**Municipal Bankruptcy in Ohio**

**Threshold Eligibility Requirements under the Bankruptcy Code and Ohio Law**

Municipal income tax revenue is critical to a city’s budget. In Ohio, the collection of municipal income tax is generally based upon where the employee works rather than where the employee lives. However, with the Covid-19 pandemic, thousands of Ohioans are working from home. Accordingly, House Bill 197 (adopted March 27, 2020) provides that municipal income tax revenue will continue to go to the City where the employee’s empty office is located.[[1]](#footnote-1)

Many employees may continue to work from home after the pandemic. If this provision of HB 197 were to change or be overturned, the Greater Ohio Policy Center estimated that Ohio’s six largest cities could lose $306 million in revenue.[[2]](#footnote-2)

Ohio mayors are keenly aware of the issue. The headline of the American Bankruptcy Institute’s February 21, 2021, newsletter read: “***Ohio Mayors Say Bankruptcies Await Cities if Pandemic Income Tax Lost***.” Dayton Mayor Nan Whaley was quoted: “I think most of the cities would have to declare bankruptcy right away, because there is just no path forward if this revenue would be taken away and nothing would be put in place.”

The legal and policy considerations associated with municipal income taxes are beyond the scope of this article. Instead, this article will provide an overview of threshold municipal bankruptcy considerations under Chapter 9 of the Bankruptcy Code and Ohio law.

**Chapter 9 of the Bankruptcy Code and the 10th Amendment to the United States Constitution.**

There are many similarities between a business “Reorganization” under Chapter 11 and a municipal “Adjustment of Debts” under Chapter 9 of the Bankruptcy Code. However, there are also distinct differences between the two.

Fundamentally, the Bankruptcy Code must co-exist with the limits on the federal government in the 10th Amendment.[[3]](#footnote-3) Therefore, Bankruptcy Code § 904 [Limitations on jurisdiction and powers of the Court] provides:

Notwithstanding any power of the court, unless the debtor [i.e., municipality] consents … the court may not … interfere with (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor’s use or enjoyment of any income-producing property.

A Bankruptcy Court in Michigan explained:

The general policy considerations underlying the municipal debt adjustment plan of chapter 9 are the same as that of chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors ... A primary distinction between chapter 11 and chapter 9 proceedings is that in the latter, the law must be sensitive to the issue of the sovereignty of the states. "The powers of the court are subject to a strict limitation - that no order or decree may in any way interfere with the political or governmental powers of the petitioner [i.e., the municipality], the property or revenue of the petitioner, or any income-producing powers." … Consequently, chapter 9 avoids placing any restrictions on the powers of the states in the exercise of their sovereign rights and duties… [[4]](#footnote-4)

Despite these limits, a number of cities have successfully confirmed plans for the adjustment of debts. Notably, the City of Detroit restructured an estimated $19 billion of debt in 2014.[[5]](#footnote-5)

**Eligibility of a Municipality to be a Debtor Under Chapter 9.**

The eligibility requirements for a municipal debtor are set for in Bankruptcy Code § 109(c):

[a]n entity may be a debtor under chapter 9 … if and only if such entity - (1) is a municipality; (2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor …; (3) is insolvent; (4) desires to effect a plan to adjust such debts; and (5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan…; (B) has negotiated in good faith with creditors and has failed to obtain the agreement…; (C) is unable to negotiate with creditors because such negotiation is impracticable; or (D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable [as a preference].

The municipality bears the burden of proving its eligibility.[[6]](#footnote-6) Eligibility is broadly construed. Nevertheless, eligibility can be hotly contested. Each of these eligibility requirements will be discussed below, including the specific authorization requirement under Bankruptcy Code § 109(c)(2) and Ohio law.

The Debtor Must be an Entity Which is a Municipality

The Bankruptcy Code’s defines an “entity” to include a “governmental unit.”[[7]](#footnote-7) A “governmental unit” includes a “municipality.”[[8]](#footnote-8) And, a “municipality” includes any “political subdivision or public agency or instrumentality of a State.”[[9]](#footnote-9) An Ohio city should qualify as a municipality.[[10]](#footnote-10)

The Municipality Must be Insolvent

The Bankruptcy Code § 101 (32)(C) defines insolvency.

