

Primer on Municipal Debt Adjustment

CHAPTER 9: THE LAST RESORT FOR FINANCIALLY DISTRESSED MUNICIPALITIES

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I. Municipal Bankruptcy Can Be an Option for Municipalities in Financial Distress

There is a saying that “while doctors bury their mistakes, in municipal financing, they are refunded.” There comes a time, however, when certain mistakes or financial difficulties cannot be refunded. Given present conditions, the probability has increased that a municipality will be faced with a significant cash flow problem and ensuing financial crisis. In such instances, the municipality may consider instituting a proceeding for municipal debt adjustment under Chapter 9 of the Bankruptcy Code,¹ attempt to resolve the fiscal emergency under other applicable law, or face acrimonious lawsuits which are both injurious to the municipality and unproductive in providing an economic solution to the problem.

Our system of federalism grants local governmental bodies the independence and the freedom to be able (with the consent of their citizens) to finance various necessary improvements through the issuance of municipal bonds. Under virtually every other form of government, the local governmental body, regardless of the merits of such proposals, must first request approval and financing from the central government before the local government is able to proceed with such commonplace municipal improvements as bridges, sewers, roads, and public buildings. Our Founding Fathers ordained that certain independence and power should be given to the states and their local governmental bodies.² Thereafter, during the late 1700’s and early 1800’s, a method of finance evolved whereby municipalities would issue their own debt obligations either based on their full faith and credit (general obligation bonds) or based upon the revenues to be collected by the municipal body in connection with the financed improvement (revenue bonds). This system of municipal finance has allowed citizens to determine on a local basis what improvements they desire and to finance such improvements without the need for federal financing or approval.

As our municipalities have grown and prospered, so has their need for continued financing. The confidence of the municipal bond market is essential, and municipalities traditionally have made every effort to honor their public debt obligations. States have enacted statutory provisions waiving sovereign rights in connection with financings to assure the bondholders that if they purchase the revenue bonds of municipalities within these states, the pledge of revenue to the bondholders cannot be diverted or terminated.³ These statutory provisions were not only for the bondholders but also for

¹ 11 U.S.C. § 901 et seq.

² See The Federalist No. 31 (A. Hamilton).

³ Most states have statutory provisions authorizing the pledge of revenues for the payment of certain bond indebtedness. Some state statutes specifically provide that the revenues so pledged cannot be diverted or used for purposes other than first making the required payment on the bond indebtedness. See Cal Educ Code § 1525.

the citizens of the state so that by providing assurance to bond investors of adequate remedies, all municipalities could make use of municipal bond financing when necessary. Currently, municipalities both large and small are facing severe economic hardship. Ironically, during times of financial crises, a municipality needs the support of the municipal bond market.

Chapter 9 of the Bankruptcy Code can be an alternative to municipalities from which the market does not shrink provided that the principles and practical realities of municipal financing are not disturbed. This material will analyze the viability of Chapter 9 as a remedy for municipalities. Particular attention will be directed to the amendments to Chapter 9 which became law on November 3, 1988⁴ ("Municipal Bankruptcy Amendments"). The Municipal Bankruptcy Amendments have made Chapter 9 a real option for municipalities since they have cured many of the ambiguities and uncertainties which existed under prior law. A modification to Chapter 9 made in the Bankruptcy Reform Act of 1994⁵ clarified the eligibility of municipalities to institute Chapter 9 proceedings.

II. Historically, Bankruptcy Has Been a Mechanism of Debt Adjustment in Other Countries

The notion of bankruptcy as a mechanism of debt adjustment was present in some of the earliest forms of law, including Greek and Roman law, which regarded the discharge of debt and the prompt and equitable liquidation of assets as a necessary ingredient of civilized society. During the fourth and fifth centuries B.C., 10 out of 13 Greek municipalities belonging to the Attic Maritime Association had defaulted on their loans from the Delos Temple, and the notion of municipal receivership was recognized⁶ when a Greek banker took over the administration and collection of taxes of Atarneus to pay off a defaulted loan. While under early Roman practices a debtor who could not pay his creditors over time met with a certain radical penalty — death — later procedures included the purportedly more humane remedy of the sale of the debtor's assets and distribution to creditors.⁷ English common law, which was, for the most part, the source from which our legal

⁴ Municipal Bankruptcy Amendments, Pub L No 100597, 102 Stat 3028 (1988).

⁵ Bankruptcy Reform Act of 1994, Pub L 103394, 108 Stat 4106 (1994) (the "1994 Bill").

⁶ Hillhouse, *Municipal Bonds, A Century of Experience* (1936).

⁷ See generally Wenger, *Institutes of the Roman Law of Civil Procedure* (1940); *Continental Illinois Nat. Bank & Trust Co. v. Chicago, Rock Island & Pacific Ry. Co.*, 294 US 648, 70 L Ed 1110, 55 S Ct 595 (1934).

system arose, recognized bankruptcy as a necessary ingredient of its legal system from the late seventeenth and eighteenth century, although imprisoning debtors for nonpayment of debts was common. Basic American bankruptcy law is less harsh and presents a debtor with a method for putting its financial affairs in order.⁸

In enacting the Constitution of the United States, the Founding Fathers determined that the legislative branch of the federal government should be vested with establishing laws regarding bankruptcy in order to ensure uniform and consistent resolution of insolvency matters. Accordingly, the Constitution provides that “Congress shall have the power ... to establish ... uniform laws on the subject of bankruptcies throughout the United States....”⁹ However, while provisions have evolved which govern bankruptcy of municipalities, the Tenth¹⁰ and Eleventh¹¹ Amendments to the Constitution preclude the power of the federal government to supervise the bankruptcy of a state.

III. Brief History of Municipal Bankruptcy Legislation in the United States

Prior to 1934, federal bankruptcy legislation did not provide a mechanism for municipal bankruptcy, insolvency, or debt adjustment.¹² During the period 1929 through 1937, there were 4,700

⁸ See generally Holdworth, *History of English Law* VIII (1936).

⁹ US Const art I, § 8, cl 4.

¹⁰ “The powers not delegated to the United States by the Constitution, nor prohibited to the States, are reserved to the States respectively, or to the people.”

¹¹ “The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or subjects or any Foreign State.”

¹² The Bankruptcy Act of 1800, 2 Stat 19 (1800); The Bankruptcy Act of 1841, 5 Stat 440 (1841); The Bankruptcy Act of 1867, 14 Stat 517 (1867); The Bankruptcy Act of 1898, 30 Stat 544 (1898). That is not to say that there were no defaults in government obligations in the 19th century. Indeed, the 1842 default by the State of Pennsylvania on its bonded debt inspired William Wordsworth to pen the sonnet “To the Pennsylvanians” in which he spoke of “won confidence, now ruthlessly betrayed.” It was the defaults of local utility districts and municipalities in the 1800’s that tarnished the integrity of the “new frontier’s” obligations. George Peabody, an eminent financier, sought to be admitted to polite English Society only to be rebuffed, not due to his lack of social grace, but because his countrymen did not pay their debts. It was the defaults by governmental bodies in the latter half of the 1800’s and early 1900’s which brought about the procedures which are now taken for granted, including debt limitations on municipal issues, bond counsel, and clearly defined bondholders’ rights.

defaults by governmental bodies in the payment of their obligations.¹³ In 1934, the House and Senate Judiciary Committees estimated that there were over 1,000 municipalities in default on their bonds.¹⁴

Units of local government were dependent upon property tax. During the Depression, there was widespread nonpayment of such taxes. (See Appendix A — Changes in Sources of Tax Revenues from 1922 to 2008 and the significant reduction on the reliance on property taxes given the experience of the Depression when property taxes as a percent of state and local revenues dropped from almost 70% in 1922 to about 17% in 2008.) Bondholders brought cases for accountings, secured judgments and obtained writs of mandamus for levies of further taxes. The first municipal debt provisions of the Bankruptcy Act of 1898 as amended from time to time (hereinafter the “Bankruptcy Act”) were enacted as emergency legislation for the relief of such municipalities, and became effective on May 24, 1934.¹⁵ These provisions were to be operative for a two-year period from that date, but this period was later extended to January 1, 1940.¹⁶

The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934 reflected an attempt to protect municipalities and corporation from debilitating disputes with creditors.¹⁷ The 1934 legislation provided a procedure whereby a local governmental unit, if it could obtain acceptances from two thirds of its creditors, could have a plan of readjustment enforced by the federal courts. Under the 1934 legislation, the court, and to some extent, the creditors, through the court, had certain control over the municipality’s revenues and governmental affairs. In 1936, the Supreme Court of the United States held, in the case of *Ashton v. Cameron County Water Improvement Dist., No. 1*,¹⁸ that the 1934 municipal bankruptcy legislation was unconstitutional in that it infringed on the sovereign powers of the states.

¹³ See A Commission Report, City Financial Emergencies: The Intergovernmental Dimension (Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1973).

¹⁴ S Rep No 407, 73rd Cong, 2d Sess 2 (1934).

¹⁵ 48 Stat 798 (1934).

¹⁶ 49 Stat 1198 (1936).

¹⁷ HR Rep No 207, 73rd Cong, 1st Sess 103 (1933); HR Rep No 517, 75th Cong, 1st Sess 34 (1937); HR Rep No 686, 94th Cong, 1st Sess 541, 542 (1975); HR Rep No 595, 95th Cong, 1st Sess 397398 (1977); S Rep No 95989, 95th Cong, 2nd Sess 110 (1978).

¹⁸ *Ashton v. Cameron County Water Improvement District, No 1*, 298 US 513, 80 L Ed 1309, 56 S Ct 892, reh’g denied, 299 US 619, 81 L Ed 457, 57 S Ct 5 (1936), with Mr. Justice Cardozo among the four dissenters, Justice Cardozo noted the widespread existence of municipal defaults and the nominal as opposed to real remedies of bondholders.

“Students of government have estimated that on January 1, 1933 out of securities to the extent of \$14,000,000,000 issued by units smaller than states, a billion were in default. The plight of the debtors was bad enough; that of the creditors was even worse. It is possible that in some instances the bonds did not charge the municipalities or other units with personal liability. Even when they did, however, execution could not issue against the property of the debtor held for public uses, and few of the debtors were the owners of anything else. In such circumstances, the only remedy was a mandamus whereby the debtor was commanded to tax and tax again.” 298 US at 534.

The invalidation of the 1934 legislation left many municipalities hopelessly insolvent and without any real practical remedy. In fact, at the time of the decision in *Ashton*, there were approximately 89 petitions pending for relief.¹⁹ In 1937, new legislation was passed which attempted to cure the defects outlined by the court in *Ashton* and to protect municipalities from the injurious protracted litigation some were enduring.

The 1937 municipal bankruptcy legislation²⁰ enacted in response to the *Ashton* decision required: (a) no interference with the fiscal or governmental affairs of political subdivisions; (b) a limitation of the protection of bankruptcy to the taxing agency itself; (c) no involuntary proceedings; (d) no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and (e) no impairment of contractual obligations by states. This legislation was upheld by the Supreme Court in *United States v. Bekins*,²¹ which noted that the statute was carefully drawn not to impinge upon the sovereignty of the states. Like the 1934 legislation, the 1937 provisions were deemed emergency in character, but expiration dates were repeatedly extended.

In 1946, the termination clause was repealed,²² thereby making the municipal bankruptcy legislation a permanent part of the Bankruptcy Act, Chapter IX. In addition, the 1946 amendments also: (a) extended the benefits of Chapter IX of the Bankruptcy Act to incorporated counties, authorities, commissions, or other similar public agencies organized for the purpose of constructing, maintaining or operating revenue producing enterprises; (b) provided for reference of special issues

¹⁹ Hempel, An Evaluation of Municipal Bankruptcy Laws and Procedures, 28 J Finance 1339 (1973). In this article, Professor Hempel discussed a number of examples illustrating how Chapter IX worked in practice. In the case of Fort Lee, New Jersey, municipal bankruptcy court jurisdiction was exercised continuously over several decades from 1928 through the 1970's. Fort Lee lost more than 40% of the assessed real estate valuation because of the construction of the George Washington Bridge. In 1938, a plan of composition was filed whereby bondholders received refunding bonds maturing in 1979 equal to the face value of their claims plus any interest in arrears. Saluda, North Carolina was prevented from filing a successful Plan of Debt Adjustment by one bondholder who held more than half of the outstanding bonds. While the default occurred in the 1930's, the case was not filed until 1971 with the bondholders getting over 40 cents per dollar of debt. Ranger, Texas filed at various times (1940, 1946, 1971) 3 refunding plans. In Medley, Florida, a plan of compensation extending the nonbonded debt was approved. The bonded debt of Medley was left untouched. 28 J Finance at 134445. The case of San Jose School District, discussed below, is illustrative for any municipality which desires to live successfully after a Chapter 9 proceeding has been filed. From the outset of the Chapter 9 proceeding, San Jose maintained that its bonds would continue to be paid; they were, and San Jose is existing outside a Chapter 9. The cases of Ft. Lee, Saluda, Ranger and San Jose all demonstrate the need for a practical resolution of temporary as well as permanent cash flow problems. The resolutions differ and if the municipality is not realistic in the beginning (overly optimistic as to revenue, payoff) a harsher and more drastic resolution will be obtained in subsequent proceedings.

