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In almost a century since Congress gave local municipalities the ability to restructure their debts under Chapter 9 of the Federal Bankruptcy Code, any government entity even considering that possibility has faced an overwhelming deterrent: the stigma of bankruptcy.

No public official, elected or appointed, wants to be known for putting a government entity in their jurisdiction into anything that can be characterized as bankruptcy. The few local government entities that have taken that step in recent decades, with Detroit by far the biggest, have been seen as extreme cases resulting from a long period of ineffective local government.

The coronavirus pandemic could change that attitude. Local government entities of all kinds—cities and towns, counties, and special-purpose entities all across the country—face severe financial problems. It is not a local phenomenon.

Widespread Impact

For cities, towns, and counties, there are increased costs and an even more severe decline in revenues from a falloff in local sales, income, and other generally applicable taxes that depend on the local economy. But where the virus has hit hardest is on the level of targeted taxes and fees in the areas of the economy most strongly affected by the virus: transportation and tourism.

Hotel taxes aren't paid on empty hotel rooms; parking charges and taxes fall dramatically in a shutdown city; road, bridge, and tunnel tolls drop along with the falloff in traffic; transit fare revenues are minimal from almost empty trains and buses; auto rental taxes are non-existent if no one is renting cars; amusement taxes go to zero when there are no concerts, shows, or sporting events; and airports get minimal terminal concession revenues or landing fees if few passengers are landing on very few planes.

That dramatic decline in targeted taxes and fees has its most drastic impact where the responsibility for those transportation and tourism facilities has been placed in special-purpose public authorities. Across the country there are thousands of such authorities for transit; toll roads, bridges, and tunnels; airports; parking facilities; convention and trade show centers; and other facilities. These governmental authorities have issued millions, in some cases billions, of dollars of debt, requiring substantial debt service payments, and they incur significant fixed operating costs, both of which typically are in large measure dependent on those targeted taxes and fees for payment.

No one knows how long it will take for general revenues or revenues from any of these targeted areas to get back to levels projected before the pandemic. For travel and tourism some experts expect it will take a very long time.

Private corporations facing scenarios of this kind have often turned to Chapter 11 reorganization under the bankruptcy code to restructure their debt, obtain a fresh start and emerge from reorganization without the overhang of unserviceable future obligations. In a political situation that combines nationwide severe financial distress, possibly unsustainable future liabilities, and a generally recognized lack of public responsibility for bringing any of this about, government entities may more readily consider restructuring and a Chapter 9 filing as an ultimate recourse.

The possibility of Chapter 9 restructuring is not an immediate alternative to federal assistance. Local entities that may consider using Chapter 9 to adjust their long-term liabilities will be in no less need of immediate federal aid to get through the near-term crisis. The question is whether, beyond that crisis, and even after taking into account whatever forms of federal assistance are available, the federal Chapter 9 process will be needed to adjust long-term liabilities to match long-term deteriorations in cash-flow, whether by extending debt maturities, reducing the amount of debt service, or other restructuring under a plan of adjustment.

To be eligible for filing under Chapter 9, a government entity must be authorized to file under state law and must be "insolvent" within the meaning of the bankruptcy code. Insolvency is defined for purposes of Chapter 9 to mean that the entity is generally not paying its debts, an extreme scenario, or is "unable to pay its debts as they become due." Under the latter "prospective cash flow insolvency test," the judgment is made based on reasonable projections at the time of filing.

Under that test, many local government entities hard hit by the virus, particularly special-purpose entities dependent on targeted taxes and fees, may well be eligible for filing.

Chapter 9 has important differences from Chapter 11 that are important for government officials to keep in mind—differences that are more favorable to government entities than Chapter 11 has been for private corporations. Some of those differences include the following.

Filing Oversight

Any filing under the Bankruptcy Code is entirely up to any public entity that qualifies as a "municipality" under the Bankruptcy Code: "a political subdivision or public agency or instrumentality of a state." No one else can force such a government entity into bankruptcy. That is unlike the situation of a private corporation, which can potentially be forced into bankruptcy by creditors if it is not generally paying its debts as they become due. No creditors—or anyone else—can file an involuntary bankruptcy against a government entity under Chapter 9 or any other provision of the bankruptcy code.

Thus, active consideration of Chapter 9 is not at all inconsistent with concurrent discussions with creditors about a voluntary out-of-court restructuring. Every public entity will want to start out by considering completely voluntary out-of-court adjustments. In some states there are processes under state law that allow restructuring under state oversight. The possibility of a Chapter 9 filing, however, gives to the public entity the added leverage of potentially taking that route if general agreement with creditors cannot be reached—or if there are outliers to a generally acceptable approach who have the legal ability to block its implementation without court action.

