

# AMERICAN BANKRUPTCY INSTITUTE JOURNAL

The Essential Resource for Today's Busy Insolvency Professional

## Feature

BY LYNN M. BRIMER, MEREDITH E. TAUNT AND MALLORY A. FIELD

### Measuring Service-Delivery Insolvency in Chapter 9



**Lynn M. Brimer**  
Strobl & Sharp PC  
Bloomfield Hills, Mich.



**Meredith E. Taunt**  
Strobl & Sharp PC  
Bloomfield Hills, Mich.



**Mallory A. Field**  
Strobl & Sharp PC  
Bloomfield Hills, Mich.

Lynn Brimer is a shareholder, and Meredith Taunt and Mallory Field are associates, with Strobl & Sharp PC in Bloomfield Hills, Mich.

Unlike the corporate debtor seeking to reorganize in a chapter 11, a municipality seeking chapter 9 protection must meet strict eligibility requirements.<sup>1</sup> Insolvency is one of the key eligibility requirements that a municipality must establish prior to the entry of an order for relief in a chapter 9 proceeding. Given the vast financial difficulties plaguing many municipalities throughout the U.S., bankruptcy courts are seemingly poised to author customized interpretations of insolvency as it pertains to potential chapter 9 debtors. As a result, bankruptcy courts have been forced to re-examine the traditional definition of “insolvency” as that term is applied in a chapter 9 proceeding.

In his recent opinion regarding eligibility, Hon. **Steven W. Rhodes** found that the city of Detroit was eligible as a debtor pursuant to chapter 9 due in large part to the court’s conclusion that Detroit is in a state of “service-delivery insolvency.”<sup>2</sup> While the concept of service-delivery insolvency is by no means novel, the parameters of such a state of insolvency are an important development to meet the needs of the new chapter 9 debtor.

#### The Traditional Chapter 9 Insolvency Analysis

The initial test for municipal insolvency is located within § 101(32)(C) of the Bankruptcy Code. A municipality is “insolvent” if it is either (1) generally not paying its debts as they become due unless such debts are the subject of a *bona fide* dispute (“current cash flow insolvency”), or (2) unable to pay its debts as they become due (“prospective cash flow insolvency”).<sup>3</sup>

1 11 U.S.C. § 109(c).

2 *In re City of Detroit*, 2013 WL 6331931, 171 (Bankr. E.D. Mich. Dec. 5, 2013).

3 11 U.S.C. § 101(32)(C).

The standards of cash flow insolvency in a chapter 9 proceeding were first notably outlined by the court in the *City of Bridgeport, Connecticut*.<sup>4</sup> Bridgeport itself had conceded that it was solvent as of the petition date; however, it suggested to its creditors and the court that it was prospectively insolvent pursuant to § 101(32)(C)(ii) based on its projected budget deficit. The state of Connecticut, among others, objected to Bridgeport’s eligibility on the grounds that they believed that Bridgeport was not insolvent on the petition date; rather, it was only *prospectively* insolvent. The *Bridgeport* court proposed a strict interpretation of the statute and concluded that “the longer the projection, the less informed the conclusion.”<sup>5</sup> In order to receive a determination of eligibility for relief under chapter 9 through the claims of prospective insolvency, Bridgeport was required to prove that it would “be unable to pay its debts as they [became] due in its current fiscal year or, based on an adopted budget, in its next fiscal year.”<sup>6</sup> Despite testimony from the Bridgeport chief of police and director of public works that they were not providing adequate service and that proposed budget cuts for the following fiscal year “would put Bridgeport in a health and public safety emergency,” the court concluded that the city had not established that it was insolvent on the petition date and therefore was not eligible for relief under chapter 9.<sup>7</sup>

#### *In re City of Stockton*

Much has transpired in the 20 years since the *Bridgeport* decision. The fiscal health of the nation is an increasing concern, and several courts have

4 *In re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn. 1991).

5 *Id.* at 338.

6 *Id.*

7 *Id.* at 335.

indicated that they are inclined to consider what could be deemed historically unconventional factors when making a determination regarding the solvency of a municipal debtor. The court in the chapter 9 case for the *City of Stockton, California* directly addressed the narrow holding in the *Bridgeport* decision.

Several of Stockton's creditors objected to its eligibility as a chapter 9 debtor, contending that the city was either not insolvent pursuant to the statutory definition or that it had manipulated itself into a state of technical insolvency. The court in *Stockton* drew on the holding in *Bridgeport* that found that the underlying "theme" of municipal insolvency as it pertained to § 101(32)(C) was that "a municipality must be in *bona fide* financial distress that is not likely to be resolved without use of the federal exclusive bankruptcy power to impair contracts," and that this "insolvency must be real and not transitory."<sup>8</sup> The court further concluded that there were in actuality three types of insolvency involved when making a determination pursuant to § 109(c)(3): cash insolvency, budget insolvency and service-delivery insolvency.<sup>9</sup> More specifically, the *Stockton* court held that because the city's creditors were claiming that the city of Stockton had somehow *manufactured* its insolvency, the concepts of budget insolvency and service-delivery insolvency became important for purposes of a determination of eligibility.<sup>10</sup>

The *Stockton* court defined "service-delivery insolvency" as the inability to fund essential government services as "required for the health, safety and welfare of the community."<sup>11</sup> The nature of the evidence considered by the *Stockton* court in support of its conclusion as to service-delivery insolvency included national crime statistics and the state of the police department, including precinct response times. The *Stockton* court found that the city presented credible evidence that

the police department had been decimated. The crime rate has soared. Homicides are at record levels. The City has among the ten highest rates in the nation for aggravated assaults with a firearm. Police often respond only to crimes-in-progress.<sup>12</sup>