²⁰ 50 Stat 654 (1937).

²¹ *United States v. Bekins*, 304 US 27, 82 L Ed 1137, 58 S Ct 811, reh'g denied, 304 US 589, 82 L Ed 1549, 58 S Ct 1043 (1938).

²² 60 Stat 409 (1946).

of fact to a referee in bankruptcy or Special Master; (c) provided for a preliminary stay of proceedings against a municipality upon the filing of a proceeding under Chapter IX; and strengthened the effectiveness and workability of Chapter IX by means of certain procedural changes.²³

Chapter IX then, while part of the Bankruptcy Act, provided a forum whereby a municipality could voluntarily seek an adjustment of indebtedness. A Chapter IX was not a proceeding to adjudge the city a bankrupt. The court's jurisdiction did not extend to declaring the city bankrupt or to administering its affairs as a bankrupt. The court was limited to disapproving or carrying out a proposed plan of reorganization of a municipality's debt.²⁴

This humble birth of municipal debt adjustment must be remembered. The principles enumerated in Ashton and the 1937 legislation are important in understanding the role of a bankruptcy court in a Chapter 9 proceeding today.²⁵ The Court cannot constitutionally interfere with the revenue, politics or day-to-day operations of the municipality. The bankruptcy court cannot replace by its rulings or appointments the city council or any other elected or appointed official. The bankruptcy court cannot rewrite state law governing municipalities or impair statutory liens or pledges of tax revenues to bondholders. The limited but vital role of the bankruptcy court is to supervise the effective and appropriate adjustment of municipal debt. This is significant when assessing the role of the bankruptcy court in municipal debt adjustment. Historically, Chapter IX and its successor Chapter 9 were intended to facilitate rather than mandate voluntary municipal debt adjustment and not municipal debt elimination.

IV. Causes of Defaults

The United States contains the most extensive and sophisticated public works system in the world including 3,866,000 miles of roadways, 565,000 bridges, 1,000 public mass transit systems, 16,000 airports, 25,000 miles of inland and intercoastal waterways, 70,000 dams, 900,000 miles of pipe in water supply systems and 15,000 waste water treatment plants provided mostly by municipalities and political subdivisions of a state. Not only our local but also our national welfare and economic

²³ See HR Rep No 6682, 79th Cong, 2d Sess 112 (1946).

²⁴ *Leco Properties Inc. v. R.E. Crummer & Co.*, 128 F2d 110 (CA5, 1942). Further, the court had no jurisdiction to determine the existence of the city or boundary disputes in the nature of quo warranto. *Green v. City of Stuart*, 135 F2d 33 (CA5, 1943).

²⁵ Upon the adoption of the Bankruptcy Reform Act of 1978 (hereinafter referred to as the "Bankruptcy Code"), the roman numerals which had previously been used to identify chapters of the Bankruptcy Act were abandoned in favor of arabic numbers. Hence, since the effective date of the Bankruptcy Code, "Chapter IX" has become Chapter 9.

growth depend upon the efficient operation of municipal facilities, most of which are financed by revenue bonds purchased by the municipal bond market.

Our ability to supply jobs in needed metropolitan areas and our ability to encourage business growth in metropolitan areas will require construction of new public work systems and the continued maintenance and operation of our present public works and infrastructure. Significant increases in infrastructure spending at both the federal and local levels are not only necessary, but inevitable. There will be an increasing demand on the municipal bond market to finance these infrastructure improvements over the next 20 years. Obviously, access to the market will be enhanced by a workable statute governing municipal debt adjustment. The Municipal Bankruptcy Amendments are a major step in providing this vehicle.

Over the last several decades, municipalities and metropolitan areas have faced a number of factors which have tended to make it more difficult for municipalities in certain areas of our country to meet municipal obligations as they become due. These factors include:

- (1) The movement in both population and manufacturing capabilities from the snowbelt to the sunbelt. (This is due not only to climate but also to the perception of individuals and corporations that there are higher tax levies in northern states.)
- (2) The decline of urban areas and the present need for major capital improvements and repairs in many metropolitan areas.
- (3) The increased percentage of municipal budgets devoted to the cost of personnel and personnel related expenses tied, for the most part, to cost of living increases which have grown at a higher rate than tax revenues.
- (4) The growing unrest among taxpayers in the face of increasing taxation without commensurate increases of benefits.
- (5) The adverse effects of inflation which have significantly increased the cost of maintenance, repair and operation of a municipality beyond what was projected at the time the municipal obligations were assumed.
- (6) The severe economic crisis that has impacted the economy at every level.

Given the increase in municipal bond defaults and the percentage of municipalities having budget deficits, it is increasingly apparent that an effective and efficient Chapter 9 bankruptcy proceeding is needed as a last resort when all else fails. However, the basic economic strength of our states and municipalities should not be underestimated. See Appendix B that sets forth the GDP for certain states that are perceived as more financially challenged than others and how they favorably compare to the PIIGS of Europe (Portugal, Italy, Ireland, Greece and Spain).

V. Recent Examples of Dealing with Municipal Financial Emergencies

A. The New York and Cleveland Experiences (A Little Help from the State Avoids a Chapter 9)

In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that New York had, for more than ten years, been using questionable accounting and borrowing practices to eliminate its annual budget deficits.²⁶ The banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could only be resolved by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. According to at least one analysis, the causes of this revenue shortfall included changing population and economic characteristics, national economic difficulties, state and federal government action, and inaction and weaknesses in the political system itself.²⁷ New York nearly defaulted on the payment of its notes in October, 1975, and it was predicted that a default was likely in December in the absence of federal aid.²⁸

At this time, the existing Chapter IX was examined to determine if it presented a viable solution for the problems facing New York City. It did not. Specifically, when filing a Chapter IX petition, a municipality had to show that a proposed plan of composition had been accepted by 51% in amount of its creditors,²⁹ and the Act did not provide a mechanism for raising funds to pay the municipality's post petition expenses. Further, the experience of Ranger, Texas and Ft. Lee, New Jersey, indicated the need for continuing court jurisdiction over execution and implementation of the Plan of Adjustment. In both Ranger and Ft. Lee, difficulties were experienced in the timely meeting of

²⁶ For a detailed study of the New York City fiscal crises see Shalala & Bellamy, *a State Saves a City: The New York Case*, 1976 Duke LJ 1119 (1976); United States Congress, House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (95th Cong 1st Sess, August 1977).

²⁷ Shalala & Bellamy, *A State Saves a City: The New York Case*, 1976 Duke LJ at 11191120.

²⁸ New York Times, October 19, 1975, Section 4 at 1.

²⁹ A major obstacle would be reaching the holders of bearer instruments. It was estimated that 160,000 individuals or families held \$4.89 billion in New York City bonds, about two thirds of the \$7.35 billion in outstanding bonds. New York Times, October 19, 1975, at 48, Col. 2. Some may state that the registration requirements of TEFRA (the Tax Equity and Fiscal Responsibility Act of 1982, Pub L No. 97248) should have solved these problems. However, as those experienced in registered bonds can attest, there are many situations where the bonds are held in nominee names (sometimes as many as 95% are in broker, bank or other nominee's names) and it is difficult to quickly and effectively communicate with bondholders.

the requirements of the Plan. As referred to previously, Ranger's 1940 Plan was modified by subsequent proceedings in 1946 and 1971.

Although New York City's then existing financial crises were averted through use of a *deus ex machina* in the form of the State Municipal Assistance Corporation which issued securities on behalf of the City,³⁰ the ineffectiveness of the old Chapter IX to a financially troubled major city provided the impetus for a substantial revision to municipal bankruptcy legislation. New York City's problems then and now are no different than most major metropolitan cities: increasing labor costs in a period of decreasing revenues. It is not unusual for at least 60%75% of municipal budgets to be for labor costs.

In December of 1978, the city of Cleveland defaulted on \$15.5 million of bond anticipation notes. When a financial emergency was declared by the state auditor in 1980, Cleveland had overdue accounts payable in excess of \$36 million and a large general fund deficit. Again, as in the case of New York, general fund expenditures exceeded revenues. Further, it appeared that restricted funds had been used to meet general obligations. Cleveland was able to solve, at least for a time, its financial problems by borrowing \$15 million from the state of Ohio to pay overdue debts, and through the issuance and sale of \$36.2 million in bonds to Cleveland banks. Although the provisions relating to municipal debt adjustment had been amended following the New York case, a resort to municipal bankruptcy was not considered.³¹

B. City of Bridgeport, Connecticut (City Troubled by Flight of Population and Business and the Use of Intercepts)

In 1991, the City of Bridgeport, Connecticut created a stir in the municipal finance community by filing a petition under Chapter 9 of the Bankruptcy Code. Bridgeport, the largest city in Connecticut, was the first city of major proportions to so file. Unlike the special purpose district bankruptcies which have become common in recent years, Bridgeport is a "real" city with many different creditors who have competing interests. Bridgeport had over \$200 million in long-term bondholders. At the same time, some 4,000 people were employed by the city pursuant to union contracts to deliver services to approximately 150,000 citizens.

³⁰ The 1970's did not have a monopoly on fiscal woes. In 1990, the New York State Financial Control Board noted the negative impact of the national and regional economics on the city's revenue base, the turmoil affecting one of the city's major revenue sources, Wall Street, and increased borrowing costs. The Financial Control Board, essentially dormant since the mid1980's, can be reactivated if certain conditions are triggered, including the inability of the city to meet debt service payments. The Bond Buyer, November 30, 1990, pp. 1, 45.

³¹ For an analysis of the factors leading to the default see Feldstein, What Really Went Wrong in Cleveland in 1978, The Municipal Bond Handbook 687 (1983). Mr. Feldstein attributes some of the problems to the weaknesses caused by a mayor whose term of office was only two years and who had limited powers and by the city's limited taxing power.

The financial problems of the city did not arise overnight. Previously, the state of Connecticut had enacted special legislation known as the “Special Act” to recognize the otherwise illegal deficits of the city, to provide a financial oversight review board to supervise and discipline city finances, and to provide certain financial assistance to the city. The Special Act authorized the financing of the deficit and provided certain payments to be made by the state to bondholders of the city in order to enhance the creditworthiness of the troubled city. This intercept mechanism, which functions in connection with the review by the oversight board, is not uncommon but could be subject to challenge in the Chapter 9 proceeding.

After the City of Bridgeport filed for bankruptcy, Connecticut moved to dismiss the bankruptcy petition on a number of grounds. Following an extensive hearing, the court concluded that Bridgeport was not “insolvent” when it filed its petition, and, therefore, the petition should be dismissed. As will be discussed, the test for an insolvent municipality is that the municipality is generally not paying its debts as they become due or is unable to pay debts as they become due. It was undisputed that, on the date of filing, Bridgeport was paying its debts as they became due. Therefore, the issue was whether, on the date of filing, Bridgeport was *unable* to pay debts as they became due. The court concluded that it had not been presented persuasive evidence that the city would be unable to pay its debts anytime in the future. While the court rejected the state’s argument that the analysis of insolvency could not be prospective in nature, the court found that the evidence established that Bridgeport would not run out of cash during the fiscal year 1991-1992. The court disagreed that the cash flow analysis demonstrated that Bridgeport would run out of cash early in the next fiscal year. According to the court, financial difficulties short of insolvency are not a basis for Chapter 9 relief. Therefore, the court concluded that Bridgeport was not insolvent when the petition was filed, that the petition must be dismissed, and that Bridgeport must continue with the budget and collective bargaining process.

In summary, while the court agreed with Bridgeport that a city should not have to wait until it runs out of money to qualify for Chapter 9 protection, it ruled that the city must demonstrate as a condition precedent to filing that, in the near future, it will run out of money and be unable to pay its debts as they become due. Because of the election of a new mayor in Bridgeport, the appeal of these rulings was not pursued. Therefore, there was no review of the bankruptcy court’s rulings. The Bridgeport filing and its dispute with the state was a motivating factor in the 1994 legislation requiring a municipality to be “specifically authorized” by a state before it can file a Chapter 9 proceeding rather than the prior test of “generally authorized to sue and be sued.”