Public entities may also consider a "pre-packaged" approach similar to that which has become common under Chapter 11, in which voting approval of a reorganization plan—by half in number and 2/3ds in amount of the claims of each impaired class of creditors (the same standard as under Chapter 11)—is obtained in advance of filing. The actual bankruptcy court process can then become a matter of just weeks, or even days, with no disruption of ongoing operations.

Authority Limits

Once a filing is made under Chapter 9, the bankruptcy court has very little authority to interfere with the ongoing operations and decisions of the public entity. Again, this is very different from filings by private corporations under other chapters of the Bankruptcy Code, pursuant to which the Bankruptcy Court has fairly extensive power to review, and potentially approve or disapprove, major corporate actions. By statute—and probably also because of federal constitutional limits on federal interference with state sovereignty—the bankruptcy court has no power to interfere with the public entity's decisions on the use of its property, its levels of taxation or its entering into contracts or incurring expenditures.

Plan of Adjustment

Only the government entity can present to the Court a proposed plan of adjustment. In contrast, a corporation in Chapter 11 has a fixed period of time to present its own plan, but if it does not present an acceptable plan within that "exclusivity" period, other parties have the right to present their own alternative plans to the bankruptcy court. In Chapter 9 only the governmental entity has that right; it remains in complete control and cannot be forced to accept any plan that it does itself advance.

Reorganization Plan

Finally, when one gets to the stage of court approval of a reorganization plan, Chapter 9 applies a general standard that the plan must be "fair and equitable" and "in the best interests" of all creditors. In Chapter 11, in contrast, a company's plan must give to every class of creditors that does not accept that plan at least as much as that class of creditors would receive in a Chapter 7 liquidation of the company. For a public entity liquidation is not an alternative and that standard does not apply. The result is greater flexibility for the court to make a judgment that takes into account a range of interests, including the need going forward for the governmental entity to continue to provide necessary public services.

The Detroit bankruptcy also revealed some other positive features of Chapter 9 that came as a surprise to many observers. One was that it led to the consideration of a variety of financial options that may have existed previously in a theoretical sense but had never seemed viable from a political or bureaucratic standpoint—or perhaps because of the general force of institutional inertia.

For example, Detroit seriously considered the possibility of privatizing its water system as a way to maximize the value of assets in its reorganization. The sale or lease of existing assets is often a feature of Chapter 11 plans in the private sector. Possibilities like that exist in today's global market for a variety of revenue-generating public assets such as airports, toll roads and bridges, and parking facilities. In the end the City of Detroit decided on a plan to transfer the water system to a regional authority in which suburban communities, already the major consumers of water from the system, assumed control in exchange for regular payments to the city.

A key point about the possibility of Chapter 9 for local jurisdictions is that its use depends on the cooperation of the state where the local jurisdiction is located. Despite Mitch McConnell's suggestion that states themselves might consider bankruptcy, Chapter 9 does not allow states to file and there is little political possibility of Congress passing legislation to allow that to happen even if one believes it is constitutional. But what happens to cities and towns and other local authorities that are now allowed to file under Chapter 9 matters enormously to the states where they are located. That is true in the general sense of mutual economic dependence and also in the narrower sense that needs not met locally will inevitably revert to the state.

The U.S. Supreme Court has said explicitly that a bankruptcy code filing by a local governmental entity is possible only with the authorization of the state. Twenty-two states have granted such authorization in some form. Given the impact of the coronavirus pandemic on the finances of many local entities, it is possible that states where the use of Chapter 9 is not now authorized will reconsider giving localities that option.

Authorization does not necessarily have to be across the board for all local jurisdictions. For example, a state might decide to authorize the use of Chapter 9 for special-purpose authorities governing certain facilities and agencies that are most directly affected by the pandemic's effects.

Alternatively, a state could require some form of intermediate steps to ensure that Chapter 9 is only used when necessary. Some states already condition the use of Chapter 9 on a local jurisdiction going through a prior state-administered process of possible reorganization.

Congress did not enact Chapter 9 in 1937 with Covid-19 in mind. But Congress was responding to the Great Depression of the 1930s, the last event with an impact on local government finances of comparable magnitude.

In the age of a coronavirus that is causing so much else to change, we are likely to see a fresh look at the possibilities of reorganization and a Chapter 9 filing as a possible step by legislators, decision makers and local government entities of all kinds.