under the jurisdiction of a fiscal overseer or a budget commission cannot levy property taxes, including motor vehicle excise taxes, without the approval of the Division of Municipal Finance.

If the budget commission is successful in stabilizing the municipality’s finances, the director of revenue can remove the budget commission and end active state oversight. If

the budget commission finds that it is unable to return the finances of the municipality to stability, however, the commission must inform the director of revenue and report the reason, or reasons, why its powers are insufficient. The director of revenue is then charged with replacing the budget commission with a receiver.

### *Step Three: Receivership*

At any stage of the above process, including prior to the appointment of a fiscal overseer, the director of revenue can choose to move directly to the appointment of a receiver if it can be demonstrated that the municipality is facing a fiscal crisis that poses imminent danger to the citizens of the municipality or their property. Regardless of when the receiver is appointed, the receiver is granted all the powers and duties of the fiscal overseer and budget commission, as well as all powers granted any city or town official, employee, authority, or commission relating to financial issues under the law, including education. In addition, the receiver has the power to file a Chapter 9 bankruptcy petition in the name of the city or town.

The receiver's salary is determined by the director of revenue, but paid by the municipality. The elected officials of the city or town under receivership serve in an advisory capacity to the receiver. Should the receiver and elected officials hold differing opinions on how to proceed on a given issue, the receiver has the final authority.

Once the director of revenue determines that the municipality's finances have been returned to stability, the director may terminate active state oversight. Upon termination of active state oversight, a department of administration and finance will be established in the municipality which will oversee financial operations and services for the next five years. The chief elected official of the municipality

will choose the director of financial operations from a three-person list submitted by the Division of Municipal Finance. The officer will report directly to the elected chief executive.

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*In anticipation of the Central Falls Chapter 9 bankruptcy filing, the General Assembly passed SB 0614A/HB 5736A, which guarantees that among all creditors and payments the city must make, including payments to retirees, municipal general obligation bondholders would be paid back first, even in the event of bankruptcy.*

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### *Bankruptcy*

If the receiver determines that the city must file for Chapter 9 bankruptcy, the receiver is responsible for guiding the city through the bankruptcy process. First, the receiver must file a petition with the U.S. Bankruptcy Court, and provide a list of creditors. Once a bankruptcy judge is appointed to oversee the proceedings, the city is required to make its bankruptcy filing known through newspapers of general circulation. At this point, interested parties such as creditors are permitted to file objections to the bankruptcy filing with the court. The city's bankruptcy petition can be dismissed if an objection is upheld. If the petition survives all objections or no objections are filed, and the court deems the filing municipality as "eligible", the bankruptcy case moves forward. The receiver is responsible for guiding the city as it formulates a plan of adjustment to reorganize its debts. The plan of adjustment can be filed with the court at the same time as the petition or at a later date set by the court. Once formulated, the plan is subject to confirmation by the bankruptcy court. If the plan is confirmed, then the municipal entity, through its receiver, or through its elected officials if the receivership has been terminated, is charged with executing the plan to move the entity toward fiscal stability.

## Central Falls

### History

Central Falls is among one of the most fiscally-stressed communities in the state, as evaluated by a variety of indicators presented in the above section on municipal fiscal stress. In FY 2011, the city had an anticipated deficit of approximately \$6 million, or roughly 35 percent of its operating budget. In addition to its current-year deficit, Central Falls faces substantial long-term obligations such as pension and other post-employment benefits (OPEB). Together, the outstanding liability for these benefits was over \$80 million in FY 2010. Moreover, fully-funding these obligations in FY 2010 would have consumed 60.3 percent of the total levy in the community.



On May 19, 2010, the Mayor and City Council of Central Falls filed a petition with the Rhode Island Superior Court for receivership. Less than a month later, Governor Donald L. Carcieri signed the Fiscal Stability Act into law. The legislation provided a pathway and mechanism for communities to become debtors under Chapter 9. Prior to the passage of this legislation, this action was not expressly allowed under state law. As part of the process, the legislation transitioned the judicial receivership to a non-judicial state receivership. This transition took place on June 18, 2010. The state receivers – first Judge Mark A. Pfeiffer and later Justice Robert G. Flanders – were granted all the powers of the city's elected officials, and charged with overseeing the city's finances.

