

CRAIN'S
CLEVELAND
BUSINESS
— on the web

Municipalities may for first time consider a new chapter -- Chapter 9 bankruptcy

Municipalities slowly accept that drastic action might be in the offing

By MICHELLE PARK

4:30 am, February 14, 2011

There are those who think the unthinkable is on the verge of happening.

Some observers in local legal and political circles speculate there will be municipal bankruptcies in the near to intermediate future as governments seek relief from the pressure of decreased revenues and increased costs.

If a municipal bankruptcy happens, it would be the first Chapter 9 reorganization ever filed in Ohio, at least as far as the auditor of state's office is aware.

Mike Caputo, who chairs the government affairs practice for Cleveland law firm McDonald Hopkins LLC, said he would be more surprised if a government didn't file for bankruptcy in the next couple years than if one did. He said bankruptcy is a word now in the dialogue of public officials that wasn't there a few years ago.

"Municipalities are gearing for significant reductions in funding at the state level," said Mr. Caputo, who lobbies in Columbus for businesses and nonprofit organizations and serves on a local school board. "In prior years, the kind of default position has been, 'Local government will just have to find a way to do more with less.' I think now some of the discussion ... suggests that there may no longer be an ability to do more with less."

Mr. Caputo's assertion that a Chapter 9 is likely isn't universally held.

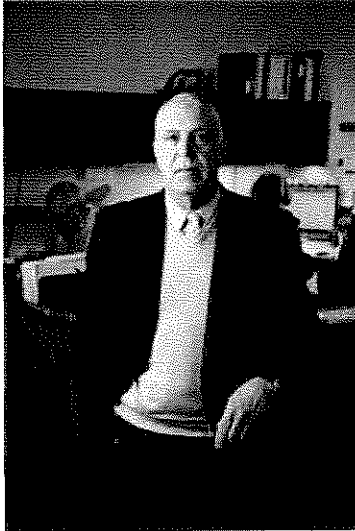
Larry Oscar, who co-chairs the creditors' rights, reorganization and bankruptcy practice at Hahn Loeser & Parks LLP in Cleveland, said he isn't anticipating municipal bankruptcies because Chapter 9 reorganization is "not a terribly effective tool."

Liquidation of the debtor is not an option for creditors under Chapter 9. Thus, there's even more incentive for creditors to prefer a revised financial plan from a government over bankruptcy, Mr. Oscar said.

Still, there are certain kinds of debt obligations — bonds in particular — that are hard to restructure outside of bankruptcy proceedings because they are owned by many people, said Christopher Meyer, a partner at Squire, Sanders & Dempsey. The perception among attorneys and accountants who work in bankruptcy, Mr. Meyer said, is that Chapter

9 filings will arise.

"I think some (municipalities) will not be able to sustain (themselves) without Draconian change in what they do ... and perhaps without seeking to use a bankruptcy tool to fix the problem," Mr. Meyer said.



John Licastro, the mayor of Bratenahl and president of the Cuyahoga County Mayors and City Managers Association, said municipal Chapter 9 reorganizations are possible.

Photo credit: JESSE KRAMER

Domino effect

Municipal bankruptcy is rare and would have a cascading impact on governments, particularly those near the entities that file.

It undoubtedly would cause municipal borrowing to become more costly because it would shake the longstanding perception that such debt is low risk. In turn, higher debt costs might deter or limit the undertaking of capital projects — for example, new roads and building.

It also could mean the stripping away of services people have come to expect from their governments and would cast a pall over a municipality, if not an entire region, potentially making an area less attractive to vendors and to current and potential employers and residents.

Some local lawyers say they expect increased demand for legal counsel from public bodies that want information about the choices available to them for grappling with their tight finances. In anticipation of Chapter 9 filings, the staff of the law firm Schottenstein Zox & Dunn is getting up to speed on municipal bankruptcy, said Colette Gibbons, partner-in-charge of the Cleveland office.

"It was really unthinkable up until now," Ms. Gibbons said of Chapter 9.

William A. Currin, a member and past chairman of the Northeast Ohio Mayors and City Managers Association, sees the talk of bankruptcy — and the reasons it's happening — as more reason for Northeast Ohio government entities to regionalize in order to share the costs of infrastructure and dispatch centers, among other expenses.

Kevin O'Brien, director of the Center for Public Management, a research center of the Maxine Goodman Levin College of

Urban Affairs at Cleveland State University, shares Mr. Currin's view. He cautioned that local governments may not have seen the worst of their troubles, as property reappraisals in Cuyahoga County are due in 2012 and a lot of yet-unrecognized property tax losses may be realized then.

Harrisburg ponders a filing

The conversation about governments going bankrupt isn't restricted to Northeast Ohio.

