

# Clients & Friends Memo

## Of Standing and Stonewalling: Chester, Pennsylvania Bankruptcy Sheds New Light on Chapter 9 Eligibility Requirements

April 13, 2023

On March 14, 2023, Judge Ashely M. Chan of the U.S. Bankruptcy Court for the Eastern District of Pennsylvania (the “**Court**”) ruled that the City of Chester, Pennsylvania (the “**City**” or “**Chester**”) was eligible for municipal bankruptcy relief under Chapter 9 of the Bankruptcy Code, specifically overruling objections that challenged Chester’s authority under state law to file for Chapter 9 relief and whether the City negotiated with its creditors in good faith.<sup>1</sup> The decision provides useful insight into some of the finer points of Chapter 9 eligibility and, like prior decisions concerning Chapter 9 eligibility, it confirms that Section 109(c)’s “good faith” negotiation requirement is a flexible standard left to the discretion of the court and that the court may consider the conduct of creditors in prepetition negotiations.

### BACKGROUND

Chester is the oldest city in Pennsylvania. The City is located near Philadelphia and has a population of around 30,000 residents. Following the loss of its manufacturing base, the City suffered a steep decrease in revenues and population. Over time, the City accumulated multi-million dollar deficits, which in 1995 led to its designation as a “distressed city” under Pennsylvania’s comprehensive state law for dealing with municipal distress - the Municipalities Financial Recovery Act, generally referred to as “**Act 47**.” Under Act 47, if a municipality is determined to be in financial distress, then the Pennsylvania Secretary of Community and Economic Development (the “**Secretary**”) must appoint a coordinator to prepare and administer a plan designed to relieve the municipality’s financial distress.<sup>2</sup>

Despite decades of state supervision under Act 47, the City’s financial situation continued to deteriorate, and in April 2020, the Governor of Pennsylvania declared a fiscal emergency for the City.<sup>3</sup> Following the declaration of such a fiscal emergency, Act 47 authorizes the Governor to direct the Secretary to file a petition in state court to appoint a receiver for the distressed

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<sup>1</sup> *In re City of Chester*, No. 22-13032-AMC, 2023 WL 2504708 (Bankr. E.D. Pa. Mar. 14, 2023).

<sup>2</sup> See 53 PA. CONS. STAT. § 11701.221.

<sup>3</sup> See 53 PA. CONS. STAT. § 11701.602(a)-(b).

municipality. On June 1, 2020, the Secretary petitioned a state court for appointment of a receiver for the City, and on June 22, 2020, the court appointed Michael Doweary (the “**Receiver**”) as receiver. Thereafter, the Receiver took various cost-saving measures, but those efforts were unable to improve the City’s financial situation.

The Receiver also undertook negotiations with the City’s major creditor constituencies in an effort to obtain debt relief for the City. At the time of the Receiver’s appointment, the City’s capital structure included two major bond issuances, consisting of (i) two series of “2017 Bonds” issued directly by the City, secured by certain casino and other revenues, and held entirely by a single financial firm - Preston Hollow Community Capital (“**Preston Hollow**”) - and (ii) one series of unsecured “2021 Notes” issued by the Delaware Valley Regional Planning Commission on behalf of the City, and held by a more disparate group of bondholders. The City also had significant liabilities to both its current and former employees, including (i) current employees subject to collective bargaining agreements and represented by various unions, and (ii) retired employees entitled to benefits from the City’s underfunded pension funds, but not benefiting from any centralized or organized representation (the “**Retirees**”). Between 2020 and 2022, the Receiver attempted to negotiate concessions from various creditors (including the bondholders and unions), but was not able to reach an agreement with any of these constituencies.

Given the City’s deteriorating financial condition and the Receiver’s failure to obtain concessions from key creditors, the Receiver ultimately filed a Chapter 9 petition in the Court on November 10, 2022. Before filing the Chapter 9 petition, the Receiver obtained the requisite written authorization from the Secretary. Two major objections were filed to the City’s eligibility for Chapter 9 relief, one by the City’s mayor and City Council (the “**Elected Officials**”), and one by bondholder Preston Hollow. The Elected Officials argued that the City lacked authority under state law to file for Chapter 9 relief, while Preston Hollow claimed that the City did not negotiate in good faith with its creditors prior to filing for bankruptcy.

## **DISCUSSION**

In addressing these objections, the Court examined whether the City met all statutory criteria for eligibility for Chapter 9 relief. Section 109(c) of the Bankruptcy Code provides that an entity may file for Chapter 9 only if that entity (i) is a municipality, (ii) is “specifically authorized” under state law to file for Chapter 9 or the filing is made by an officer with authority to file the Chapter 9 petition, (iii) is insolvent, (iv) desires to effect a plan of adjustment, and (v) has engaged in good faith negotiations with its creditors. 11 U.S.C. § 109(c). With respect to the fifth requirement, a debtor may be excused from engaging in prepetition negotiations where such negotiations are “impracticable.” 11 U.S.C. § 109(c)(5)(C). Further, Section 921 of the Bankruptcy Code provides that a petition may be dismissed when the debtor fails to satisfy any of the criteria for eligibility or where the petition is filed in bad faith. 11 U.S.C. § 921(c).