Governor Chafee requested supplemental aid for Central Falls in his FY 2011 revised budget request. The legislature did not concur with the Governor's request. However, the General Assembly passed legislation guaranteeing that, among all creditors and payments the city must make, including payments to retirees, municipal general obligation bondholders would be paid back first, even in the event of bankruptcy.

### Bankruptcy

In July 2011, Justice Flanders proposed a restructuring plan that would have cut retiree pensions by up to 50 percent. Retirees voted to reject the proposal on July 29, 2011. On August 1, 2011, Justice Flanders, on behalf of the City of Central Falls, filed for Chapter 9, the first municipal bankruptcy filing in the history of Rhode Island. The City's police and firefighters' unions, municipal workers' union and the police and fire retirees each formally challenged the legality of the August 1<sup>st</sup> bankruptcy filing.

Once under bankruptcy protection, the city revoked its three collective bargaining

agreements with the city's police, fire, and general employees. Since then, the receiver worked with the police, firefighters, and other city workers to negotiate new collective bargaining agreements, as mandated by law. At the same time, the receiver and public safety retirees have reached a settlement addressing their pension benefits going forward<sup>11</sup>. The agreement between the receiver and retirees included the following provisions:

- Reductions in the annual cost-of-living adjustment for current retirees;
- Cutting pensions up to 55 percent; and
- Requesting that the state legislature create a \$2.6 million fund to help offset pension reductions through 2016.

On January 10, 2012, the bankruptcy judge approved the new collective bargaining agreements, as well as the agreement between the receiver and the retirees, contingent upon the approval, by the General Assembly, of an appropriation of between \$2.0 and \$2.6 million. As a result of the city reaching new collective bargaining agreements with the unions, and the city reaching a settlement with the retirees, all of the challenges to the legality of the bankruptcy filing have been dismissed or withdrawn and the city has been declared an "eligible" debtor.

### **East Providence**

East Providence's reported deficit has grown to approximately \$7.3 million over the last two years. The majority of the deficit is attributable to a \$4.6 million debt due to Bradley Hospital for in-school services for the city's special education students.

On November 14, 2011, East Providence became the second municipality in Rhode

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<sup>11</sup> General public employees for the city participate in the state-run MERS system, and thus their pensions were not subject to renegotiation with the receiver.

Island during 2011 to receive intervention from the state. On the same day, Moody's Credit Service placed the city on review for possible bond rating downgrade. Approximately one month later, Moody's downgraded the city's bond rating for the second time in 2011. Currently, the city's bond rating is Ba1, or non-investment grade. The city was able to borrow \$10 million in tax anticipation notes – short-term debt sold by the city with property tax payments collected later in the year serving as a form of collateral – in order to support government operations between December 2011 and January of 2012. The state has since moved forward with the second step in Rhode Island's municipal financial assistance program and appointed a state budget commission.

### **Other Communities**

On March 5, 2012, Woonsocket reported a \$10 million deficit that has accumulated over the last two years. The deficit is reported to be the result of overspending by the school department, which, as recently as December 2011, was projecting to end the current fiscal year with a small surplus. The city has indicated that bankruptcy remains an option. Providence is also facing the possibility of a Chapter 9 filing due to a \$22 million structural deficit. Mayor Taveras has warned that the city could be forced into bankruptcy as early as June 2012.

### **Municipal Fiscal Flexibility**

The Governor has proposed a series of seven bills intended to increase municipal fiscal flexibility in response to the current challenges faced by municipalities. The bills affect three primary areas of local government: state mandates, education and pensions. The bills were introduced in the Senate by Senators DaPonte and Bates, and have been referred to the Senate Finance Committee. The companion bills were

introduced in the House by Representatives Brien and Newberry and have been referred to the House Finance Committee.

### **Pension Reform**

*SB 2825, HB 8009: An Act Relating to Towns and Cities – Critical Plan Empowerment Act – Municipal Pensions*

Currently applies to: Bristol, Central Falls, Coventry, Cranston, Cumberland, East Providence, Johnston, Narragansett, Newport, Pawtucket, Providence, Scituate, Smithfield, Tiverton, Warwick, West Warwick, Westerly<sup>12</sup>; The bill would designate any locally-administered pension plan under 60.0 percent funded to be in “critical status.” Any city or town with a plan in “critical status” would be granted the right to suspend COLAs, consistent with the recently-enacted state pension reform, as long as the community could demonstrate that the COLA suspension would generate savings and that the suspension is both reasonable and necessary to create fiscal stability. If an eligible community were to choose this course of action, it would be required to invest at least 50.0 percent of the savings from the COLA suspension in the plan.

