Kluwer Mediation Blog

New chapter in bankruptcy mediation? Municipalities and other public debtors

Rafal Morek (DWF LLP) · Friday, March 9th, 2012

Even if in most jurisdictions it is still rarely practiced, a few areas of law exist in which mediation may provide as many benefits as it does in bankruptcy. A drastic increase in the amount of bankruptcy filings during the recent financial crisis has forced bankruptcy judges and attorneys to seek and employ various methods of alternative dispute resolution. In many cases, ADR can provide fast and inexpensive ways to avoid traditional bankruptcy litigation. It serves the interest of both creditors and debtors alike.

For many people, the idea of a company or an individual filing for insolvency is fairly well understood. However, the notion of a city, municipality or another public entity filing for protection from its creditors, is unheard of. In some jurisdictions, such a situation is inadmissible or unregulated by insolvency laws.

Non-Americans are used to hearing that the U.S. is special. This relates also to bankruptcy, mediation and – no surprise – bankruptcy mediation. While Chapter 11 of the US Bankruptcy Code (which deals with corporate rescue) is known as being amongst the most "debtor-friendly" bankruptcy statutes in the world, the Code's little-known Chapter 9 is sometimes considered even "friendlier" for a municipality seeking protection. The list of recent municipal bankruptcies includes for example:

– Millport, Alabama, 2005, due to loss of sales tax revenues after factory closing
– Westfall Township, Pike County, Pennsylvania, 2009, due to losing a lawsuit
– Central Falls, Rhode Island, August 2011, due to inability to pay obligations, especially pensions.

[Based on a much longer list at Wikipedia].

From incompetent or even corrupt local officials to toxic bonds global and financial crisis, there are plenty of reasons why municipalities can enter into severe financial problems. As a result of municipal bankruptcy, banks, bondholders and other creditors are forced to accept harsh 'haircuts'. On the other hand, for defaulting municipalities, access to credit becomes severely constrained, and borrowing costs are far higher. This has the effect of imposing drastic reductions in public services, which in turn has the potential to have a devastating impact on people's lives. Municipalities are forced

to cut police forces, firefighters, libraries and public service pensions.

Just a few months ago, California became the fist US state which introduced the concept of mandatory mediation in municipal bankruptcies. The state has already witnessed a handful of municipal bankruptcies, including the filings by the city of Desert Hot Springs (2001) and by the city of Vallejo (2008), or the reorganization of Orange County that began in 1994 and long remained the largest municipal bankruptcy in U.S. history. It is feared that further municipal bankruptcies may harm California's credit rating, increasing its borrowing costs.

The AB 506 bill prohibits a local public entity from filing under federal bankruptcy law unless it participated in a neutral evaluation (or mandatory mediation) process with 'interested parties', or declared a fiscal emergency, i.e. that the financial state of the local public entity jeopardizes the health, safety, or well-being of the residents.

The 'neutral evaluation' is defined as "*a form of alternative dispute resolution that may be known as mandatory mediation. A 'neutral evaluator' may also be known as a mediator*" (Section 3 (h)). The bill defines 'interested party' as "*a trustee, a committee of creditors, an affected creditor, an indenture trustee, a pension fund, a bondholder, a union that, under its collective bargaining agreements*", etc.

The nature of this neutral evaluation (or mandatory mediation) process is not entirely clear. Its main rules are based on the principles of mediation:

– a local public entity and all interested parties participating in the process are required "to negotiate in good faith";
– each party's representative must have the authority to settle and resolve disputes or be in a position to present any proposed settlement or plan of readjustment to the parties participating in the process;
– a neutral evaluator (or a mediator) is selected, through a mutually agreed upon process, "to oversee the neutral evaluation process and facilitate all discussions in an effort to resolve their disputes"; if the parties are not able to agree on a neutral evaluator (a mediator), Section 4(c)(2) provides for a selection scheme;
– the process is confidential – the bill prohibits parties from disclosing statements made, information disclosed, or documents prepared or produced, during the process, at the conclusion of the neutral evaluation process, or during any bankruptcy proceeding;
– the parties execute a settlement agreement (or proposed plan of readjustment that requires the approval of a bankruptcy judge).

Just last week, Stockton, a city of more than 290,000 people, became the first city to resort to the mediation process under the AB 506 bill. The city has been hit hard by the recession and foreclosures, forcing it to make deep cuts in its public budget. Stockton faces a deficit of over $20 million the next fiscal year. It is related to bond payments from redevelopment projects and underfunded liabilities for retired city employee health care. Subject to the results of the process, Stockton may soon become the largest U.S. city ever to file for bankruptcy.

As the AB 506 bill provides for a 60-day deadline for completion of the process, the

first mediation under the new law will soon be tested. If it works, it may form a new model of bankruptcy mediation with participation of public entities. Stockton is no exception. There are probably hundreds of municipalities as well as a few states (obviously also outside the U.S.) that also could use mediation to restructure their debts in agreement with their creditors.

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