C. Orange County, California (Creative Financing to Solve Tax Revenue Shortfalls)

Orange County, California is the fifth largest county in the United States with an annual budget of approximately \$4 billion. An unwise leveraged investment policy, which in periods of falling interest rates had produced as much as 20-30 percent of the revenues for the County, created a liquidity crisis in the late fall of 1994 as a consequence of rising interest rates during 1994. The County filed a petition for relief under Chapter 9 of the Federal Bankruptcy Code on December 6, 1994.

While the real impact of the Orange County Chapter 9 filing took years to determine, a number of observations were readily apparent. The bankruptcy was shocking in the first instance because of the unwillingness to pay posture originally exhibited by the County. Unlike New York, Philadelphia, and Cleveland, which took extraordinary measures (including raising taxes) to avoid default, the wealthy county of Orange County, California made the surprising and speedy decision to file for bankruptcy after it had suffered a dramatic loss because of investments in derivative securities. A proposal to raise the sales tax by half a cent to help the County out of its financial crisis was defeated in June, 1995 during the course of the bankruptcy proceedings. Such action is consistent with the anti-tax sentiment in California that generated such legislative measures as Proposition 13.

Approximately \$2 billion of Orange County short-term obligations (due in under one year or less) came due in July and August, 1995 during the pending of the bankruptcy. Principal was not paid when due. As part of the Plan of Adjustment, the holders of these obligations voluntarily agreed to have the maturity extended for an additional year (at an increased interest rate). Paying these obligations when they matured depended upon refinancing them in the public markets.

The long-term and short-term debt of Orange County held by the public was paid from the proceeds of two financings: the issuance of tax-exempt certificates of participation and taxable refunding pension obligation bonds. The Orange County securities were sold but at a cost to Orange County. The County paid a penalty of 10 to 23 basis points and, including underwriting fees and costs of bond insurance, Orange County paid approximately \$60 million more to borrow because of its status as a bankrupt issuer.

It remains to be seen whether the financial penalty that the marketplace has imposed upon Orange County may reappear in the future. States are reviewing restrictions on the investment policies of their political subdivisions, and there has been some discussion of possible changes to the Bankruptcy Code in light of the Orange County and more recent experience.

D. City of Vallejo, California (The Consequences of Too-Rich Benefit Programs)

The City of Vallejo filed for Chapter 9 in 2008. The principal causes of the filing were the unsustainable public employee compensation and pension packages. In terms of Chapter 9 jurisprudence, the case produced an important ruling on Chapter 9 eligibility. Specifically, insolvency is to be determined by a cash flow analysis. In the Vallejo case, the debtor filed a motion to reject collective bargaining agreements, which was met by protracted litigation and ultimately with the unions agreeing to certain modifications of benefits given the court's ruling that the contracts could be rejected. However, Vallejo was not able to touch the pension payments for current retirees because California law prohibited altering benefits of those already in the system even though benefit reduction was a part of the rationale for the bankruptcy filing. The current employees were asked to pay a increasing cost of their medical coverage. Further, for current employees, the City was able to do away with such contractual obligations as binding arbitration and minimum manning for the fire department. The City also eliminated a contract clause that required the City to pay firefighters an

average of what their peers made in ten area cities, including major cities like Sacramento, the state capital. Unfortunately, there were dramatic cuts in public safety with the budgets of the police and fire departments slashed almost 50 percent. Interest payments to bondholders were to be suspended for 3-1/2 years. At least \$9.5 million in legal fees were spent by the City in the process.³²

VI. Existing Municipal Bankruptcy Provisions

Having observed the deficiencies of the old Chapter IX in practice, Congress set about creating a mechanism to manage the financial troubles of a municipality. On April 8, 1976, the bill amending Chapter IX of the Bankruptcy Act was signed into law, Public Law 94260 (hereinafter referred to as “1976 Legislation”).³³ Among the major changes was the elimination of the requirement that the municipality obtain the prepetition consent of 51%³⁴ of its creditors. The 1976 Legislation allowed the city to file for bankruptcy without the approval of its creditors and permitted the city to continue borrowing for essential government services. The provisions regarding municipal bankruptcy were further modified in the Bankruptcy Reform Act of 1978, known as the Bankruptcy Code³⁵, whereby Chapter IX was redesignated Chapter 9. Chapter 9 was amended slightly by the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (hereinafter referred to as “1984 Act”).³⁶

³² Alison Vekshin and Martin Z. Braun, *Vallejo Bankruptcy ‘Failure’ Scares Cities Into Cutting Costs*, Bloomberg, available at http://www.Bloomberg.com/news/2010-12-14/Vallejo_s_california_bankruptcy_failure (last visited February 20, 2012).

³³ 90 Stat 315 (1976). For a general discussion of the 1976 Legislation see Norton Bankr L & Prac § 47.01 et seq.; Bond, Municipal Bankruptcy under the 1976 Amendments to Chapter IX of the Bankruptcy Act, 5 Fordham Urb LJ 1 (1976); Ellison, The Recent Revision of the Federal Municipal Bankruptcy Statute: A Potential Reprieve for Insolvent Cities?, 13 Harv J on Legis 549 (1976); King, Municipal Insolvency: Chapter IX, Old and New; Chapter IX Rules, 50 Am Bankr LJ 55 (1976); Patchan and Collins, The 1976 Municipal Bankruptcy Law, 31 U Miami L Rev 287 (1977).

³⁴ The prior consent requirement was workable during the depression when most refundings were accomplished through the vehicle of the Reconstruction Finance Corporation which bought a large portion of the outstanding bonds.

³⁵ 11 U.S.C. § 101 et seq.

³⁶ On July 10, 1984, President Reagan signed the Bankruptcy Amendments and Federal Judgeship Act of 1984 (“1984 Act”), Pub L No. 98353. This legislation consists of three main parts: creation of a new Bankruptcy Court to replace the Bankruptcy Reform Act provisions found unconstitutional in Northern Pipeline in the Supreme Court’s decision of June 28, 1982, (Title I of the 1984 Act); creation of additional district and circuit court judgeships (Title II of the 1984 Act); and Amendment of the Bankruptcy Code making changes in areas where either certain abuses or concerns were raised regarding the Bankruptcy Reform Act of 1978. Such areas included rejection of labor contracts, grain storage facility bankruptcies, repurchase agreements, timesharing agreements, shopping center bankruptcies, discharge of debts incurred by drunk drivers and consumer credit (Title III of the 1984 Act).

On November 3, 1988, President Reagan signed into law important, substantive amendments to Chapter 9 which corrected some of the inconsistencies between existing bankruptcy law and municipal law, the Municipal Bankruptcy Amendments. The Municipal Bankruptcy Amendments became effective as of that date. The Municipal Bankruptcy Amendments are designed to harmonize bankruptcy law with existing municipal law and financing practices. Their focus includes assurance that liens on “special revenue” not be extinguished, that prepetition payments on bonds and notes be free from the taint of possible preference attack, and that revenue bonds not be transformed into general obligation bonds. Further, the Amendments make a general failure to pay debts the criterion for municipal insolvency and eligibility for filing.³⁷ The 1994 Law clarifies the split which had developed in case decisions and provides that municipalities must be specifically authorized by the State in order to be eligible to file for bankruptcy.³⁸

Chapter 9 is not a vehicle for elimination of debt but rather for debt adjustment. A Chapter 9 proceeding is a mechanism for a debtor municipality, through a court supervised proceeding, to attempt to settle disputes with its creditors. Since a municipal unit cannot liquidate its assets to satisfy creditors and continue to function as a municipality, the primary purpose of Chapter 9 of the Bankruptcy Code is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims. Indeed, one of the stated purposes of the Bankruptcy Code was to provide a “workable procedure so that a municipality of any size that has encountered financial difficulties may work with its creditors to adjust its debts.”³⁹ Under this legislation, a city cannot be forced to take any specific action without the state’s consent.

The causes of these municipal bankruptcies include large judgments which the local governments are unable to pay,⁴⁰ other court action,⁴¹ burdensome labor contracts,⁴² related real estate developments which went into private bankruptcy,⁴³ changes in government structure,⁴⁴ poor

³⁷ Municipal Bankruptcy Amendments, Pub L No 100597 (1988).

³⁸ 1994 Bill at Section 402.

³⁹ HR Rep No 137, 93rd Cong, 1st Sess 237248, reprinted in [1978] US Code Cong and Ad News 6221.

⁴⁰ Bay St. Louis, Miss, South Tucson, Ariz, and Wapanucka, Okla.

⁴¹ North and South Shenango Joint Municipal Authority.

⁴² San Jose School Dist.

⁴³ Grimes County Municipal Utility Dist. No. 1; Sanitary & Improvement Dist. No. 5 of Cass County, Neb.; Sanitary & Improvement Dist. No. 4 of Lancaster County, Neb.; Sanitary & Improvement Dist. No. 42 of Sarpy County, Neb.; Sanitary & Improvement Dist. No. 7 of Lancaster County, Neb.

⁴⁴ The Management Institute of San Leandro; San Jose School District; Jersey City Medical Center; Monterey County Special Health Care Authority.

financial planning,⁴⁵ or declining land values and real estate deflation which have plagued special districts.⁴⁶ One of the causes of the Orange County crisis was the imposition of a constitutionally imposed lower tax cap (Proposition 13),⁴⁷ the Vallejo filing was caused, at least in part, by labor costs including OPEBs, and the Jefferson County bankruptcy has been linked to the large indebtedness undertaken in connection with its sewer system.

VII. Where to Look for More Detail Regarding Municipal Bankruptcy

In these pages and the accompanying appendices, we have and will discuss the highlights of the municipal bankruptcy process. However, you may have additional questions regarding the technicalities of the process, including the impact of the automatic stay, creditors and creditor committees in a Chapter 9, the debtor's use, sale or lease of property and executory contracts or details regarding the Orange County bankruptcy. For further detail regarding these topics and a general discussion of the remedies available upon default, your attention is directed to the chapters by the author which appear in the books referred to on the cover of these materials and in particular to the *Municipalities in Distress?* book. Appendix C includes charts providing the breakdown of the number of Chapter 9 filings since 1937 and a breakdown since 1980 of the type, number per year and number per state.

⁴⁵ Pleasant View Utility Dist. of Cheatham County; Pulaski Memorial Hospital.

⁴⁶ E.g., Colorado Centre Metropolitan District; Villages at Castle Rock Metropolitan District No. 4; Hamilton Creek Metropolitan District; Summit County, Colorado; WillOWisp; Wolf Creek Valley Metropolitan District No. II, Mineral County, Colorado; Wolf Creek Valley Metropolitan District No. IV, Mineral County, Colorado; Dawson Ridge Metropolitan District No. 1.

⁴⁷ Article XIII A of the California Constitution.

VIII. Initiation of Chapter 9 Proceeding and Effect on Bondholder Rights and Remedies

Only a municipality may be a debtor under Chapter 9 of the Bankruptcy Code.⁴⁸ Only a municipality can initiate a Chapter 9 proceeding. There can be no involuntary Chapter 9 proceeding. Not only are involuntary proceedings constitutionally prohibited, as set forth in *Ashton v. Cameron County Water Improvement Dist. No. 1*,⁴⁹ but also there is no statutory basis for such an involuntary action. Only § 301 of the Bankruptcy Code, providing for voluntary cases, is incorporated into Chapter 9. A municipality is a political subdivision, or public agency, or instrumentality of a state.⁵⁰ A municipality is not eligible to be a debtor pursuant to any other Chapter of the Bankruptcy Code.⁵¹

Moreover, under the 1994 Act, in order to proceed under Chapter 9, state law must have specifically authorized the entity to be a debtor under Chapter 9.⁵² Some states have specifically authorized a municipality to so proceed.⁵³ Some states have specifically prohibited municipalities from filing under the Bankruptcy Code.⁵⁴ Others authorize a filing under certain conditions.⁵⁵

⁴⁸ 11 U.S.C. § 109(c). Claims by holders of industrial revenue bonds are not governed by Chapter 9, and amounts owed by private companies to the holders of industrial development bonds are not to be included among the assets of the municipality. S Rep No 95989, 95th Cong, 2d Sess 109 (1978). The determination of whether or not an entity is a “municipality” can be difficult. Although originally Chapter 11 relief was sought and denied because of the debtor’s status as a municipality, the Court in *In re Jersey City Medical Center*, 817 F2d 1055 (CA3, 1987), ruled that a public municipal hospital was a proper debtor under Chapter 9. Conversely, the cases *American Milling Research and Development, Inc.*, No. 7400129 and *Fort Cobb Irrigation District*, No. 7600679, were initially filed under Chapter 9 but were converted to Chapter 11 bankruptcies.

⁴⁹ *Ashton v. Cameron Water Improvement District No. 1*, 298 US 513, 80 L Ed 1309, 56 S Ct 892, reh’g denied, 299 US 619, 81 L Ed 457, 57 S Ct 5 (1936).

⁵⁰ 11 U.S.C. § 101(29).

