

Clients & Friends Memo

Harrisburg: A Case Study in State Law Barriers to Chapter 9

January 10, 2012

On November 23, 2011, the Bankruptcy Court for the Middle District of Pennsylvania dismissed Harrisburg, Pennsylvania's Chapter 9 bankruptcy petition because, shortly before the filing, the state legislature expressly prohibited Harrisburg from seeking relief under Chapter 9. Harrisburg's failed attempt to remain in Chapter 9 highlights the political factors and state law constraints that municipalities must consider prior to seeking bankruptcy relief.¹ This article will discuss the origins of Harrisburg's debt crisis, the Harrisburg City Council's attempt to file for Chapter 9 without the Mayor's approval, the legal obstacles placed in the path of the City Council's bankruptcy filing, and the lessons that other distressed municipalities and creditors can learn from Harrisburg's experience.

Harrisburg's Debt Crisis and Bankruptcy Filing

Harrisburg's debt crisis stemmed from the city's decision to guarantee revenue bonds tied to a waste-to-energy incinerator owned by the city's public utility, the Harrisburg Authority. As a result, Harrisburg looked to the Pennsylvania Municipalities Financial Recovery Act² or "Act 47" for relief. Act 47 both provides for state government aid to distressed municipalities and governs access to Chapter 9 of the Bankruptcy Code. For a city to receive state aid under Act 47, the Commonwealth of Pennsylvania must first determine that the city is financially distressed, in which case Pennsylvania appoints a coordinator to develop a fiscal recovery plan.

As Harrisburg's fiscal crisis mounted, the Mayor sought an Act 47 financial distress determination. Pennsylvania designated Harrisburg as financially distressed in October 2010. The Commonwealth then appointed an Act 47 coordinator, who submitted a detailed fiscal recovery plan. The City Council repeatedly rejected this plan, however, arguing that it prioritized the interests of creditors over the needs of the citizenry. The City Council favored a Chapter 9 filing as an alternative to the creditor-friendly Act 47 plan, and in June of 2011, the City Council voted to prepare for a possible

¹ For a detailed explanation of the benefits of Chapter 9, see John J. Rapisardi, Lary Stromfeld, Douglas S. Mintz, Terence L. Workman & Timothy T. Brown, [Chapter 9 Bankruptcy Strategies: A Big Stick, Rarely Used](#).

² 53 P.S. §§ 11701.102-11701.304.

Chapter 9 filing. In response, on June 30, 2011, the Pennsylvania General Assembly passed “Act 26.” Act 26 provides that prior to July 1, 2012, “no distressed city [of the third class] may file a petition for relief under 11 U.S.C. Ch.9 (relating to adjustment of debts of a municipality) or any other federal bankruptcy law . . .”³ Act 26 was specifically designed to prevent Harrisburg, a distressed city of the third class, from filing for Chapter 9 relief.

On October 11, 2011, the City Council voted to authorize Harrisburg to file for Chapter 9, without Mayor Linda Thompson’s support. Later that same day, Harrisburg filed a Chapter 9 petition in the Bankruptcy Court for the Middle District of Pennsylvania. Both the Mayor and the Commonwealth of Pennsylvania sought dismissal of the Chapter 9 filing, as did the county in which Harrisburg is located and various other creditors and parties in interest. In addition to arguing that Act 26 mandated dismissal of Harrisburg’s petition, the objectors argued that the City Council lacked the authority to take legal action on Harrisburg’s behalf without the Mayor’s approval. The objectors ultimately prevailed on both of these arguments, and on November 23, 2011, Bankruptcy Judge Mary D. France orally dismissed Harrisburg’s Chapter 9 case. Judge France reasoned that Harrisburg was not specifically authorized to file for Chapter 9 as required by the Bankruptcy Code and that the City Council did not have the authority under municipal law to commence a Chapter 9 case on Harrisburg’s behalf.

Was Harrisburg Eligible to File for Chapter 9?

Although the U.S. Constitution gives Congress the power to establish uniform national bankruptcy laws,⁴ “where federal bankruptcy law intersects with the rights of states to regulate the activities of political subdivisions created by the state, principles of dual sovereignty as defined by the Tenth Amendment must be considered.”⁵ The Tenth Amendment, which protects state sovereignty, provides that “the powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the People.”⁶ To preserve state sovereignty in accordance with the Tenth Amendment, Congress crafted Chapter 9 to require municipalities to comply with strict eligibility requirements in order to obtain Chapter 9 relief.