*SB 2828, HB 8011: An Act Relating to Towns and Cities – Accidental Disability Allowance*

Applies to: all cities and towns; The bill would reduce disability pensions from 66 2/3 percent of pay to 50 percent if the disabled employee is able to perform other work functions.

*SB 2824, HB 8010: An Act Relating to Towns and Cities*

Applies to: all cities and towns; The bill would mandate that benefits of locally-administered plans do not exceed those provided for in MERS plans.

### **School Districts**

*SB 2823, HB 8008: An Act Relating to Education – School Committees and Superintendents – School District Accounting Compliance*

Applies to: all school districts; The bill would give the Rhode Island Department of Education (RIDE) new oversight powers, and would mandate that all local education agencies use a standardized budget format. RIDE would be granted the power to withhold state education aid from communities that do not comply.

*SB 2827, HB 8007: An Act Relating to Education – State Aid Programs*

Education aid applies to: all school districts; Distressed communities relief aid applies to: Central Falls, Cranston, North Providence, Providence, Pawtucket, Providence, West Warwick, and Woonsocket; The bill would modify the distribution of state aid for distressed communities, and basic education and housing aid distributions for all communities, with the exception of East Providence.

*SB 2829, HB 8012: An Act Relating to Education – Foundation Level School Support*

Applies to: all school districts; The legislation would grant municipalities a limited exemption from the annual education maintenance of effort requirement if they take action to appropriate funds to pay down the debts of their school systems.

### **Highly Distressed Communities**

*SB 2826, HB 8006: An Act Relating to Towns and Cities – Distressed Communities*

Applies to: Pawtucket, Providence, Woonsocket, and West Warwick; The “Highly

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<sup>12</sup> Based on the September 2011 analysis of pension and OPEB plans by the Auditor General:

<http://www.oag.ri.gov/reports/MuniPensionsRI2011.pdf>

NOTE: not all plans in an eligible community are eligible and that the eligible communities/plans may change subject to the outcome of actuarial valuations.

Distressed Community Intervention Act” would create a separate designation for communities that rank in the lowest 20 percent of all four of the “distressed community aid” indices. The act would enable city or town councils of “highly distressed” communities to pass ordinances to temporarily suspend certain state mandates. These measures would be in effect for the period of time the municipality is designated “Highly Distressed” and for the two years following the community’s exit from such designation. The councils would be able to adopt ordinances to:

- Suspend teacher step increases;
- Consolidate school and municipal back-office functions;
- Suspend the mandate for safety monitors on buses serving children in grades K-5;
- Suspend school district busing of children who attend private or religious schools;
- Reduce accidental disability pensions for public safety employees from the current range of 66 2/3 and 100 percent to 50-66 2/3 percent;
- Participate in a statewide purchasing system;
- Suspend the mandate for reimbursement of law enforcement personnel for education expenses;
- Grant the municipal CEO approval of all school contracts and budgets, with line item veto;
- Eliminate the provision that school nurses must be certified teachers;
- Discontinue public safety collective bargaining agreements when they expire, ending the mandate that expired contracts remain in effect throughout the binding arbitration process; and
- Ensure that health care plans for retirees conform to active employee plans.

In addition, municipal councils in highly distressed communities would be required to estimate the full financial impact of

collectively-bargained contracts and balance such contracts with the their ability to pay.

Finally, the act modifies the scope of collective bargaining and binding arbitration for public safety employees of any highly distressed community, while requiring higher levels of accountability. Base salaries would become the only issue that can be submitted, and the act would limit the aggregate base salary increases to no more than two percent and all proposals would be required to be accompanied by financial impact data. In addition, arbitrators would be required to consider the financial impact of awards, aggregate compensation of employees, and property tax levy, and to produce a report certifying that ability to pay was the primary determining factor.