⁵¹ Only a “person” is eligible for relief under Chapters 7 and 11 of the Code. “Governmental unit” is excluded from the definition of “person.” 11 U.S.C. § 101(33).

⁵² 11 U.S.C. § 109(c)(2).

⁵³ See:

Ala Code § 11-81-3

Ariz Rev Stat Ann § 35-603

Ark Code Ann § 14-74-103

Idaho Code Ann. § 67-3903

Minn. Stat. Ann. § 471.831

Prior to 1994, a number of states had been silent on the issue of whether local governmental bodies were authorized to file under Chapter 9. The power of a municipality “to do all acts necessary, proper or convenient” including the right to sue and be sued had been held sufficient to authorize a municipality to file.⁵⁶ Given the judicial and legislative history surrounding municipal debt

Mo. Ann. Stat. §427.100

Mont Code Ann. § 7-7-132

Neb. Rev. St. § 13-402

Okla. Stat. Ann. Tit. 62 §§ 281, 283

S.C. Code Ann. § 6-1-10

Tex. Loc. Gov’t Code § 140.001

Wash. Rev. Code § 39.64.040

Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1402 of the Colorado revised statutes states that “any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition”

⁵⁴ See, e.g., Ga Code Ann §§ 36-80-5.

⁵⁵ The Chapman and Cutler LLP survey discussed the requirements of each state for a Chapter 9 filing. See Appendix D for a listing of who may file Chapter 9, what limitations there are on municipalities as to filing and which states do not authorize their municipalities to file.

⁵⁶ In re Pleasant View Utility Dist. of Cheatham County, Tenn, 24 BR 632 (BR MD Tenn, 1982). The court concluded that the term “generally authorized” as used in § 109(c) means only that the state should give some indication that the municipality has the necessary power to seek relief under the federal bankruptcy law. The court so held despite legislative history of the section which indicated that the Senate rejected the House’s proposal that a municipality would be eligible to file a Chapter 9 petition unless such filing was prohibited by state law. See HR Rep No 595, 95th Cong, 1st Sess 263264, 318319, reprinted in [1978] US Code Cong & Admin News 5963, 62206222. The Senate’s position was a departure from the earlier notion that a municipality’s authority to file a municipal bankruptcy was an inherent element of existence. See In re South Beardstown Drainage & Levee Dist., 125 F2d 13 (CA7, 1941). See also In re City of Wellston, 43 BR 348 (BR ED Mo, 9184), in which the court held that a grant of powers to act for the preservation of peace and good order and for the benefit of trade and commerce was sufficient to authorize the filing of a Chapter 9 petition.

But see In re North & South Shenango Joint Municipal Authority, No. 8100408 in the United States Bankruptcy Court for the Western District of Pennsylvania. There, the bankruptcy court found that a joint municipal authority which had been created under Pennsylvania law to construct and operate sewer systems, had been “generally authorized” to file a petition under Chapter 9. The court relied on the distinction in Pennsylvania law between municipal authorities like the debtor authorized to do all acts “necessary or convenient for the promotion of their business,” and political subdivisions, which were required to obtain the approval of the state Department of Community Affairs before they could file a petition for relief under the federal bankruptcy law. The court found that the decision to restrict political subdivisions’ resort to bankruptcy evidenced a contrary intent regarding municipal authorities. 14 BR 414 (BR WD Pa, 1981). The Third Circuit declined to exercise jurisdiction over the appeal. Pennbank v.

adjustments and state authorization to file a Chapter 9, it was important to note there could have been an overlooked problem in this regard. Commentators cited the reported decisions in North and South Shenango Joint Municipal Authority as a statement of law.⁵⁷ This case as reported could stand for the proposition that home rule power granted to a municipality is sufficient authority for it to be eligible to institute a Chapter 9 proceeding even though there is no expressed statutory power to file. However, such was not the final result in North and South Shenango, in which the Bankruptcy Court was reversed by the district court in an unreported decision.

In a decision arising out of the filing by a Colorado special purpose district before the 1994 legislation, the court revisited the same issue. The special purpose district had, under applicable statute, the ability to be a party to suits, actions and proceedings, to borrow money, incur indebtedness and issue bonds, to refund any bond indebtedness, to manage, control and supervise all of the business and affairs of the district and to exercise all rights and powers necessary or incidental to or implied from the special powers granted by the statute. The statute further provided that the specific powers granted should not be considered as limitations upon any power necessary or appropriate to carry out the purposes and intent of the statute. The court found that the express and specific authorization to file a Chapter 9 is not required by 11 U.S.C. § 109(c)(2) and the aforementioned general powers were sufficient to constitute a general authorization for a Chapter 9 filing. The court held that the ability to file a Chapter 9 was necessary or incidental to the power to refund bond indebtedness and the District's ability to manage, control or supervise its business and affairs.⁵⁸ However, a Philadelphia bankruptcy court decision,⁵⁹ citing the North and South Shenango case, held that the right to sue and be sued did not constitute the requisite affirmative action required by the Bankruptcy Code. In the bankruptcy of the City of Bridgeport, the court also concluded that specific authorization to file a Chapter 9 petition was not required.⁶⁰ The legislative history behind the 1994 Act specifically noted the controversy and the purpose of the amendment to clarify the matter. The state law must specifically authorize the filing.⁶¹ The court in the Orange County bankruptcy ruled that the Orange County Investment Pool was not specifically authorized to file a

Washbaugh, 673 F2d 1301 (CA3, 1981). However, the District Court, to which an appeal was also taken, reversed the Bankruptcy Court and held that there was no sufficient showing of state authorization. 80 BR 57 (BR WD Pa, 1982). The case was then handled in a state court proceeding. (Letter of Kirkpatrick, Lockhart, Johnson & Hutchinson, Pittsburgh, Pennsylvania to author dated August 8, 1984).

⁵⁷ See e.g., 4 Collier on Bankruptcy, §900.03 n 12.

⁵⁸ Villages at Castle Rock Metropolitan District No. 4, No. 89 B 16240 (D Colo, May 11, 1990).

⁵⁹ In re Carroll Township Authority, 119 BR 61 (BR WD Pa, 1990).

⁶⁰ In re City of Bridgeport, 128 BR 688 (D Conn 1991).

⁶¹ See Bankruptcy Reform Act of 1994 Section by Section Description appearing at 140 Cong Rec H 10771 (daily ed 10/4/94).

Chapter 9 petition by a statute which referenced a laundry list of public entities that are authorized to file but which did not refer to an investment fund.⁶²

Further, the municipality must be insolvent or unable to meet its debts as they mature, and desire to effect a plan to adjust its debts.⁶³ The determination of insolvency is not as easy as it seems. The Municipal Bankruptcy Amendments have clarified the definition of insolvency and resulted in a more workable definition from a municipal law standpoint.⁶⁴ In addition, it must be demonstrated that one of the following has occurred:

- (1) The municipality has obtained the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under Chapter 9;
- (2) The municipality has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under Chapter 9;⁶⁵

⁶² In re County of Orange, 183 BR 594 (BC CD Cal. 1995). See also In re Alleghany Highlands Economic Development Authority, 720 BR. 647 (BC WD Va. 2001).

⁶³ 11 U.S.C. §§ 109(c)(3) and (4).

⁶⁴ In the case of In re Sullivan County Regional Refuse Disposal District, 165 BR 60 (BR D NH 1994), the court held that the failure of the debtors to impose a special assessment, as they had a right to do, did not raise a question with respect to their insolvency. Rather, it was held that such failure to do so was relevant with regard to good faith. See also In re City of Desert Hot Springs, 2003 WL 22682471 (9th Cir. 2003). In re City of Vallejo, California, No. 08-26813-A-9, 2008 WL 4180008 (Bankr. E.D.Ca. Sept. 5, 2008), the court held that insolvency is determined using a cash flow analysis based upon the City's obligations as of the petition date as those obligations actually exist. Hypothetical circumstances (such as labor concessions) are not part of the analysis.

⁶⁵ The issue of good faith negotiations often is subject to dispute. In the case of In re Chillowee RIV School District, 145 BR 981 (BR WD Mo 1992), the school district had transferred funds from the incidental fund into the salary fund and into the equipment fund so that those funds would have more money than originally budgeted. The incidental fund (which would be subject to attack by former teachers) would not have substantial funds subject to disbursal. The court held that the mere fact that the debtor attempted to place itself in as good a position as it could for entering a bankruptcy situation was only one factor to be considered. The mere fact that prebankruptcy planning had occurred was not indicative of bad faith as such. The court held that it was only when prebankruptcy planning left the stage of preparation and became fraud on creditors that there was a serious problem. However, in the case of In re Ellicott School Building Authority, 150 BR 261 (BR D Colo 1992), where the Authority held a meeting with bondholders regarding its proposed plan describing the proposal as a take-it-or-leave-it situation and expressed unwillingness to compromise, the court found that no true good faith negotiations had taken place. Similarly, in the case of In re Sullivan County Regional Refuse Disposal District, 165 BR 60 (BR D NH 1994), where the districts did not seriously attempt until four or five weeks prepetition to develop a feasible prepayment plan, the districts never exercised their assessment powers, and the districts never set out for creditors comprehensive workout plans dealing with all their liabilities and assets in terms comparable to a Chapter 9 plan, the debtors failed to establish prepetition good faith negotiations.

- (3) The municipality is unable to negotiate with creditors because such negotiations are impractical; or
- (4) The municipality reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under § 547 of the Bankruptcy Code.⁶⁶

With regard to an unincorporated tax or special assessment district which does not have its own officials, an action is commenced under Chapter 9 by filing a petition by such district's governing authority or board or body which has the authority to levy taxes or assessments to meet the obligations of each district.⁶⁷ See Appendix D regarding who may file Chapter 9 and what states authorize municipalities to file.

The fact that a municipality has filed a petition does not necessarily ensure that its debts will be adjusted in that proceeding. Section 921(c) provides that, after objection to the petition, the court, after notice and a hearing, may dismiss the petition, if it can be shown to the bankruptcy court that a petition was not filed in good faith or not in accord with the requirements of Chapter 9.⁶⁸ Further, if a creditor can show that any of the following has occurred, the court may dismiss the petition:

- (a) There has been a want of prosecution of the municipal debt adjustment proceeding;
- (b) There has been an unreasonable delay that is prejudicial to creditors;
- (c) There has been a failure to propose a plan within the time fixed by the court to propose such a plan, or such plan has not been accepted by the appropriate percentages of creditors;
- (d) The court has denied confirmation of the plan as being in the best interests of creditors and feasible; or

⁶⁶ 11 U.S.C. §§ 109(c)(5) (A)(B).

⁶⁷ 11 U.S.C. § 921(a).

⁶⁸ 11 U.S.C. § 921(c) See *In re Jersey City Medical Center* 817 F2d 1055 (CA3, 1987). Section 901(a) of the Bankruptcy Code incorporates Section 301 of the Bankruptcy Code which states that "the commencement of a voluntary case under a chapter of this title constitutes an order for relief under such chapter." Section 921(d) provides that if the petition is not dismissed under subsection (c) of this section the court shall order relief under this chapter. Colliers has indicated that this provision is superfluous. *Collier on Bankruptcy*, §921.04 (15th ed). However, one court has rejected Colliers' conclusion, and has found that, given the complexities of the qualifications for Chapter 9 filing, Congress clearly intended that a distinct "order for relief" would be entered by the court in Chapter 9 cases. *In re Colorado Centre Metropolitan District*, 113 BR 25 (BR D Colo, 1990).

- (e) If a court has maintained continuing jurisdiction after confirmation, there has been a material default by the municipality with respect to such a plan or a condition specified in the plan for termination of the plan has occurred.⁶⁹

IX. Unique Features of Chapter 9

Chapter 9 specifically incorporates by reference a number of provisions of the Bankruptcy Code.⁷⁰ This procedure has created a number of open issues. Of key interest to bankruptcy practitioners is the fact that Section 901 of the Bankruptcy Code does not incorporate Sections 327 through 331, which are the professional retention and compensation provisions.⁷¹ Those sections permit the employment of professional persons for the debtor, including counsel and financial advisors, and payment of compensation to such professional persons retained pursuant to court order. Assumedly, it was believed that legislating in that area would infringe on the municipality's rights contrary to the strictures of § 904. There is no provision in the Bankruptcy Code for the payment of the attorneys' fees of counsel or other advisors to the debtor. Unless the debtor consents, there does not appear to be an ability for counsel for the debtor to obtain payment from the court.