**State Law Authorization (11 U.S.C. § 109(c)(2))**

The Elected Officials claimed that the City lacked authority to file for Chapter 9 bankruptcy because the City's home rule charter vested all legislative power with the City Council, and thus the Elected Officials' authorization, not the authorization of the Receiver, was required in order for the City to file for Chapter 9. The Court disagreed and overruled their objection. As an initial matter, the Court held that the Elected Officials had neither constitutional nor statutory standing to object to the Chapter 9 filing because they lacked a personal stake in the Chapter 9 case and are not creditors of the City.

Even assuming that the Elected Officials possessed standing to object, the Court held that the City was authorized under state law to file for Chapter 9 because the receiver was empowered under Act 47 to file a Chapter 9 petition. Specifically, Section 109(c)(2) provides that this state law authorization requirement may be satisfied if the filing is made by **"a governmental officer . . . empowered by State law to authorize"** the municipality to be a Chapter 9 debtor. Act 47 in turn expressly authorizes a receiver to "file a municipal debt adjustment action under the Bankruptcy Code and to act on the municipality's behalf in the proceeding," provided the receiver first receives written authorization from the Secretary to make a Chapter 9 filing.<sup>4</sup> Because the Receiver complied with all of Act 47's procedural requirements, including receiving written authorization from the Secretary, the Court held that the Receiver was authorized under Act 47 to file the Chapter 9 petition. In so holding, the Court rejected the Elected Officials' argument that Chester's home rule charter required their approval for the filing. Instead, the Court held that the state legislature had the power to limit a municipality's home rule powers, and that the City's home rule charter was limited here by Act 47.

**Desire to Effect a Plan of Adjustment (11 U.S.C. § 109(c)(4))**

The Elected Officials also objected to Chester's eligibility on the grounds that the City did not "desire to effect a plan" of adjustment because the Elected Officials did not approve the Chapter 9 petition or any related plan. For reasons similar to the Court's finding that the City was authorized under state law to file for Chapter 9, the Court held that the Elected Officials' approval was irrelevant to whether the City desired to effect a plan because the Receiver was able to express this desire on the City's behalf by way of his powers to act on the City's behalf in the Chapter 9 proceeding. The Court found that Section 109(c)(4)'s "desire to effect a plan" requirement seeks to avoid Chapter 9 filings that are merely intended to evade creditors or that serve some other ulterior motive. The Court held that no evidence of such an improper motive was present in

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<sup>4</sup> 53 PA. CONS. STAT. § 11701.706(a)(9).

Chester's case, because the City took steps to curb expenses, resolve claims, and refer significant issues to mediation, among other reasons.<sup>5</sup>

### **Good Faith Negotiations (11 U.S.C. § 109(c)(5))**

The Court next addressed Preston Hollow's contention that the City failed to negotiate in good faith or demonstrate that such negotiations were impracticable. Preston Hollow argued that in the six-month period immediately preceding the petition date, the Receiver had not negotiated in good faith with Preston Hollow because, among other things, the Receiver did not provide Preston Hollow with any concrete proposal for the treatment of its bonds. The Court found this objection unavailing, concluding that the six-month period preceding the petition date was not the only relevant timeframe for negotiations. Based on Preston Hollow's alleged unwillingness to consider any significant impairment of its debt in 2020 through 2022, the Court found that it was reasonable for the Receiver to conclude that the parties "were simply too far apart and could not reach terms satisfactory to avoid a bankruptcy filing." Moreover, the City had other significant creditor constituencies, and the Court found that the Receiver made specific proposals for the treatment of some of those creditors' claims. While those proposals were rejected, the Court found that such proposals served as further evidence that the City negotiated in good faith with its creditors. The Court therefore ruled that the City had negotiated in good faith for purposes of Section 109(c)(5).

In addition, Section 109(c)(5)(C) excuses a debtor from engaging in good faith negotiations where such negotiations would be "impracticable." The Court found that such negotiations would be impracticable with Preston Hollow. Specifically, the Court stated that it is "impossible to negotiate with a stonewall," and here, Preston Hollow did not materially change its position in the multiple episodes of negotiation between 2020 and 2022. The Court also held that negotiations may be "impracticable" where the debtor must break off negotiations and file for bankruptcy in order "to preserve its assets," as the Court found the City needed to do here. Further, the Court found that negotiations were also impracticable with the Retirees, because those creditors did not have legal representation prior to the Chapter 9 filing. The Court therefore held that the City satisfied Section 109(c)(5)(C)'s impracticability standard with respect to Preston Hollow and the Retirees.