The term “insolvent” means … (C) with reference to a municipality, financial condition such that the 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) unable to pay its debts as they become due.

In other words, the Bankruptcy Code offers two different insolvency tests. “Generally not paying debts as they come due” refers to an inability to pay current, undisputed debts. “Unable to pay debts”, on the other hand, refers to an inability to pay future debts.[[11]](#footnote-11) Regardless, “the theme underlying the two alternative definitions of municipal insolvency is that a municipality must be in bona fide financial distress that is not likely to be resolved without use of federal exclusive bankruptcy power to impair contracts.”[[12]](#footnote-12)

The Municipality Must Desire to Effect a Plan to Adjust its Debts

This eligibility requirement has been called “highly subjective” and linked to the good faith requirement under Bankruptcy Code § 921(c). One noted bankruptcy treatise described this eligibility requirement as follows:

A statement by the municipality of its intent to implement a plan of adjustment coupled with evidence of actions taken, and/or being taken by the municipality in furtherance of such intent should be sufficient to meet the statutory requirement. Whatever the probative evidence of a municipality’s stated subjective intent, actions taken by the municipality that demonstrate preparation for, and desire to, address its financial circumstances and adjust its obligations provide objective evidence of a desire to effect a plan that adjusts its debts.[[13]](#footnote-13)

The Four Alternative Requirements Under Bankruptcy Code Section 109(c)(5)

The municipality must also satisfy one of the four alternatives under Bankruptcy Code § 109(c)(5): either an agreement with creditors; an inability to reach agreement with creditors after good faith negotiations; an inability to negotiate because negotiation is impracticable; or threatened creditor action makes negotiation impracticable. Section 109(c)(5) is often viewed as an extension of the requirements in § 109(c)(4) discussed above.

The Specific Authorization Pursuant to Ohio Law.

Finally, Bankruptcy Code § 109(c)(2) requires that the municipality must have specific authorization to become a Chapter 9 debtor. Revised Code (ORC) 133.36 provides, in part:

For the purpose of enabling subdivisions to take advantage of the act of congress entitled “An act to establish a uniform system of bankruptcy throughout the United States,” approved July 1, 1898, including acts amendatory thereof and supplementary thereto, and for that purpose only, and notwithstanding any statutes of this state to the contrary… the taxing authority of any subdivision provided for in the act and acts amendatory thereof and supplementary thereto, upon approval of the tax commissioner, may file a petition stating that the subdivision is insolvent or unable to meet its debts as they mature, and that it desires to effect a plan for the composition or readjustment of its debts, and to take such further proceedings as are set forth in the act of congress and acts amendatory thereof and supplementary thereto as they relate to any such subdivision.

There are no reported decisions discussing ORC 133.36 in connection with the Bankruptcy Code’s “specific authorization” eligibility requirement. However, at least two “municipalities” have requested authorization to file bankruptcy from Ohio’s Tax Commissioner pursuant to ORC 133.36.

On December 2, 2011, the Commissioner responded to a request from the Buckeye Water District for authorization to file bankruptcy under Chapter 9. In denying the request, the Commissioner noted that the District’s request failed to set forth:

the underlying financial data and other supporting information necessary for [the Commissioner] to evaluate whether the District (a) is in fact insolvent or unable to meet its debts as they mature *right now* (italics in original), or (b) will be solvent or unable to meet its debts as they mature if the garnishment of the District’s bank accounts occurs. Instead, the request is based totally upon conjecture in terms of what might be anticipated from the Court. Accordingly, because your request did not demonstrate that the District is insolvent now or will be insolvent in the very near future, at this juncture, I am unable to authorize the District to seek bankruptcy protection.[[14]](#footnote-14)