Given the legislative history and Supreme Court decisions discussed above relating to the formulation of Chapter 9, and, in particular, to the *Ashton* decision, there was both (a) in Section 903, the confirmation of the reservation of the state power to control municipalities which specifically limits the bankruptcy court so that it may not limit or impair the power of the state to control by legislation or otherwise a municipality's exercise of the political or governmental powers including expenditures for such exercise and (b) in Section 904, the limitation on the jurisdiction and powers of the Chapter 9 court which cannot, without consent of the municipality, interfere with the governmental or political powers or the revenues, property, use or enjoyment of the property of the municipal or state limitation on municipality powers. This means that, if by state statute, certain liens or claims are established, granted and come into existence by means of the state statute, such as will be described below as Statutory Liens, the bankruptcy court cannot impair, limit or adversely affect such liens. If the state limits the power of the municipality to take certain actions or to modify certain pledges pursuant to a Statutory Lien, the bankruptcy court is not authorized or empowered to modify or change that. Likewise, the bankruptcy court under Section 904 has a limitation on its

⁶⁹ 11 U.S.C. § 927. The effect of dismissal is governed by § 349 of the Bankruptcy Code. Dismissal generally does not bar discharge in another proceeding or institution of another proceeding except as provided in § 109(f) (180day rule as to institution of cases dismissed).

⁷⁰ 11 U.S.C. § 901.

⁷¹ 11 U.S.C. §§ 327-331.

jurisdiction and power so that it cannot interfere with any political, governmental power of the municipality or any property or revenue of the municipality or the municipality's use and enjoyment of any income-producing property without that municipality's consent, and the municipality, consistent with Section 903, cannot act inconsistent with the provisions, requirements and limits placed on it under state law. This is a significant difference from a debtor in a Chapter 11 proceeding whereby the court can proceed to supervise any change in expansion or contraction of business out of the ordinary course and has to approve increases in borrowings or other changes in operation and business.

While Section 503(b)(4) of the Bankruptcy Code, which provides for payment of counsel or accountants to a creditor, indenture trustee, equity security holder or committee which has made a substantial contribution to a case under Chapter 9, is incorporated by reference, Section 503(b)(4) makes no mention of counsel for the debtor. The provisions for retention and compensation of counsel for the debtor in a corporate bankruptcy do not require the substantial contribution test.⁷² Particularly in many of the special purpose district bankruptcies, where funds are scarce, the source of payment of fees to counsel for the debtor is a difficult issue which must be reckoned with if the debtor is to receive adequate representation. Further, if the debtor does determine to pay its counsel out of funds which other creditors deem inappropriate, it appears that the court will not interject itself.⁷³

Section 901 also does not incorporate by reference the sections which provide for initial creditors' meetings or examinations of the debtor.⁷⁴ Although, in fact, in many cases, the U.S. Trustee's Office proceeds to insist on such a creditors' meeting, there does not appear to be specific statutory authority for such.

Section 541, "Property of the Estate," is not incorporated into Chapter 9. This section typically creates the estate of the debtor. In a Chapter 9 proceeding, there is no debtor-in-possession concept and the debtor retains title to, possession of, and control over all of its property other than "special revenues" pledged to certain obligations as defined in §928. Any other approach would run afoul of the concerns discussed in the *Ashton* case. The priority of expenses and claims is embodied in Section 507 of the Bankruptcy Code.⁷⁵ This section, which governs the seniority of certain types of unsecured claims, includes special treatment for wage claims, contribution to employee benefit plans, etc. Chapter 9 only incorporates by reference the provision giving priority to administrative expenses allowed under 503(B).⁷⁶ Thus, it would appear that there are no priority unsecured claims under

⁷² 11 U.S.C. § 503(b)(4).

⁷³ See *In re Sanitary and Improvement District No. 7 of Lancaster County, Nebraska*, 96 BR 966 (BR Neb, 1989).

⁷⁴ See 11 U.S.C. §§ 341 and 343.

⁷⁵ 11 U.S.C. § 507.

⁷⁶ 11 U.S.C. § 507(a).

Chapter 9, except for such administrative expenses. As more Chapter 9s are filed, problems which may exist on account of the format of Chapter 9, incorporation of provisions from other Chapters, may become apparent.

Appendix E sets forth the major reasons: “Why Chapter 9 (Municipal Debt Adjustment) is Unlike Chapter 11 (Corporate Reorganizations).

X. The Required Maintenance of Municipal Service During a Municipal Bankruptcy

While in a Chapter 9 proceeding, the municipality will still have to function as a municipality. Depending upon the statutory mission of the municipality, there are certain necessary and basic municipal services which must be provided, such as police, fire, and under certain instances, sewer, water and electrical services. Defining what these necessary municipal services are is a question of state law and may by itself be a complex issue. A bankruptcy court and creditors will not be able to successfully interfere with such service. Section 904 of the Bankruptcy Code recognizes this reality. Accordingly, certain revenues and activities of the municipal body which may be the cause of the “insolvency” may not be able to be restrained, curtailed, or modified without a compelling reason. Even municipal debt secured by “special revenues”, which pledge is preserved by reason of Section 928 of the Bankruptcy Code, is subject to the payment of necessary operating expenses.

No court has ever interpreted the meaning of “necessary operating expenses” as it applies under § 928(b) of the Bankruptcy Code, and the Bankruptcy Code itself does not define the term.⁷⁷ Thus, a review of the legislative history surrounding the 1988 Bankruptcy Amendments may be helpful.

The House of Representatives Report in connection with the Municipal Bankruptcy Amendments recognized:

Subsection (b) sets forth a minimum standard for paying operating expenses ahead of debt service where revenues are pledged. It is not intended to displace any broader standard contained in the terms of the pledge or applicable nonbankruptcy law.

⁷⁷ The bankruptcy court in the Jefferson County, Alabama Chapter 9 has scheduled a hearing in April 2012 to determine what are “necessary operating expenses” and what is “net revenue” that can be paid to the holders of the sewer warrants as Special Revenues.

H. R. Rep. at 8. As the House directed:

This is important because payment of operating expenses -- those necessary to keep the project or system going -- must be protected so that the project or system can be maintained in good condition to generate the [revenue] to repay bondholders (and importantly to provide residents of the municipality with the service the project or system is meant to deliver).

Id. Key to this passage is that the House intended “necessary operating expenses” to include only those items that were actually necessary to maintain the condition of the system.

Indeed, the Senate Report accompanying the 1988 Municipal Bankruptcy Amendments was also clear as to Congress’s intent to subordinate the payment of pledged revenues only to “necessary operating expenses.” In its Report, the Senate described “necessary operating expenses” as “operating expenses which are necessary to keep the project or system going and producing special revenues.” Senate Rep. at 22. Further, the Senate noted that “[t]he operating expenses are to be necessary and directly related to the project or system generating the special revenues and are not the expenses of the municipality generally or for other systems or projects.” *Id.* at 23.

Thus, based on both the House and Senate’s explanation for why each body approved § 928(b), both chambers intended for a narrow interpretation of “necessary operating expenses” to set a “minimum standard” and was not intended to displace any broader standard existing in the applicable indentures or non-bankruptcy law.

Given the fluctuation and delay in cash flow (tax collection), it is evident that a municipality which traditionally has had to rely on the municipal bond market for financing its operation must consider how such financing will be accomplished in a Chapter 9. Section 364 of the Bankruptcy Code, which provides for voluntary credit extension on a priority basis is applicable to a Chapter 9, but the paucity, if not absolute lack, of large municipal Chapter 9 filings leaves doubt in the minds of many investors as to whether any Chapter 9 financing is prudent. States as well as regions should consider establishing emergency funds for financing of municipal operations during times of financial crisis when traditional sources are unavailable.⁷⁸ At least some states — Pennsylvania under the Financially Distressed Municipalities Act,⁷⁹ and Illinois in an action to assist the City of East St. Louis — have done so to a limited extent.

⁷⁸ See e.g., Ohio Rev Code Ann § 118:17 et seq; NY Pub Auth Law § 3001 et seq.

⁷⁹ Pa Stat Ann Tit 53, § 11701.102 et seq.

XI. Labor Contracts Are an Important Element of the Municipal Budget Whose Status in a Chapter 9 Has Been the Subject of Discussion

On February 22, 1984, in the matter of *National Labor Relations Board v. Bildisco & Bildisco*,⁸⁰ the Supreme Court held that § 365(a) of the Bankruptcy Code⁸¹ provides that, with certain limitations, the trustee may unilaterally assume or reject “any executory contract” of the debtor, including a collective bargaining agreement.

Bildisco & Bildisco (“Bildisco”), a New Jersey general partnership in the business of distributing building supplies, filed a voluntary petition in bankruptcy for reorganization under Chapter 11 of the Bankruptcy Code. Prior to filing, Bildisco had negotiated a three-year collective bargaining agreement with the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America (“Union”) which provided that the agreement was binding on the parties and their successors regardless of bankruptcy. After filing, Bildisco requested permission from the bankruptcy court pursuant to § 365(a) to reject the collective bargaining agreement. At the hearing on the matter of rejection, Bildisco presented a sole witness, a general partner who testified that rejection would save his company \$100,000 in 1981. The bankruptcy court granted permission to reject the collective bargaining agreement on January 15, 1981.

A collective bargaining agreement is an executory contract which is subject to rejection under § 365(a). According to the Supreme Court, the fact that Congress did not exclude collective bargaining agreements from the scope of § 365 indicates that § 365 does apply to such agreements. However, because of the “special nature” of labor agreements, the Court found that a standard for rejection more stringent than the normal “business judgment” rule should apply.⁸² According to the Supreme Court, a bankruptcy court should permit rejection of a collective bargaining agreement subject to § 365(a) but only if the debtor can show both that the agreement burdens the estate and that the equities balance in favor of rejection. This would include a consideration of the likelihood and consequences of:

- (1) Liquidation for the debtor absent rejection;

⁸⁰ *National Labor Relations Board v. Bildisco & Bildisco*, 465 US 513, 79 L Ed 2d 482, 104 S Ct 1188 (1984).

⁸¹ 11 U.S.C. § 365(a).

⁸² See *Group of Institutional Investors v. Chicago, M., St. P. & P.R. Co.*, 318 US 523, 87 L Ed 959, 63 S Ct 727 (1943); *In re Minges*, 602 F2d 38 (CA2, 1979); *In re Tilco, Inc.*, 558 F2d 1369 (CA10, 1977). See also *International Brotherhood of Electrical Workers, Local 2376 v. City of Vallejo (In re Vallejo)*, 432 B.R. 262 (E.D. Ca. 2010) (upholding the Bankruptcy Court’s decision to permit the debtor - city to reject a collective bargaining agreement).

- (2) Reduced value of the creditors' claims that would follow from affirmance and the hardship that would be imposed on them; and
- (3) Impact of rejection on the employees.

In striking the balance, the bankruptcy court must consider not only the degree of hardship faced by each party, but also any qualitative difference between the types of hardship each may face. Nevertheless, the Supreme Court rejected the test espoused by the Union that *Bildisco* should not be permitted to reject the collective bargaining agreement unless it could demonstrate that its reorganization would fail unless rejection was permitted.

Given the fact that labor obligations are among the most burdensome problems faced by municipalities, as evidenced by the San Jose School District bankruptcy,⁸³ the *Bildisco* result obviously could be attractive to some local governments. However, municipal workers generally perform a governmental function. Absent a resolution by the debtor municipality's legislative body approving or disapproving rejection, the provisions of § 904 of the Code require that the bankruptcy court cannot interfere with the political or governmental powers of the debtor. Accordingly, the jurisdiction of the bankruptcy court is limited, and the termination of a labor contract contrary to the wishes of the municipality's elected officials may be subject to attack as beyond the court's power. Further, if *Bildisco* is to be applicable to a Chapter 9, a clearer standard for review by the Bankruptcy Court should be promulgated to ensure no violation of § 904 or the Tenth Amendment. Interestingly, in the Vallejo case, the City's motion to reject the collective bargaining agreement with the police union was ultimately followed by an agreed-upon revised collective bargaining agreement, which some have suggested may not have been worth the agony and expense of the Chapter 9 proceeding.

XII. Statute Governing the Rejection of Collective Bargaining Agreement in the Corporate Context

Congress, in the Bankruptcy Amendments and Federal Judgeship Act of 1984, responded to the Supreme Court's decision in *Bildisco*⁸⁴ which permitted unilateral rejections of a collective bargaining agreement by a debtor. The Supreme Court in *Bildisco* rejected the standard whereby a

⁸³ *In re San Jose Unified School Dist. No. 58302387A9* (BR ND Ca., 1983).

⁸⁴ *National Labor Relations Board v. Bildisco & Bildisco*, 465 US 513, 79 L Ed 2d 482, 104 S Ct 1188 (1984).

collective bargaining agreement could be rejected only if it was demonstrated to be onerous and burdensome and would thwart the efforts to save the debtor from collapse.⁸⁵ In response, Congress added § 1113 to the Bankruptcy Code. This provision had the effect of modifying the Supreme Court's ruling so as to prohibit unilateral rejection without a court hearing and ruling upon an application for such rejection.