### **"Insolvency" under the Bankruptcy Code (11 U.S.C. § 109(c)(3))**

The Court also addressed other eligibility requirements under the Bankruptcy Code, including Section 109(c)(3)'s requirement that a municipal debtor be "insolvent."<sup>6</sup> The Court held that the City was "insolvent" as of the petition date "because it is currently unable to fund, and historically

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<sup>5</sup> Notably, the Elected Officials now have appealed the Court's eligibility decision, meaning that the municipal markets soon may receive further guidance from the higher courts on the "state law authorization" and "desire to effect a plan" requirements central to the Elected Officials' objection.

<sup>6</sup> With reference to a municipality, "insolvent" means that such municipality is "(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) is unable to pay its debts as they become due." 11 U.S.C. § 101(32)(c).

has failed to fund, its substantial obligations under the Pension Plans, which are unconditionally owed and presently enforceable.” The Court did not, however, explain why the City’s obligations to the pension plans were unconditionally owed and presently enforceable, which is a matter of state law.<sup>7</sup> Further, while the Court found that for seven consecutive years the City did not pay the minimum annual contribution to the pension plans, it did not clearly differentiate those annual payments from the full unfunded liability of the pension plans. Nevertheless, the Court’s “insolvency” conclusion was based on additional facts, including that the City had not been paying its debt obligations as they become due and that its revenues are insufficient to pay its tax obligations.

### CONCLUSION

Over the past few years, federal aid has buoyed municipal balance sheets, helping to stave off the wave of Chapter 9 filings that many feared would materialize at the beginning of the COVID-19 pandemic. With interest rates rising and a potential economic downturn on the horizon, however, Chapter 9 filings may become more common in the coming months and years. The Chester eligibility decision serves as a valuable primer on some of the thornier issues central to Chapter 9 eligibility, and highlights the flexibility that courts have in examining each of the Bankruptcy Code’s eligibility requirements.

First and foremost, the Chester decision illustrates the broad powers that states have over their municipalities, and thus serves as a reminder that careful analysis of applicable state laws is essential to assessing the bankruptcy risk associated with any particular municipal issuer.

The Chester decision also confirms that the good faith negotiations requirement under Section 109(c)(5) is a relatively flexible standard and that courts have discretion in its application in eligibility disputes.<sup>8</sup> Despite the relatively minimal negotiation efforts of the debtor in the months leading up to the petition date, the Chester Court found that its inquiry was not limited to the months immediately preceding the bankruptcy filing and that the Court may extend its inquiry to years prior to the petition date.

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<sup>7</sup> Preston Hollow did request discovery on the “insolvency” issue, but in the Court’s view failed to present any evidence, or any specific basis for believing, that the City was not “insolvent,” such that the Court ultimately accepted the City’s evidence as sufficient on this issue.

<sup>8</sup> Prior summaries of other major eligibility opinions can be accessed at the following links: Stockton (<https://www.cadwalader.com/resources/clients-friends-memos/court-holds-that-stockton-is-eligible-to-file-for-chapter-9>); San Bernardino (<https://www.cadwalader.com/resources/clients-friends-memos/court-holds-san-bernardino-eligible-for-chapter-9>); Detroit (<https://www.cadwalader.com/resources/clients-friends-memos/court-rules-that-detroit-is-eligible-for-chapter-9-and-that-pensions-may-be-impaired-in-chapter-9>); and Harrisburg (<https://www.cadwalader.com/resources/clients-friends-memos/harrisburg-a-case-study-in-state-law-barriers-to-chapter-9>).

Moreover, the Chester Court excused the debtor from good faith negotiations with Preston Hollow because that creditor purportedly stonewalled the debtor in negotiations and rebuffed settlement attempts. Creditors should therefore be mindful that the good faith requirement is a two-way street: Not only must a debtor engage in substantive negotiations, but creditors also must meaningfully engage with the debtor. If, as in the case of Chester, a creditor rebuffs any attempt to impair its claims, then a court may perceive that creditor as “stonewalling,” which may serve as a basis for excusing the debtor from further negotiations. Creditors therefore should bear in mind that their conduct may come under scrutiny in a Chapter 9 case, and act in a manner consistent with Section 109(c)(5)'s good faith negotiation requirements.

Finally, the Chester decision suggests that the failure to make the minimum legally required annual contributions to a pension system qualifies as “insolvency” for purposes of Chapter 9's eligibility requirements. This conclusion was based in part on the Court's finding that such annual payments were “unconditionally owing and presently enforceable.” It is not clear whether that conclusion would apply under the laws of other states or to the obligation of the City with respect to the full unfunded pension liability. It is not uncommon for public pension funds to contain significant unfunded liabilities, yet it would be surprising if those liabilities were considered to be presently owing and enforceable for purposes of assessing whether a municipality is “insolvent” under the Bankruptcy Code.

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