When Vallejo, California, filed for bankruptcy in 2008 after failing to win union pay cuts, Councilwoman Stephanie Gomes said officials around the U.S. would have their eyes trained on the city of 120,000.

She was right. The lesson they’ve taken from the two-year-old case, which has cost Vallejo $9.5 million in legal fees and made it a nationwide symbol for distressed municipal finances, is that out-of-court negotiations yield better results.

“They spent a lot of money with very little outcome,” said Jay Goldstone, San Diego’s chief operating officer. Faced with an $82 million deficit in his city’s 2010 budget, Goldstone negotiated pay cuts and higher benefit contributions from unions in 2009 that will save as much as $40 million annually, he said.

Bankruptcy has become less attractive even as U.S. municipal borrowers coped with what the National League of Cities said was the biggest decline in general-fund revenue since 1986 last fiscal year. The mention of Vallejo, the biggest California city and second-largest local government after Orange County to file for bankruptcy, can spook investors and raise interest costs, said Bill Lockyer, the state’s treasurer.

“Declaring bankruptcy is a huge admission of failure on the part of elected officials and their local managers,” Lockyer said in a Dec. 3 telephone interview. Vallejo’s filing “sent a chill through the markets.” Vallejo, a one-time Navy town 32 miles (51 kilometers) north of San Francisco, entered Chapter 9 bankruptcy protection in May 2008. The filing, after employee unions refused to accept salary cuts and the recession eroded tax revenue, allows municipalities to reorganize debt rather than liquidate.

Exit Plan

A five-year budget blueprint approved by the City Council on Nov. 30 spells out how Vallejo will meet $195 million of unfunded pension obligations, its largest liability. It also delays payments to bondholders, trims employee benefits, creates a rainy-day fund and allocates $5 million for unsecured creditors. The city must submit a bankruptcy-exit plan that includes the blueprint to a Sacramento court by Jan. 18.

Vallejo shows that negotiated settlements of budget problems may be better than the distractions of court deadlines and paying millions in legal fees, said Paul Rosenstiel, California’s deputy treasurer from 2007 to 2009.
“A lot of cities looked at Vallejo and concluded that painful as it might be, there must be a better solution,” said Rosenstiel, a principal with municipal-bond underwriter De La Rosa & Co. in San Francisco.

**Felt in Tracy**

The Vallejo bankruptcy resonates in Tracy, a city of about 82,000 residents 60 miles east of San Francisco, said Zane Johnston, the finance director.

In the face of a $7.5 million budget gap, the police union agreed this year to cancel remaining raises and boost the retirement age to 55 from 50 for new hires even though its contract wasn’t up for renewal, Johnston said in a Dec. 6 telephone interview.

“At the bargaining table,” he said, “Vallejo is the example that everybody knows about that doesn’t have to be mentioned because it can scare the living daylights out of some people.”

The ability of U.S. cities to file bankruptcy is limited. They must be authorized by state law to file under Chapter 9 of the [U.S. bankruptcy code](http://www.bloomberg.com/news/print/2010-12-14/vallejo-s-california-...). Twenty-five states lack such statutes.

While cities from Detroit to Harrisburg, Pennsylvania, have publicly raised the prospect, the number of filings has declined. Five municipal entities sought protection this year compared with 10 in 2009, according to data compiled by James Spiotto, head of the bankruptcy practice at Chapman & Cutler, a Chicago law firm. The biggest this year was a South Carolina toll road with more than $300 million in debt, he said.

**Company Contrast**

Since 1937, 619 local government bodies, mostly small utility or sewer districts, have filed for bankruptcy, according to Spiotto. In contrast, there were more than 11,000 Chapter 11 filings, used by companies to reorganize debt, in 2009 alone.

Local-government bankruptcies will “be minimal and isolated to mismanaged or weak credits,” BlackRock Inc., the world’s largest money manager, told clients on Dec. 7. States such as Pennsylvania and Rhode Island have become increasingly active in helping prevent them, it said.

When Harrisburg, the state capital, was weighing a Chapter 9 filing because it couldn’t make $282 million of payments on bonds it guaranteed for a trash incinerator, Governor Ed Rendell stepped in. Warning that a default by the city of 47,000 could raise borrowing costs elsewhere, Rendell advanced $3.3 million to Harrisburg for a general-obligation debt payment on Sept. 13.

“We couldn’t stand by and let the city default on these bonds,” Rendell said at the time.

**State Program**
Pennsylvania is considering Harrisburg’s application to the state’s distressed municipalities program, under which it would get help with a recovery plan that finds ways to raise revenue and streamline operations.

BlackRock cited new legislation in Rhode Island prohibiting Chapter 9 filings after the city of Central Falls suggested that path. The town of about 18,000 faced a fiscal 2010 deficit of $3 million, or 17 percent of revenue.

States “will quickly put procedures in place geared toward preventing Chapter 9 filings,” it said in its report.

State oversight boards were created for New York City in the mid-1970s and Philadelphia in 1991. They can bring cities back to an “adult state,” said Spiotto, by requiring balanced budgets, reviewing labor contracts and negotiating debt restructurings.

“We’ve had all sorts of municipalities with problems that were addressed outside of bankruptcy,” said Spiotto.

**Bondholder Action**

If states don’t act, bondholders will. In September, Bank of New York Mellon Corp. got a judge to appoint a receiver to manage the Jefferson County, Alabama, sewer system after a $3.2 billion debt refinancing collapsed and drove the municipality toward insolvency. Local officials, who are negotiating with bondholders, say a bankruptcy is still possible.

Vallejo made its filing as labor costs, its largest expense, were projected to be about $79.4 million in the 2008-2009 fiscal year, outpacing estimated net general-fund revenue of about $77.9 million, according to court documents.

“Vallejo’s problem was that they could make no further cuts without breaking legal contracts,” Michael Coleman, a fiscal policy adviser at the League of California Cities, said in a telephone interview Dec. 6. “That’s unique to virtually any other city in California.”

Vallejo had no other options, Marc Levinson, a partner with the Sacramento-based law firm Orrick, Herrington & Sutcliffe LLP who is drafting Vallejo’s bankruptcy-exit plan, said in a Dec. 3 telephone interview.

**Lack of Concessions**

“Negotiations broke down and we couldn’t get the concessions from the unions and from the bondholders that would keep us out of bankruptcy,” Levinson said.

The city has reached agreements with administrative and police unions that yielded $6 million in savings.
through June 2010, its website says. The firefighters union agreed to a new contract that was approved by the council in March.

Vallejo still has to sort out more than 1,000 creditor claims as part of its exit plan. And funding of $5 million for unsecured creditors won’t be completed until the 2012-2013 fiscal year.

The bankruptcy process could take another six months, further distracting local officials, said Christopher Mier, chief strategist with Loop Capital Markets LLC in Chicago.

Meanwhile, city residents will have 159 fewer fire and police personnel than seven years ago, road maintenance at 10 percent of recommended levels and no grants for arts and cultural programs.

“Bankruptcy hasn’t been a panacea for the city or the unions,” said Ron Oliner, a partner at Duane Morris LLP in San Francisco who represents Vallejo’s police union.

Gomes, the council member, said the city learned a lesson.

“It’s best to negotiate your way out of the fiscal problem,” she said, “before you go into bankruptcy.”

The case is In re City of Vallejo, 08-26813, U.S. Bankruptcy Court, Eastern District of California (Sacramento).

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