There is no reference or amendment contained in the 1984 Act or incorporation into § 901 of the Bankruptcy Code that would indicate that § 1113 would be applicable to a Chapter 9 proceeding. As a result, § 1113 is not applicable to a Chapter 9 proceeding and *Bildisco* is applicable and still valid as to a Chapter 9 to the extent it is not inconsistent with § 904 of the Bankruptcy Code or the Tenth Amendment.

XIII. “Special Revenues” Pledged to Bondholders

Many municipal bonds are revenue bonds secured by a pledge of revenues derived from the project or a special tax levy. Prior to the enactment of the Municipal Bankruptcy Amendments, there was real concern as to the continuation of such a pledge after the filing of a Chapter 9 petition. Section 552(a) of the Bankruptcy Code, which is applicable to a Chapter 9, provides that any prepetition pledge terminates upon bankruptcy as to property acquired after the filing of a petition, except for “proceeds, product, ... etc.” of property already subject to the lien.⁸⁶ This section invalidates the reach of after acquired property clauses to property acquired by the debtor after the filing of the petition. The only exception is for “proceeds”, a term that is largely undefined by the Bankruptcy Code or cases. Thus, prior to the enactment of the Municipal Bankruptcy Amendments, § 552 could have been interpreted to defease the lien on revenues assigned by the debtor to secure bonds unless the revenues collected after the filing of the petition could be traced as proceeds of some other property of the debtor which was subject to a lien prior to the filing.⁸⁷ The fear was that if a municipality filed a Chapter 9 petition, § 552 would permit general creditors of the municipality to seek payment from the pledged revenues. Not only would such a result eliminate the difference between general obligation and revenue bonds, but it would have a serious effect on the municipal bond market.

⁸⁵ See *Brotherhood of Railway & Airline Clerks v. REA*, 523 F2d 164 (CA2, 1975) cert denied 423 US 1017. For a discussion of the conflict between labor and bankruptcy law in this case and under the Bankruptcy Code, see Note, Labor Law Bankruptcy Collective Bargaining Agreements and Chapter 11 Reorganizations Under Subtitle J of the Bankruptcy Amendments and Federal Judgeship Act of 1984, 59 Tul L Rev 1694 (1985).

⁸⁶ 11 U.S.C. § 552(a).

⁸⁷ See S Rep No 506, 100th Cong, 2d Sess 5 (1988).

These concerns are addressed by § 928 of the Bankruptcy Code, one of the Municipal Bankruptcy Amendments.⁸⁸ Subsection (a) renders § 552(a) inapplicable to revenue bonds secured by “special revenues”. Specifically, § 928 of the Bankruptcy Code provides that in the case of “special revenues,” the security interest in “special revenues” remains valid and enforceable even though such revenues are received after a Chapter 9 filing. As previously noted, subsection (b) of § 928 provides that in the case of project or system financing, the bondholders’ lien on “special revenues” is subject to necessary operating expenses of the project or system. Thus, subject to the payment of operating expenses, holders of special revenue bonds would continue to receive payment on those bonds, regardless of the bankruptcy filing.⁸⁹ Section 928 is intended to negate Section 552(a) in the municipal context. The legislative history makes clear that this section is not intended to create new rights that otherwise would not exist under state law and constitutional provisions. Section 928 removes the limitation on preexisting rights created by § 552(a) where special revenues are concerned.⁹⁰

Thus, § 928 provides that special revenues acquired by the debtor after the commencement of a bankruptcy case are subject to any lien granted on special revenues prior to the bankruptcy filing. Section 928 is intended to ensure that revenue bonds do not become transformed into general obligation bonds with a call against all the assets of the municipality upon the filing of bankruptcy petition. Prior to the addition of § 928 to the Bankruptcy Code, § 552(a) of the Bankruptcy Code was applicable to revenue debt in a Chapter 9. That section provides that property acquired by a debtor after the commencement of the bankruptcy case is not subject to a lien created prior to the bankruptcy filing unless the acquired property constituted proceeds of the property pledged prior to the bankruptcy filing. The result of the application of § 552(a) in the municipal context generally was to strip the lien of revenue bondholders. Therefore, the revenue bondholders would become unsecured creditors with a claim against the postpetition revenues that had previously secured the revenue bonds and their claims would become part of the general obligations of the municipality. The general funds would then be used to pay all creditors including the revenue bondholders. As a result, rather than taking the risk that a specific revenue stream would be sufficient to pay debt service on their bonds, revenue bondholders were, in fact, taking the risk that the general fund of the municipality would not be sufficient to repay all debts of the municipality. Section 928 resolved this problem by providing that revenue bondholders continue to have a lien on special revenues generated after the bankruptcy case. As the legislative history also makes clear, the addition of § 928 was motivated by the desire to make it easier for municipalities to obtain needed financing for public projects.

⁸⁸ 11 U.S.C. § 928.

⁸⁹ *In re Jefferson County, Alabama*, 2012 Bankr. LEXIS 40 (Bankr. N.D. Ala. Jan. 19, 2012); *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

⁹⁰ See S Rep No 506, 100th Cong, 2d Sess 12 (1988).

In addition to providing that the lien on special revenues continues after a Chapter 9 filing, the Municipal Bankruptcy Amendments also dealt with the problem of timely payment. In order to avoid the delay in payment caused by the automatic stay of § 362, the 1988 Amendments added a new subsection to § 922 of the Bankruptcy Code that makes the automatic stay provision inapplicable to the payment of pledged special revenues to the holders of municipal indebtedness.

The Senate Report accompanying the Municipal Bankruptcy Amendments observed that the payment of the net revenues, after payment of operation and expenses of the income producing property, should be paid to the holders of secured bonds without the application of the automatic stay, which is the derivation of § 922(d) in the Code, as the Senate Report states:

This provision [362] is overly broad in Chapter 9 requiring the delay and expense arising from a request for relief from automatic stay to accomplish what many state statutes mandate: the application of pledged revenues after the payment of operating expenses to the payment of secured bonds. The automatic stay should specifically be inapplicable to application of such revenues.

In fact, as the Senate Report noted at page 21,

Reasonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal finance.

The clear intent of Congress in enacting the 1988 Amendments was to provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing. The Senate Report states:

To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to receive revenues pledged to them in payment of their debt obligations of a municipality, a new section is provided in the Amendment to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and *that they will have unimpaired rights to the project revenues pledged to them.*

New Section 927 [928] along with the definition of Special Revenues in Section 902(3) protect the lien on revenues.⁹¹

In sum, Congress made clear that revenue bondholders are entitled to receive the revenues pledged to them without any interference and on a timely basis.

⁹¹ Senate Report, at 12 (emphasis added).

Particular attention should be directed to the definition of “special revenues,” the pledge of which survives bankruptcy.⁹² “Special revenues” are defined as:

- (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;
- (B) special excise taxes imposed on particular activities or transactions;
- (C) incremental tax receipts from the benefited area in the case of tax increment financing;
- (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or
- (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sale, or income taxes (other than tax increment financing) levied to finance the general purpose of the debtor.

Examples of the “special revenues” mentioned in clause (A) include receipts derived from or received in connection with the ownership, financing, operation or disposition of a municipal water, electric or transportation system. An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (B). “Special excise taxes” are taxes specifically identified and pledged in the bond financing documents and are not generally available to all creditors under state law. A general state sales tax would not be a special excise tax. In a typical tax increment financing referred to in (C), public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts may be part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the preexisting tax base of the community. Examples of revenues from particular functions under clause (D) would include regulatory fees and stamp taxes imposed for the recording of deeds or any identified function and related revenues identified in the municipality’s financing documents, such as tolls or fees related to a particular service or benefit. Under clause (E), an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered “special revenues.” Likewise, any special tax or portion of a general tax specifically levied to pay for a municipal financing should be treated as “special revenues.”⁹³ By its terms, Section 552(a) only applies to liens resulting from security

⁹² 11 U.S.C. § 902(2).

⁹³ See *Heffernan Memorial Hospital District*, 202 BR. 147 (BR S.D. Cal. 1996).

agreements, not other types of liens such as statutory liens⁹⁴. In the *Orange County* case, the district court held that the lien securing the payment of certain notes was a statutory lien that secured the filing of the County's Chapter 9. For this purpose, although a project or system may or may not be revenue producing, the incremental tax must be specifically identified with such project or system.

XIV. Statutory Liens Protect Bondholders

In certain situations, even if holding general obligation bonds for which the contractual pledge of a municipality's taxes or revenues generally would terminate on the filing of a municipal bankruptcy petition, a bondholder may continue to receive payment in the wake of a Chapter 9 filing if the underlying statute authorizing the issuance contains a statutory lien, which lien comes into existence by virtue of the statute and arises by force of the statute on specific circumstances or conditions and not requiring further action by the municipality.⁹⁵ A statutory lien cannot be canceled on the filing of a bankruptcy petition or by the bankruptcy court. As noted above, this approach was recognized by the district court on appeal in the *Orange County* bankruptcy. There, the court found that the lien securing tax and revenue anticipation notes pursuant to a California statute authorizing the county to pledge assets to secure notes was a statutory lien. Since the statute imposed the pledge, not a security agreement, it survived the filing of a Chapter 9 petition.⁹⁶

The significance of Special Revenues and Statutory Liens was illustrated recently by the case of *Sierra Kings Health Care District*, in which a court order reaffirmed the fact that a Chapter 9 proceeding and any order or plan of debt adjustment cannot interfere with notes, bonds or municipal obligations that are paid from the pledge of taxes or revenues that are special revenues or subject to a statutory lien.⁹⁷ Of special significance is the fact that the *Sierra Kings* court confirmed, for the first time, the postpetition effectiveness of a municipality's pledge of *ad valorem* taxes which qualified as both a special revenue pledge and a statutory lien. The Chapter 9 proceeding, orders and plan would not affect the timely payment on these bonds according to their terms.

⁹⁴ In re County of Orange, 189 BR. 499 (CD Cal. 1995).

⁹⁵ In re County of Orange, 189 BR. 499 (C.D. Cal. 1995).

⁹⁶ *Id.*

⁹⁷ In re Sierra Kings Health Care District, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

XV. Payments to Bondholders Are Not Preferences and Priority of Payments in a Chapter 9 Proceeding

A. Preferences

Section 547 of the Bankruptcy Code,⁹⁸ which is applicable to a Chapter 9 proceeding,⁹⁹ would give the municipality the ability to avoid any transfer to or for the benefit of a creditor made on account of an antecedent debt while the debtor was insolvent within 90 days of the date of the filing of a petition. The concerns raised by the applicability of this section to municipal revenue bond financing were several.¹⁰⁰ An argument could be made that interest payments made during the 90 day period, either from revenues obtained before or during the 90 day period, were preferential and had to be returned to the debtor municipality.¹⁰¹ Further, there was fear that deposits made pursuant to the defeasance provisions of indentures, if made within 90 days before the filing of a Chapter 9, could be deemed to be preferential.

The Municipal Bankruptcy Amendments not only address the problem of revenue bondholders, but actually provide assurance to holders of all municipal bond or note obligations.¹⁰² Section 926(b) of the Bankruptcy Code now provides that a transfer of property of the debtor to or for the benefit of any holder of a bond or note on account of such bond or note may not be avoided under § 547. While this section refers to “bonds or notes,” there is nothing in the legislative history to support the view that this provision is limited only to instruments bearing such titles. The intent appears to be that § 926(b) should be applicable to all forms of municipal debt.

B. Payment Priorities of Claims in a Chapter 9

There are priorities of payment of claims in a Chapter 9 proceedings.

1. Secured Claims

Obligations secured by a Statutory Lien are secured and are to be paid to the extent of that lien, pledge or dedication of tax revenues. Likewise obligations secured by Special Revenues (subject

⁹⁸ 11 U.S.C. § 547.

⁹⁹ 11 U.S.C. § 901.

¹⁰⁰ See S Rep No 506, 100th Cong, 2d Sess 7 (1988).

¹⁰¹ But see the decision of the United States Supreme Court in the *Matter of Union Bank v. Wolas*, 112 S Ct 527 (1991).

¹⁰² 11 U.S.C. § 926.

to necessary operating expenses) are to be paid timely to the extent of the lien. Secured liens based on bond resolutions or contractual provisions that do not meet the test of Statutory Liens or Special Revenues, to the extent perfected prepetition and to the extent of the value of the prepetition property or proceeds thereof, should be paid. Under §§ 522 and 928 of the Bankruptcy Code, a contractual lien on such collateral granted prepetition or its proceeds (that is not Special Revenues or a Statutory Lien) would not continue and be paid to the holder of the bonds, notes or other securities. Section 929 of the Bankruptcy Code provides, even if the transaction is styled as a municipal lease, a municipal lease financing will be treated as long term debt and secured to the extent of the value of the property or facility.