Several years later, the Commissioner responded to a request for approval to seek bankruptcy protection from the mayor of East Cleveland. The Commissioner declined to consider the mayor’s request because the Ohio statute requires that the request be brought by the taxing authority, (i.e., the City Council), rather than the mayor. The Commissioner’s May 9, 2016, response reiterated the eligibility and good faith requirements under Bankruptcy Code §§ 109(c) and 921(c), and summarized what should accompany a request pursuant to ORC 133.36:

… any request to seek authority of the Tax Commissioner under R.C. 133.36 should be accompanied with the information/application you plan to make with the Bankruptcy Court: i.e.,: (3) Demonstrate the City’s insolvency; (4) Desire to effect a plan to adjust such debts; (5) Provide either: (a) the agreement of the City’s creditors; (b) demonstrate that the City has negotiated in good faith and has failed to obtain the agreement of a majority of its creditors; (c) demonstrate why such negotiation is impracticable; or (d) demonstrate that the taxing authority and the financial planning and supervision committee reasonably believes that a creditor may attempt to obtain a preferential transfer; and (6) Demonstrate that the Chapter 9 filing is in good faith.

**Conclusion.**

Chapter 9 might provide a solution for an insolvent city. However, the Commissioner has taken the position that the Commissioner’s approval is required before a municipality can commence a case under Chapter 9. Fortunately, the Commissioner has provided guidance regarding what is necessary to support a request for authorization to file bankruptcy pursuant to ORC 133.36.

1. Litigation regarding this portion of HB 197 is pending in the Franklin County Common Pleas Court. See The Buckeye Institute, et.al., v. Megan Kilgore, et.al., Case No. 20 CV 004301; and J. Eric Denison v. Megan Kilgore, et. al., Case No. 21 CV 0848. [↑](#footnote-ref-1)
2. Staver, A., Rouan, R. (2020, Nov. 8). Should you pay commuter taxes while working from home? Republicans say no, cities say yes. *Columbus Dispatch*. <https://www.dispatch.com/story/news/2020/11/08/ohio-income-taxes-covid-work-from-home/6185682002/> [↑](#footnote-ref-2)
3. The 10th Amendment reads: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the states, are reserved to the states respectively, or to the people.” [↑](#footnote-ref-3)
4. In re Addison Community Hosp. Auth., 175 B.R. 646, 649 (Bankr. E.D. Mich. 1994). [↑](#footnote-ref-4)
5. Saunders, P. (2018, July 19). Detroit, Five Years after Bankruptcy. *Forbes*. <https://www.forbes.com/sites/petesaunders1/2018/07/19/detroit-five-years-after-bankruptcy/?sh=19e366ddcfeb> [↑](#footnote-ref-5)
6. In re City of Detroit, Michigan, 504 B.R. 191, 2013 Bankr. LEXIS 5120, at \*53-54 (Bankr. E.D. Mich. December 5, 2013). [↑](#footnote-ref-6)
7. 11 U.S.C. § 101 (15). [↑](#footnote-ref-7)
8. 11 U.S.C. § 101 (27). [↑](#footnote-ref-8)
9. 11 U.S.C. § 101 (40). [↑](#footnote-ref-9)
10. An analysis of what other political subdivisions, public agencies and instrumentalities may or may not constitute a municipality is beyond the scope of this article. [↑](#footnote-ref-10)
11. In re City of Stockton, California, 493 B.R. 772, 788 (Bankr. E.D. Ca. 2013). [↑](#footnote-ref-11)
12. In re City of Detroit, Michigan, 504 B.R. 191, 262, 2013 Bankr. LEXIS 5120, 15 \*168-69 (Bankr. E.D. Mich. Dec. 5, 2013). [↑](#footnote-ref-12)
13. 6 Collier on Bankruptcy P 900.02[2][d] (16th 2020). [↑](#footnote-ref-13)
14. The Commissioner also noted that it was unclear whether the Commissioner could grant authorization to an entity that was not included within the definition of a taxing authority under ORC 5705.01(C). [↑](#footnote-ref-14)