"Today in Ohio, a lot of cities are having trouble that never had trouble before," Mr. O'Brien said. "That is not unique to Ohio, and that's not unique to the Midwest."

The financial struggles of some municipalities have been reported widely. Vallejo, Calif., filed Chapter 9 in May 2008 after negotiations with unions failed. The city is seeking modifications to its collective bargaining agreements and adjustments to its municipal debt obligations, according to case filings.

And Pennsylvania's capital city, Harrisburg, is in the state's program for distressed municipalities. Its struggles are blamed on the debt of the city's waste-to-energy facility, and Harrisburg City Council has hired a law firm to advise it on the possibility of filing for bankruptcy.

It's been reported, too, that policy-makers in Washington, D.C., are exploring the possibility of allowing states to declare bankruptcy. (While local municipalities can file Chapter 9, states cannot.)

A report released in late January by the Center on Budget and Policy Priorities, a nonpartisan research and policy institute in Washington, D.C., said it's a mistaken impression that extreme and drastic measures such as bankruptcy are needed to avoid imminent fiscal meltdown. The report notes that while recession-induced deficits are causing severe problems, they are a cyclical problem that will ease as the economy recovers.

Longer-term issues related to pension obligations and bond indebtedness, the report said, can be addressed over the next several decades.

States of emergency rise

In Ohio, a municipal entity needs the state tax commissioner's approval to file to reorganize its debts under Chapter 9. Some say Ohio's fiscal emergency program staves off municipal bankruptcy. The program appoints a commission to develop a plan to remedy a municipality's deficit situation, and the commission oversees the financial activity of the government until the emergency is terminated.

The number of municipalities in Ohio entering fiscal emergency each year has been on the rise since 2007 and was the highest it has been in at least a decade in 2010, when six were added. A total of 24 remain in fiscal emergency; they include Garfield Heights, the only Cuyahoga County municipality on the list, which was added in October 2008.

McDonald Hopkins' Mr. Caputo said he believes Chapter 9 filings are less likely in Northeast Ohio because the region's economy is diverse. Rural municipal governments may be devastated by the revenues lost when one company closes; Cleveland is better insulated in that respect, he said.

While John Licastro, mayor of Bratenahl and president of the Cuyahoga County Mayors and City Managers Association, said the municipal leaders he knows aren't talking Chapter 9, he believes it's a possibility. Mayor Licastro and others noted that in the coming two-year budget, which begins July 1, state officials may decrease the local government fund and may eliminate the estate tax, 80% of which local municipalities receive.

"Who knows how deep the cuts will be, and how long before the economy turns around?" Mayor Licastro said. "Most communities have had two years of dropped revenue. Will we have a third? Will we have a fourth? Most communities

have already cut to the bone."

Tough choices await

Defaults on municipal obligations will come before any Chapter 9 filings, predicted Mike de Windt, senior managing director and CEO of private equity firm Gates Group Capital Partners in Mayfield Heights.

"Choices are going to have to be made about who gets paid and who doesn't," Mr. de Windt said.

Mr. de Windt said he's confident there's room for the private sector to become part of the solution, citing the way municipalities could leverage income-producing assets to generate capital to meet critical needs.

One example: A city leases its parking assets, such as lots, meters and garages, to a financial firm to monetize the asset.

Discussions of municipal bankruptcy are the result of a lack of political will to make hard choices, asserts Raymond Headen, a lawyer with Bricker & Eckler LLP in Cleveland.

"Municipal bankruptcy is potentially too costly to let occur by any one jurisdiction," Mr. Headen said. If bondholders aren't paid on time what they're owed by a single entity, it would result in higher interest rates for all, he said.

"Sane minds will not allow that," Mr. Headen said.

Gary Norton Jr., mayor of East Cleveland, a city that was on the state's fiscal emergency list for 17 years until 2006, said he also believes Chapter 9 filings aren't all that likely. But he's not sorry they're a topic of conversation.

"I would much rather exaggerate this (possibility) than hide it or not discuss it," Mayor Norton said. "I'd err on the side of, 'Let's make sure everybody's aware of it.'"

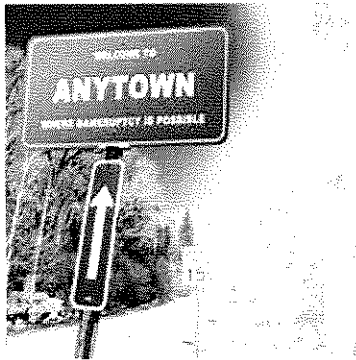


Photo credit: STEVE BENNETT

ILLUSTRATION

PRINTED FROM: <http://www.crainscleveland.com/article/20110214/SUB1/302149995&template=printart>

© 2011 Crain Communications Inc.