2. Administrative Claims

An obligation that arises after filing for value as a cost of operation is treated as an administrative expense (which could include expenses incurred in connection with a Chapter 9 case itself). Chapter 9 incorporates § 507(a)(2), which by its terms provides a priority for administrative expenses allowed under 503(b).

Some have argued that this could include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case. Section 943 of the Bankruptcy Code provides that all amounts of administrative expenses must be disclosed and be reasonable in a Plan of Adjustment to be confirmed.

3. Unsecured Claims

Unsecured general obligations in a Chapter 9 proceeding can include trade and vendor claims, worker compensation, wages and benefits, unfunded pension liabilities and even general obligation bonds, notes, warrants, tans, bans, rans and other securities to the extent not secured by a Statutory Lien, Special Revenues or a prepetition, perfected lien on prepetition collateral. Subordination agreements are honored in Chapter 9 under Section 510(a) of the Bankruptcy Code which is incorporated into Chapter 9. There is no priority for value of goods provided prepetition within 20 days of the Petition Date under § 503(b)(9) unlike a Chapter 11 proceeding. Chapter 9 does not incorporate § 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collective bargaining agreement (as noted above) making standards less restrictive such as “impairs the ability to rehabilitate”) or §§ 507(a)(4) and (5) which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacations, severance, sick leave or contributions to pension plans currently at \$11,725 per employee.

Appendix F will further spell out the priorities of payments in a Chapter 9 proceeding and how certain types of bonds and notes are treated in Chapter 9.

XVI. Use of Letters of Credit as Backing for Municipal and Conduit Obligations

Letters of credit are not guarantees, and are not considered to be ultra vires for national banks. A letter of credit is considered to be the full faith and credit of a financial institution in the amount set forth therein, and, as a general rule, when the conditions of the letter of credit are met, payment cannot be enjoined.¹⁰³ In drafting any letter of credit transaction, it is important that all documents clearly indicate that the letter of credit is not a guarantee. Upon presentment of specified documents and fulfillment of certain conditions, a letter of credit is an unqualified obligation to pay.¹⁰⁴

A letter of credit is an “independent” contract between the issuing bank and the beneficiary.¹⁰⁵ As such, if the stated conditions are satisfied, it survives the bankruptcy of the debtor for whom it was issued.¹⁰⁶ Neither the letter of credit nor its proceeds are property of the estate. In issuing the letter of credit, the bank agrees to pay out of its own assets.¹⁰⁷ In the case of conduit financing, the “debtor” for this purpose would be the corporation for whose benefit the municipality issued the bonds.

A number of years ago, the municipal finance community was jarred by a bankruptcy court decision holding that a letter of credit obtained for a conduit financing could not be drawn on by the indenture trustee on account of the bankruptcy of the company despite the fact that such was an event of default under the documents.¹⁰⁸ The court, assuming that the trust indenture was an executory contract, held that such ipso facto clauses were not enforceable. The court would not

¹⁰³ Circumstances which will justify an injunction against payment of a letter of credit are limited to situations of fraud in which the wrongdoing of the beneficiary has so violated the entire transaction that the legitimate purposes of the independence of the issuer’s obligations would no longer be served. *Intraworld Industries Inc. v. Gerard Trust Bank*, 461 Pa 343, 336 A2d 316 (1975); *Edgewater Const. Co. v. Percy Wilson Mortgage & Finance Corp.*, 44 Ill App 3d 220, 357 NE2d 307 (1976); *Crocker Nat. Bank v. Superior Court of State of California*, 434 US 984 (1977), 68 Cal App 3d 863, 136 Cal Rptr 481 (1977).

¹⁰⁴ See *Wichita Eagle & Beacon Publishing Co. v. Pacific Nat. Bank of San Francisco*, 493 F2d 1285 (CA9, 1974). See also *In re Eastern Freight Ways, Inc. v. Seaboard Surety Co.*, 9 BR 653 (SD NY, 1981).

¹⁰⁵ UCC § 5114, Official Comment, § 2.

¹⁰⁶ *In re Page*, 18 BR 713, 715 (DCD, 1982); *In re Marine Distributors, Inc.*, 522 F2d 791, 795796 (CA9, 1975); *Courtaulds North America, Inc. v. North Carolina Nat. Bank*, 387 F Supp 92 (MD NC, 1975) rev’d on other grounds 528 F2d 802 (CA4, 1975).

¹⁰⁷ *In re Page*, 18 BR 713, 715 (DCD, 1982).

¹⁰⁸ *In re Prime Motor Inns*, 123 BR 104 (BR SD Fla, 1990), rev’d 130 BR 610 (SD Fla 1991).

permit the draw because the effect of such a draw would be to increase the liabilities of the debtor because of the increased monetary obligations of the debtor under the reimbursement agreement with the letter of credit bank. This decision is contrary to other cases,¹⁰⁹ and was reversed by the district court. However, a recent case has not extended that reasoning to include situations where the letter of credit secures performance under a lease instead of a bond indenture.¹¹⁰

XVII. Plan of Adjustment for Municipality: Time, Content, Impairment of Claims and Acceptance

Section 941 of the Bankruptcy Code provides that the debtor shall file a plan for the adjustment of its debts.¹¹¹ If such plan is not filed with the petition, the debtor shall file such plan at such later time as the court fixes.¹¹² The cumbersome requirement of obtaining prepetition consents by creditors is abolished. The municipality may modify the plan at any time prior to confirmation provided such modification is consistent with the requirements of Chapter 9.¹¹³

Sections 1122 and 1123(a)(14) of the Bankruptcy Code,¹¹⁴ which are applicable to Chapter 9 and Chapter 11 proceedings,¹¹⁵ govern the required contents of a reorganization plan. The United States Supreme Court, in considering a plan of adjustment under the old Chapter IX, held that before a plan could be confirmed, it must appear to the court that, based on past and prospective tax revenues and operating expenses, the municipality will be able to make payments under the plan.¹¹⁶

¹⁰⁹ *In re Zenith Laboratories, Inc.*, 104 BR 667 (BR NJ, 1989).

¹¹⁰ *In re Metrobility Optical Systems Inc.*, 268 BR. 326 (BR NH 2001).

¹¹¹ 11 U.S.C. § 941. This section gives the debtor the exclusive right to propose a plan. HR Rep No 595, 95th Cong, 1st Sess 399 (1977). The exclusivity is consistent with § 904 of the Code which precludes any interference in the affairs of the Chapter 9 debtor. For the elements of a plan pursuant to Chapter 11 see generally Norton Bankr L & Prac § 59.01 et seq.

¹¹² Bankruptcy Rule 3016(a) provides that a Chapter 9 debtor may file a plan at any time.

¹¹³ 11 U.S.C. § 942.

¹¹⁴ 11 U.S.C. §§ 1122 and 1123(a)(14). The general provisions concerning the contents of a Chapter 11 plan are made applicable here, with two exceptions relating to the rights of stockholders, which are not applicable in Chapter 9 cases.

¹¹⁵ 11 U.S.C. § 901.

¹¹⁶ *Kelly v. Everglades Drainage District*, 319 US 415, 87 L Ed 1485, 63 S Ct 1141 (1943).

Such a test does not take into consideration federal and state aid and grants to municipalities. The plan must be based upon an analysis of the debtor's cash flow including taxes and other revenues and a determination of the validity and amount of claims pursuant to § 502 of the Code. Once a feasible plan has been developed, consideration must be given as to any voter or regulatory approval necessary based upon the structure of the plan. Discussions with key creditors and creditors' committees as to their views regarding any proposed plan is central to developing a plan that can be confirmed without lengthy litigation.

A fundamental aspect of a municipal bond is the exemption from Federal income taxation which is enjoyed by interest paid on the bonds. Determination of whether or not interest paid on the bonds is so exempt is normally made by "bond counsel" who are hired by the municipal issuer when the bonds are issued to give such an opinion to the purchasers and owners of the bonds. There are complex Federal tax requirements which are preconditions for the tax exemption and accordingly part of any municipal debt adjustment plan must deal with a determination of whether or not the interest paid on the new obligations will be tax exempt. Indeed, this can be of critical importance for holders of mutual funds or unit investment trusts which are generally restricted by their organizational documents to only owning tax exempt securities.

The plan may provide for, among other things, sale of property of the estate, either subject to or free of any lien; cancellation or modification of any indenture or similar instrument; extension of a maturity date or a change in an interest rate or other term of outstanding securities; or issuance of securities of the debtor for existing securities; and may impair any class of claims secured or unsecured.¹¹⁷

The plan shall include the following:

- (A) Designation of the classes of claims that exist specifying any class of claim or interest that is not impaired under the plan;
- (B) Statement of the treatment of any class of claims or interests that is impaired under the plan;
- (C) Statement providing for the same treatment for each claim or interest in a particular class unless the holder of a particular claim or interest agrees to a less favorable treatment of such claim or interest;

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11 U.S.C. §§ 1123(a) and (b). For example, the Plan of Reorganization in *In re San Jose United School District, No. 58302387A* (BR ND Cal, Sept. 1, 1983), treated the following topics: 1) Definitions; 2) Administrative Expenses; 3) Classification of Claims; 4) Treatment of Claims (including bondholders whose claims were not impaired by the Plan: "The Plan shall not alter any legal, equitable or contractual rights to which each claim entitles the holder thereof"); 5) Amendments and Waiver; 6) Retention of Jurisdiction; and 7) Executory Contracts (including the rejection of the labor contract).

- (D) Statement of a means for the execution of the plan such as the sale of property, transfer of property; the satisfaction or modification of any lien, the cancellation or modification of any indenture or similar instrument, the curing or waiving of default, extension of a maturity date, the change of interest rate or other terms of outstanding securities, or the issuance of new securities;
- (E) Statement, if appropriate, of the settlement or determination of any disputes belonging to the debtor; and
- (F) Assumption or rejection of any executory contracts or unexpired leases.¹¹⁸

The plan can include any other appropriate provision not inconsistent with the applicable provisions of the Bankruptcy Code. Section 1122 which governs the classification of claims is applicable to a Chapter 9 proceeding. Under § 1122, the plan may place a claim or interest in a particular class only if such claim or interest is substantially similar to other claims or interests of such class, except that the plan may designate a separate class of claims consisting of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience. Classification of claims becomes important because under § 1129, it is necessary to obtain the acceptance of at least one class of impaired creditors before the debtor may move the court to cram down the plan. Courts have held that there must be some limit on the debtor's power to classify creditors in such a manner to assure that at least one class of impaired creditors will vote with the plan and make it eligible for cram down consideration by the court. Using such a standard, a court in the bankruptcy of a municipal medical center approved the separate grouping of the claims of medical malpractice victims, employee benefit plan participants and trade creditors.¹¹⁹ Further, where bonds and warrants are treated differently under state law, their separate classification in a plan of reorganization under Chapter 9 has been held to be appropriate.¹²⁰ While separate classification has been denied for nonsubstantive reasons, differences in security or other reasonable distinctions will likely be supported.¹²¹

¹¹⁸ *Id.* It has been held that it is not unfair to treat bondholders of the same issue alike in a Chapter IX regardless of what they paid for the bonds. *Equitable Reserve Assoc. v. Dardanelle Special School District, No. 15 Yell County, Ark*, 138 F2d 236 (CA8, 1943); *West Coast Life Ins. Co. v. Merced Irrigation District*, 114 F2d 654 (CA9, 1940). Similarly, it has been held that there is nothing unfair in Chapter IX in refusing special treatment to bondholders who had obtained judgments or writs of mandamus prior to the bankruptcy. *Evergreen Farms Co. v. Willacy County Water Control & Improvement District No. 1*, 124 F2d 1 (CA5, 1942); *Vallette v. Vero Beach, Fla*, 104 F2d 59 (CA5, 1939). *See also In re Illinois California Exp., Inc.*, 50 BR 232 (BR Colo, 1985).

¹¹⁹ *In re Jersey City Medical Center*, 817 F2d 1055 (CA3, 1987).

¹²⁰ *Sanitary and Improvement District No. 65 of Sarpy County, Neb. v. First Nat. Bank of Aurora*, 79 BR 877 (D Neb, 1987).

¹²¹ *See, e.g., Taylor v. Provident Irrigation District*, 123 F2d 965 (CA9, 1941) (different maturity dates not basis for separate classification).