In particular, section 109(c)(2) of the Bankruptcy Code provides that a municipality may be a Chapter 9 debtor only if it “is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization

³ 72 P.S. § 1601-D.1(B).

⁴ U.S. CONST. amend. I, § 8, cl. 4.

⁵ *In re City of Harrisburg, PA*, Case No. 1:11-bk-06938 (MDF), at *9 (Bankr. M.D. Pa. Dec. 5, 2011).

⁶ U.S. CONST. amend. X.

empowered by State Law to authorize such entity to be a debtor under such chapter”⁷ In this case, the bankruptcy court found that at the time the City Council voted to prepare for a bankruptcy filing, Act 47 provided the necessary authorization for Harrisburg to file for Chapter 9.⁸ However, Act 26 revoked this authorization with respect to municipalities of Harrisburg’s size and character before Harrisburg filed for Chapter 9. Therefore, the primary issue before the bankruptcy court was whether the passage of Act 26 prohibited Harrisburg from filing for Chapter 9.

Federal Constitutional Issues

Although Act 26 expressly prohibited Harrisburg’s bankruptcy filing, the City Council argued that it could file for Chapter 9 protection by attacking the validity of the new law on federal and state constitutional grounds. With respect to the U.S. Constitution, the City Council argued that Act 26 violated the Supremacy Clause⁹ because it conflicted with federal bankruptcy law by restricting Harrisburg’s ability to file for Chapter 9 protection. The bankruptcy court rejected this argument because the Bankruptcy Code explicitly requires express state authorization for a municipality to file for Chapter 9. Therefore, it was within Pennsylvania’s discretion to revoke its prior authorization under Act 47.

The bankruptcy court also rejected the City Council’s argument that the Privileges and Immunities Clause of the Fourteenth Amendment¹⁰ protected Harrisburg’s right to file for bankruptcy, holding that the Fourteenth Amendment does not protect municipal entities from state action.

State Constitutional Issues

The City Council also challenged Act 26’s validity under numerous provisions of the Constitution of the Commonwealth of Pennsylvania. From the outset, the bankruptcy court expressed considerable doubt regarding its authority to overturn Pennsylvania law under the Pennsylvania Constitution, stating that “[a] federal court has limited power to construe a state statute.”¹¹ Nonetheless, the City Council argued that Harrisburg had a vested right to file for Chapter 9 at the time of Act 26’s enactment and that Act 26 was enacted improperly. The bankruptcy court rejected both of these arguments, holding that Act 26 governed and that the bankruptcy filing violated Act 26. Moreover, the bankruptcy court concluded that the City Council did not have the authority to commence a Chapter 9 filing on Harrisburg’s behalf without the approval of the Mayor and/or City Solicitor.

⁷ 11 U.S.C. § 109(c)(2).

⁸ *In re City of Harrisburg*, at *11.

⁹ U.S. CONST. art. VI, cl. 2.

¹⁰ U.S. CONST. amend. XIV, § 1.

¹¹ *In re City of Harrisburg*, at *14.

Harrisburg's Attempted Appeal

On December 10, 2011, the City Council attempted to appeal the bankruptcy court's dismissal of its Chapter 9 petition, but the bankruptcy court found that the deadline for appeal had passed.

Lessons from Harrisburg

Although Chapter 9 provides significant benefits to distressed municipalities, the Pennsylvania General Assembly's quick and effective move to block Harrisburg's bankruptcy filing illustrates the severe constraints municipalities are under when seeking relief under Chapter 9 without the support of the state government. Here, the Commonwealth of Pennsylvania specifically passed a law which prevented Harrisburg from filing for Chapter 9 relief. Ultimately, the bankruptcy court respected the ability of the state government to statutorily preempt a Chapter 9 filing by Harrisburg.

Harrisburg's experience further illustrates that, for a city government to seek Chapter 9 protection, unity among the distinct branches of the municipal government is essential. An attempt by one branch of a city government to take such a drastic legal action without the cooperation of the other branches is almost certainly doomed to failure.

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