Service-delivery insolvency played an additional role in the *Stockton* decision as the court examined whether a liquidation of Stockton's untapped resources would make a material difference in the city's solvency. The court in *Stockton* found that it was "too speculative to assume that such revenues will rise at the same or greater rate as the regional economy in light of the City's service-delivery insolvency."<sup>13</sup> The *Stockton* court further relied on the service-delivery insolvency as confirming evidence that the cash insolvency facing the city was not a mere technicality, but an actual insolvency sufficient to meet the requirement of §§ 101(32)(C) and 109(c)(3).<sup>14</sup>

### ***In re City of San Bernardino***

As a consequence of the *Stockton* decision, bankruptcy courts have become increasingly willing to explore a more

expansive approach in determining whether a municipality meets the insolvency requirements of § 109(c)(3). The city of San Bernardino, Calif., filed its petition pursuant to chapter 9 and was deemed eligible via an opinion entered on Oct. 16, 2013.<sup>15</sup> Although insolvency was not a contested issue during the eligibility trial, in order to meet its burden of proof regarding eligibility, the city of San Bernardino presented its case for insolvency.

The *San Bernardino* court evaluated the factual background that led to the city becoming insolvent, finding that "the influx of population created a greater demand for public services, from public safety (police and fire) to more mundane matters such as street repair and infrastructure maintenance.... The City's population of approximately 213,000 is spread over 59.3 square miles, compounding the difficulty in providing adequate services."<sup>16</sup> While the *San Bernardino* decision does not utilize the phrase "service-delivery insolvency," it does specifically rely on the lack of sufficient city services as a major factor leading to the bankruptcy filing in August 2012. Although not directly at issue, the court in *San Bernardino* concluded that the "[c]ity's financial problems fall within the situations contemplated by chapter 9."<sup>17</sup>

### ***In re City of Detroit***

On July 18, 2013, the city of Detroit filed the largest municipal bankruptcy to date. **Kevyn Orr**, Detroit's emergency manager, filed a declaration in support of the city's eligibility, detailing not only significant service-delivery issues, but also numerous additional problems that the city faces as a result of its service-delivery issues. During its eligibility trial, the city called Detroit Police Chief James Craig as a witness. He testified that conditions within the city were "deplorable." He further stated, "If I might just summarize it in a very short way ... everything is broken, [there are] deplorable conditions, crime is extremely high, morale is low, [and there is] the absence of leadership."<sup>18</sup>

In its opinion on eligibility, the *Detroit* court referred to the decision in *Stockton*, citing specifically that court's application of three categories of insolvency, including the service-delivery insolvency.<sup>19</sup> The *Detroit* decision expressed that "while the City's tumbling credit rating, its utter lack of liquidity, and the disastrous COPs and swaps deal might more neatly establish the City's 'insolvency' under 11 U.S.C. § 101(32)(C), it is the City's service-delivery insolvency that the Court finds most strikingly disturbing in this case."<sup>20</sup>

### **The Future of Service-Delivery Insolvency**

Post-*Stockton*, bankruptcy courts have exhibited an inclination to consider other indicia of decline and deterioration throughout their analyses of any challenges to the insolvency of the debtor. While it does not eliminate the requirements of a determination of cash insolven-

<sup>8</sup> *In re City of Stockton*, 493 B.R. 772, 788 (Bankr. E.D. Cal. 2013).

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 789-90.

<sup>13</sup> *Id.* at 790.

<sup>14</sup> *Id.* at 790-91.

<sup>15</sup> *City of San Bernardino*, 499 B.R. 776 (Bankr. C.D. Cal. 2013).

<sup>16</sup> *Id.* at 779.

<sup>17</sup> *Id.* at 790.

<sup>18</sup> *In re City of Detroit*, 2013 WL 6331931, 171.

<sup>19</sup> *Id.* at 171-72.

<sup>20</sup> *Id.* at 172.

cy contained within § 101(32)(C), a determination of a service-delivery insolvency might simplify the eligibility process for a chapter 9 debtor that would have otherwise faced greater scrutiny. The decisions of *Stockton*, *San Bernardino* and *Detroit* might signify the beginning in an ever-changing and ever-expanding definition of “insolvency” under chapter 9.<sup>21</sup> **abi**

**Editor’s Note:** *For more on this topic, see Municipalities in Peril: The ABI Guide to Chapter 9, Second Edition (ABI, 2012), available for purchase at the ABI Bookstore (bookstore.abi.org).*

*Reprinted with permission from the ABI Journal, Vol. XXXIII, No. 2, February 2014.*

*The American Bankruptcy Institute is a multi-disciplinary, non-partisan organization devoted to bankruptcy issues. ABI has more than 13,000 members, representing all facets of the insolvency field. For more information, visit ABI World at [www.abiworld.org](http://www.abiworld.org).*

---

<sup>21</sup> For a further discussion on the evolving definition of insolvency in a chapter 9 setting, see Andrea Saavedra and Christopher Hopkins, “The Statutory Definition of ‘Insolvent’ — Part Two — Chapter 9 Debtors,” *Weil Bankruptcy Blog* (Nov. 5, 2013), <http://business-finance-restructuring.weil.com/valuation/the-statutory-definition-of-insolvent-part-two-chapter-9-debtors/>.