#### Comments

Chapter 9 bankruptcy relief offers fiscally-stressed municipalities some advantages. One of the advantages of filing for Chapter 9 is that the municipality, if approved, has the opportunity to reduce or restructure its financial obligations and debts in the hopes that such action leads to solvency and fiscal stability down the road. Additionally, when a municipality files for Chapter 9 it receives the protection of an automatic stay against legal action that its creditors might otherwise take. This protection extends not only to the municipal government, but to its employees, elected officials, and residents. The stay grants the municipality the time to establish a plan to deal with its fiscal distress without the threat of legal action. Ultimately, however, bankruptcy only provides for a restructuring of obligations, and will not fundamentally alter a community’s economic reality or tax base, and as such, may not be a panacea for all municipalities.

One of the downsides to filing bankruptcy is that a municipality’s bond ratings are

downgraded, increasing the cost of future borrowing. Further, the fact that a municipality has filed for Chapter 9 becomes an issue that must be disclosed when a community goes out to financial markets. If the cost of bonding remains high, communities are less likely to undertake projects funded by such means; therefore, such communities are less likely to have updated, quality programs, facilities, and services. In addition, other costs, such as legal fees, salaries, financial consulting fees, and money owed the state for its role may be substantial.

The longer-term residual impacts of bankruptcy are more difficult to quantify, but must also be considered. In addition to the fact that bankruptcy does not alter the fundamental economic structure of a community, it does not provide any guarantee that the community will not return to the practices that led to bankruptcy in the first place. As such, the community may become less attractive to prospective businesses, which may be hesitant to invest in a community that has a weak economic outlook and a record of fiscal mismanagement leading to insolvency. Similarly, potential residents may be hesitant to purchase in a community that has the potential for reduced service delivery and higher taxes as a result of bankruptcy. To what extent these events occur, and the ultimate effect they may have on a community, remains to be seen, but nevertheless should be taken into account.

There are also broader implications to municipal bankruptcy filings. A major, local-level financial crisis may threaten the credit of the state and other municipal governments in the state as it may be perceived as being indicative of greater financial troubles in the region. As a result, bonding efforts of the state and surrounding municipalities may be looked at with greater caution. The state has attempted to mitigate this impact through

passage of legislation that guarantees that among all creditors and payments the city must make, including payments to retirees, municipal general obligation bondholders would be paid back first, even in the event of bankruptcy. This action, however, may have had the unforeseen consequence limiting the large financial obligations that can be restructured under bankruptcy to collective bargaining agreements and pension obligations.

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*In light of the absence of the express inclusion of Section 1113 in Chapter 9, along with precedent set in both County of Orange and City of Vallejo, it appears that the Bildisco standard for the unilateral rejection of a CBA applies after an entity files a Chapter 9 petition.*

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As the state and local governments emerge from the recent recession, both levels of government must determine the best path to resolve municipal fiscal stress. Elimination of, or cuts to, major state aid programs such as general revenue sharing and the motor vehicle excise tax reimbursement, while effective at helping the state resolve its budget crisis, were not accompanied by increased fiscal flexibility at the municipal level. Had these changes occurred in tandem, as RIPEC recommended, municipalities may have been better equipped to respond to the loss of revenue. These across the board cuts had differential impacts on Rhode Island's local governments depending on the extent to which they relied on state aid and their ability or willingness to address their fiscal imbalances. Specifically, communities that have a higher reliance on state aid, which are generally those with the lowest fiscal capacity, were disproportionately negatively affected by cuts to state aid.

At the local level, anemic economic growth and unstable housing markets – particularly in the state's poorest communities – have eroded municipal tax bases. However, almost every municipality designated as “distressed”, with

the exception of West Warwick, has increased the property tax levy over the cap at least once in the last two years. Notably, in fiscal year 2011, the levy in Woonsocket increased by 22.3 percent while the levy in Central Falls grew by nearly 20 percent. At the same time, as property values in the residential market have declined, and commercial values have increased statewide, some of the overall property tax burden has shifted toward commercial entities. Such shifts may discourage business investment in these communities, ultimately negatively impacting economic development efforts.

Together, these events have resulted in municipal expenditure structures that have outpaced revenue growth, and exposed long-standing structural issues such as unfunded pension and OPEB liabilities. Ultimately, however, some local governments did not adequately respond to these challenges. Some local governments entered into unaffordable commitments that they have been either unable or unwilling to modify. This does not mean, however, that efforts have not been made to seek reductions in expenditures. For instance, according to a RIDE survey, school departments across the state have negotiated over \$90 million in savings over the last two years. Similarly, overall local employment

has declined statewide over the past few years.

