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# School Districts Under Financial Distress

*Distressed school districts have a number of options to set them on the path to financial recovery.*

By Marc Hirschfield, James Day, Ferve Ozturk, and Alexis Beachdell



**S**chool districts around the nation are experiencing unprecedented financial distress. Faced with a dwindling local tax base instigated by shifting demographics and tightening state budgets, increasing numbers of school boards and school administrators are being forced to examine their options for putting their school districts' finances in order.

Although the level of federal funding has actually increased in recent years, state funding for elementary and secondary education has declined in more than 30 states because of the impact that job losses and declines in property values have had on the tax base. Ballooning underfunded pension liability and personnel costs have also been major drivers of financial instability.

School districts pushed to the brink have a number of alternatives available to them for navigating and overcoming financial distress, each with strengths and drawbacks. Districts that cannot successfully resolve their financial issues may be subject to state takeover.

District administrators should carefully review the available restructuring alternatives and keep informed about the developing legal landscape.

## Chapter 9 Bankruptcy

Chapter 9 of the Bankruptcy Code provides an avenue for municipalities, including school districts, to reorganize their debts. A Chapter 9 filing can offer school districts valuable leverage and control over district operations and can equip them with the tools to modify

collective-bargaining agreements and pension obligations, to hold litigation against the district at bay, and to limit creditors' rights.

Administrators and school boards considering filing for Chapter 9 bankruptcy should first determine whether state law expressly provides authority for local government entities to file for Chapter 9. Only 24 states have statutes enabling local government entities (including school districts) to file for Chapter 9 bankruptcy.

A substantial advantage of Chapter 9 is that it enables a school district to continue operating while its financial obligations are being modified, but principles of federalism and state sovereignty limit the federal bankruptcy court's jurisdiction. For example, unlike in Chapter 11, a Chapter 9 debtor need not seek

approval from the bankruptcy court to borrow money outside the ordinary course of business or to use cash collateral. However, the Chapter 9 process is costly and may affect the district's future ability to borrow.

In addition, because bankruptcy courts' powers are limited, a bankruptcy court cannot always address the fundamental issues underlying a school district's financial distress, such as underfunded pensions, which are among school districts' most burdensome financial commitments.

Although bankruptcy courts' powers to restructure pension obligations are limited under Chapter 9, the U.S. Supreme Court has provided that municipalities can reject collective-bargaining agreements by demonstrating that (a) the agreement burdens the debtor's ability to reorganize, and (b) the equities balance in favor of rejection. Accordingly, courts have allowed rejection of collective-bargaining agreements with unions in Chapter 9 proceedings.

With respect to pensions, Chapter 9 may enable municipalities to restructure pension obligations that are state-mandated, although administrators must pay careful attention to differences across state systems before drawing comparisons.

Despite the potential advantages of a Chapter 9 filing, to date, only six education-related districts have filed for protection under Chapter 9. Even Detroit's Chapter 9 filing—the most high-profile example of a successful restructuring under Chapter 9—did not include its municipal school district.

Pension and collective-bargaining reforms are politically charged, controversial issues both in and out of bankruptcy, particularly in situations where teachers are compensated largely through pensions and health insurance to hold down state or municipal spending. Even so, the Chapter 9 process can give district administrators the powerful tools they need to renegotiate pension and other compensation-related issues that are contributing to the district's financial instability.

## Voluntary Receivership and State Takeover

In some states, school districts that are unable or unwilling to use Chapter 9 may have the option of receivership. A receivership is a state court proceeding in which a receiver is appointed to oversee and restructure a financially distressed entity's operations. Most receivership statutes are broadly worded to confer extensive authority on the receiver.

Receiverships are still subject to court oversight, but the federalism concerns that restrain the authority of the bankruptcy court in Chapter 9 would not exist in receivership because receiverships are a product of state law. Despite their potential benefits, the use of voluntary school district receiverships is largely untested. It remains to be seen whether states will enact legislation explicitly

authorizing voluntary receivership for school districts.

Statutes authorizing state-imposed receivership or state takeovers, however, are becoming increasingly prevalent. More than two-thirds of states have enacted statutes authorizing a state or municipality to take over a distressed school district.

Involuntary receiverships and state takeovers can be triggered by a district's fiscal instability, poor academic performance, or both. Takeover statutes run the gamut from general grants of takeover authority to detailed directives that outline the extent of authority that may be exercised during the takeover and how the restructuring should be funded.

Takeover is often the last stop for a school district facing serious financial distress. Historically, state takeovers have been rare—between 1980 and 2011, fewer than 100 state takeovers occurred, most of them for fiscal reasons—but that may be changing. In 2014, for example, Pennsylvania's governor placed the York City School District into receivership.

Massachusetts and Ohio are among a small group of states with statutes that give the state broad authority to supplant an existing school board or administrator with a state-appointed receiver. Massachusetts used its statute to take over the Lawrence Public School District in 2011, and Ohio used its newly authorized statute to take over the Youngstown City School District in 2015.

Those recent events suggest that states are increasing willing to be more aggressively involved in school district restructuring, regardless of the potential for strong political backlash.

## Know the Alternatives

Troubled school districts are not limited to bankruptcy, voluntary receivership, or state takeover. Though not an immediate resolution, districts can lobby state or local governments for emergency legislation that grants authority to challenge collective-bargaining agreements or that provides emergency financing.

In addition, neighboring districts can consolidate or share services to keep costs low. Merging two districts, though often met with opposition, may make sense in states where a voucher or tuition system permits students from unaccredited districts to transfer to a neighboring accredited school.

School districts on the edge of distress have a number of options to set them on the path toward financial recovery. District administrators are well-advised to consider the availability, advantages, and pitfalls of various alternatives and to keep abreast of legal developments.

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