Chapter 9 must, ultimately, be viewed as the option of last resort for local governments facing impending insolvency – the tangible and potential costs are too great to view municipal bankruptcy in any other light. There are currently opportunities for communities to restructure certain obligations rather than having to resort to bankruptcy, such as renegotiating active collective bargaining contracts, pursuing shared services opportunities, and prioritizing program and service delivery. However, the ability of communities to dynamically respond to fiscal crises may be restricted due to state mandates, municipal organizational structures, time horizons or fiscal capacity.

Currently, one Rhode Island city is in bankruptcy proceedings, one is under state oversight, and two more have noted they face current-year deficits with little fiscal respite in sight. Rather than provide relief for communities in the form of additional state aid or increased spending flexibility, the state made a policy choice to allow for increasing levels of state intervention, a process which ultimately may lead to bankruptcy. As an alternative, the Governor has proposed a set of municipal fiscal provisions that would allow municipalities to modify some of their financial or structural obligations in order to resolve budgetary issues prior to reaching the point of state intervention. While these approaches are not mutually exclusive, they represent different approaches to the issue of municipal fiscal stress.

Policy choices made by the state – specifically the reduction of aid to local governments without accompanying mandate relief, and a provision for increasing state intervention for fiscally-stressed communities – increased the responsibility of municipalities to make changes to their fiscal structure. The ability of communities to respond to these challenges

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*In order to qualify for relief under Chapter 9 a municipality must:*

- Be specifically authorized, under state law, in its capacity as a municipality or by name, to file under Chapter 9;*
  - Be insolvent;*
  - “Desire to affect a plan” to adjust its debts; and*
  - Either have obtained the consent of creditors holding a majority of the claims in each class that the entity intends to impair under the plan; have failed to obtain consent after good-faith negotiations; be unable to negotiate with said creditors because such negotiation is impracticable; or reasonably believe “a creditor may attempt to obtain a transfer that is avoidable as a preference.*
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**Table 9  
Proposed Municipal Fiscal  
Flexibility Provisions**

**Pension Reform**

SB 2825;	An Act Relating to Towns and Cities -
HB 8009	Critical Plan Empowerment Act
SB 2828;	An Act Relating to Towns and Cities –
HB 8011	Accidental Disability Allowance
SB 2824;	An Act Relating to Towns and Cities
HB 8010	

**School Districts**

SB 2823;	An Act Relating to Education – School
HB 8008	Committees and Superintendents – School District Accounting Compliance
SB 2827;	An Act Relating to Education – State
HB 8007	Aid Programs
SB 2827;	An Act Relating to Education –
HB 8012	Foundation Level School Support

**Highly Distressed Communities**

SB 2826;	An Act Relating to Towns and Cities –
HB 8006	Distressed Communities

SOURCE: RI Legislative Bill Status System

varies by their fiscal capacity and structure. In some cases, municipalities were able to effectively balance their budgets despite cuts to local aid. In other cases, however, municipalities made policy decisions to bridge budgetary gaps that did not result in long-term structural change. Without substantive restructuring, local governments will not be able to support current service levels in the coming years. The parties subject to this restructuring effort – employees, retirees,

vendors and debtors – may be best served by local officials empowered to make modifications to these agreements, ideally through a collaborative process, rather than through bankruptcy, in which the primary goal is to make the community solvent.

In recognition of the fact that a one-size-fits all approach is not the most efficient or effective resolution to the problems faced by the state’s municipalities, enabling legislation that provides relief from state mandates may be the most effective means of addressing municipal fiscal stress given the current economic climate. Moreover, enabling legislation upholds the principle of home rule, as established in the Rhode Island Constitution. Ultimately, communities must be granted increased flexibility to rework their financial obligations including, but not limited to, those relating to organizational structures and personnel. In turn, these communities must take a proactive approach to restructuring their finances before they become insolvent. If municipalities do not act to take control of their fiscal situation to the extent possible, the state itself can, and should, intercede on behalf of a municipality in order to provide a pathway to solvency.