The impairment of claims provisions of § 1124 of the Bankruptcy Code¹²² are applicable to a Chapter 9 proceeding.¹²³ The confirmation standards adopted in Chapter 9 are the same as those of Chapter 11. This is a change from the prior Chapter IX, which required compliance with the fair and equitable rule.¹²⁴ A claim or interest is impaired under the plan unless:

- (A) It remains unaltered as to its legal, equitable, and contractual rights;
- (B) Any default which caused the acceleration of the indebtedness is cured; and in addition:
 - (1) The original maturity of such claim or interest is reinstated as such maturity date existed before the default;
 - (2) Any damages suffered by the holder of such claim or interest as a result of reasonable reliance by such holder on such contractual provisions or such applicable law is appropriately compensated; and
 - (3) After curing the default, the equitable, legal and contractual rights of the holder of the claim or interest are not altered or modified.
- (C) The holder of such claim or interest receives on account of such claim or interest cash equal to the amount of such claim or the greater of:
 - (1) Any fixed liquidation preference to which the terms of any security representing such interest entitles the holder of the interest; and
 - (2) Any fixed price at which the debtor under the term of such security may redeem such security from such holder.¹²⁵

The plan of adjustment must be tailored to the specific needs and revenue projections of the municipality. Subject to state law restrictions, debt service on the bonds may be extended, reduced or otherwise modified in a plan of adjustment. Creditors including bondholders and indenture trustees should consider the feasibility of any proposed plan and its compliance with the terms of both state law and the Bankruptcy Code. The plan must not only be feasible and in compliance with the terms of the Bankruptcy Code and state law, but also be acceptable to the requisite creditors.

¹²² 11 U.S.C. § 1124.

¹²³ 11 U.S.C. § 901.

¹²⁴ HR Rep No 595, 95th Cong, 1st Sess 394397 (1977).

¹²⁵ 11 U.S.C. § 1124.

Section 524(a) governs the effect of discharge which voids judgment, remedies or collection efforts on pre-confirmation obligations other than as provided for in the plan. The order of confirmation discharging certain prepetition indebtedness is in effect an injunction against any further actions to collect that debt other than provided for in the plan.¹²⁶

XVIII. Postpetition Disclosure and Solicitation

The disclosure standards of § 1125 of the Bankruptcy Code¹²⁷ are applicable to a Chapter 9 proceeding.¹²⁸ An acceptance or rejection of a plan may not be solicited from the holder of a claim or interest unless at the time of or before such solicitation there is transmitted to such holder the plan or a summary of the plan and a written disclosure statement approved by the court after a notice and hearing as adequate.¹²⁹ Adequate information is defined in the Bankruptcy Code as “information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interest of the relevant class to make an informed judgment about the plan.”¹³⁰ In essence, adequate information is similar to the type of facts that the municipality must disclose in its official statement to those who purchased its bonds. In the disclosure statement the municipality must disclose all facts which would be material and relevant to a creditor's evaluation of the plan including the feasibility of the plan based upon claims and available revenues.¹³¹ The benefits and detriments of the plan to creditors and the effect of delayed confirmation must be spelled out. In its disclosure materials, the San Jose School District stressed its

¹²⁶ 11 U.S.C. § 524(a)(2).

¹²⁷ 11 U.S.C. § 1125.

See Norton Bankr L & Prac § 62.13 et seq for a discussion of its application in a Chapter 11.

¹²⁸ 11 U.S.C. § 901.

Under the Bankruptcy Act, the Supreme Court held that a municipality ought to have disclosed that the fiscal agent soliciting acceptances was also a bondholder. *American United Mut. Life Ins. Co. v. Avon Park, Florida*, 311 US 138, 85 L Ed 91, 61 S Ct 157 (1940). Query whether, in the light of 11 U.S.C. § 903, the language of § 1125 relieving the court from the necessity of following state law regarding disclosure should be applicable to a Chapter 9.

¹²⁹ 11 U.S.C. § 1125(b).

¹³⁰ 11 U.S.C. § 1125(a)(1).

¹³¹ See Fippinger, Securities Law Disclosure Requirements for the Political Subdivision Threatened With Bankruptcy, 10 Fordham Urb LJ 541 (1982).

nonimpairment of bonded debt.¹³² A municipality may tender different disclosure statements (differing in amount, detail or kind of information) to different classes of creditors.¹³³

XIX. Acceptance of the Plan

In order to be accepted, a plan must have the assent of at least two thirds in allowed amount of each class and more than one-half of the number of creditors of each class voting.¹³⁴ Accordingly, a municipality, in devising its plan of adjustment in classifying debt, must consider the type and amount of debt which must accept the plan. If too many diverse creditors are put into one class, it could adversely affect the ability of the municipality to gain acceptance of the plan. If a plan is carefully crafted, it will define separate classes for varying interests, keeping the amount of indebtedness and creditors per class to a manageable level. However, some plans classify unsecured bonded indebtedness with trade debt and employee claims with the view toward avoiding nonacceptance by the class. As referred to previously, Section 1122(a) of the Code provides that claims can be classified together only if such claim or interest is “substantially similar” to the other claims or interests of such class. Improper classification of claims would be a basis for objecting to confirmation pursuant to § 1128.

Acceptance by a class is not required if the class is not impaired.¹³⁵ Assuming one impaired class has accepted the plan, acceptance of other classes is not required if the plan does not discriminate unfairly, and is fair and equitable with respect to each class that is impaired and has not accepted the plan.¹³⁶ If a class is to receive nothing under a plan, that class is deemed to have rejected

¹³² *In re San Jose Unified School Dist.*, No. 58302387A (BC ND Cal, 1983).

¹³³ 11 U.S.C. § 1125(c).

¹³⁴ 11 U.S.C. §§ 1126(c) and 1129(a)(8)(A) are made applicable to Chapter 9 pursuant to 11 U.S.C. § 901.

See generally Norton Bankr L & Prac § 61.12.

¹³⁵ 11 U.S.C. § 1129(a)(8)(B).

There is a split of authority as to whether the requirements of § 1129(a)(10), requiring acceptance by at least one class of claimants for confirmation, is satisfied by an unimpaired class which is deemed to have accepted the plan. § 1126(f).

See *In re W.E. Parks Lumber Co.*, 19 BR 285 (BR WD La, 1982); *In re Landau Boat Co.*, 13 BR 788 (BR WD Mo, 1981); *Contra In re Pine Cove Village Apartment Co.*, 19 BR 819, (BR SD NY, 1982); *In re Barrington Oaks General Partnership*, 15 BR 952 (BR D Utah, 1982).

¹³⁶ 11 U.S.C. § 1129(b)(1), commonly known as the “cramdown” provision.

the plan.¹³⁷ Under § 946 of the Bankruptcy Code an exchange of a new security as part of a workout before the case is filed can constitute an acceptance of the plan of reorganization if the exchange was under a proposal that later became the plan. However the plan must be in accordance with the prepetition exchange agreement. Furthermore the disclosure requirements of § 1126(b) require adequate prepetitioned disclosure. Although in the corporate sphere prepackaged Chapter 11s have found popularity as a means of binding nonconsenting creditors, at least one case has held that a municipality may not file under Chapter 9 immediately following the exchange if the purpose of filing is to force dissenting creditors into submission.¹³⁸

XX. Confirmation of Plan

The confirmation requirements of § 1128 of the Bankruptcy Code are applicable to a Chapter 9,¹³⁹ and there are additional Chapter 9 requirements.¹⁴⁰ After notice to all interested parties, the court shall hold a hearing on the confirmation of a plan. A party in interest and a special taxpayer may object to the confirmation of a plan.¹⁴¹

The court shall confirm a plan only if it meets the specific requirements of Chapter 9, including being proposed in good faith and not by any means forbidden by law. This means that there are no hidden agreements between the parties not specifically set forth in the plan nor any acceptances of the plan obtained through such hidden agreements.

In addition, at least one class of claims which is impaired under the plan and which is not an insider claim must have accepted the plan, or the court must have determined that the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is

See generally Norton Bankr L & Prac § 62.06.

¹³⁷ 11 U.S.C. § 1126(g).

¹³⁸ *Wright v. City of Coral Gables*, 137 F2d 192 (CA5, 1943).

¹³⁹ 11 U.S.C. § 901. See generally Norton Bank L & Prac § 63.01 et seq for confirmation under Chapter 11.

¹⁴⁰ 11 U.S.C. §§ 1128 and 1129.

¹⁴¹ 11 U.S.C. §§ 1128(a) and (b); 934(a). A “special taxpayer” means record owner or holder of legal or equitable title to real property against which a special assessment or special tax has been levied, the proceeds of which are the sole source of payment of an obligation issued by the debtor to defray the cost of an improvement relating to such real property. 11 U.S.C. § 912(2). A general change in all assessments or in the tax rate would not qualify any property holder in the district as a special taxpayer affected by the plan.

impaired under, and has not accepted, the plan.¹⁴² In other words, even if such claimants constituted impaired classes, the acceptance of the plan by affiliates, elected officials or relatives of elected officials would not support confirmation since such claimants are insiders.¹⁴³

In addition to the requirements set forth above, the court shall confirm the plan if:

1. The plan complies with the provisions of Chapter 9;¹⁴⁴
2. The plan complies with the provisions of other Chapters of the Bankruptcy Code made applicable to Chapter 9;
3. All amounts to be paid by the municipality to any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;¹⁴⁵
4. The municipality is not prohibited by law from taking any action necessary to be taken to carry out the plan;¹⁴⁶
5. The plan provides that each holder of a claim of the kind specified in § 507(a)(1) of the Bankruptcy Code (administrative expenses during the course of the proceeding) will receive, on account of such claim, property of a value, as of the effective date of the plan, equal to the amount of such claim, except to the extent that the holder of a particular claim of such kind has waived such payment on such claim; and
6. The plan is in the best interest of the creditors and feasible.¹⁴⁷

¹⁴² 11 U.S.C. § 1129(a)(2), (3), (8), (10) and (b).

¹⁴³ An affiliate may include the municipality which leases substantially all of the property of a municipal lease authority. 11 U.S.C. § 101(2)(D).

¹⁴⁴ 11 U.S.C. § 1129(a)(1).

¹⁴⁵ 11 U.S.C. § 1129(a)(4).

¹⁴⁶ 11 U.S.C. § 1129(a)(3).

¹⁴⁷ 11 U.S.C. §§ 943, 1129. The “best interest of creditors” test does not mean liquidation value. It is expected that the court will be guided by standards set forth in *Kelly v. Everglades Drainage District*, 319 US 415, 87 L Ed 1485, 63 S Ct 1141 (1943) and *Fano v. Newport Heights Irrigation District*, 114 F2d 563 (CA9, 1940). In *Kelly*, the court found that, in approving a plan, the bankruptcy court must make adequate findings bearing on the probable future tax revenues of the district, such as the revenues received in the past from each source of taxation, the present assessed value of property subject to each tax, the tax rates currently prescribed, the probable effect on future revenues of a revision made in the tax structure, the extent of past tax delinquencies, and any general economic condition of the district which may reasonably be expected to affect the percentage of future delinquencies. Similarly, in *Fano*, which involved a Chapter IX filed by an irrigation district which had a \$15,000 deficit on accrued interest on its bonds, a plan to pay 62.50 cents on the dollar was not confirmed as “equitable” or in the “best interest of creditors” where the district was debt free, except for interest, with assets in good condition and in value greatly exceeding the

The debtor may modify a plan at any time prior to confirmation so long as the modified plan meets the requirements of Chapter 9.¹⁴⁸ The court will dismiss a case under Chapter 9 if confirmation of a plan under Chapter 9 is refused.¹⁴⁹ If a plan is confirmed, the Court may retain jurisdiction over the case for such period of time as is necessary for the successful implementation of the plan.¹⁵⁰

A party in interest (creditor, special taxpayer or debtor) may request the court within 180 days after the date of confirmation to revoke such order if and only if the order was procured by fraud.¹⁵¹ Such an order revoking an order of confirmation should contain necessary provisions to protect any equity acquiring rights in good faith reliance on such an order and should also revoke the discharge of the debtor.

A decision reflects the interplay between the various requirements for plan confirmation imposed by Chapter 9 and state law considerations.¹⁵² Like so many of the Chapter 9 filings, the case involves a special district. The debtor had issued unsecured bonds and warrants prepetition. Under state law, bonds had priority over warrants. That is, the law required that bonds be fully paid according to their terms prior to utilizing revenues for payments of warrants. The plan of adjustment did not pay the bondholders the full amount of their claim with interest but paid some recovery to warrantholders. Despite the state law constraints, the court held that under the Bankruptcy Code, the debt of the municipality could be adjusted, and therefore, the plan was not objectionable in this respect.

indebtedness of the district, and there was no sufficient showing as to why the district's tax rate could not have been increased sufficiently to meet the district's obligations.

It may be helpful in evaluating whether the requirements of Chapter 9 are met to review other cases applying the more stringent "fair and equitable" test. Where a court was presented with a dismal history and bleak financial future of a drainage district, it approved a plan for payment of 20 cents for each dollar of principal amount of the bonds. *Delno v. Market St Ry Co.*, 124 F.2d 965 (CA9, 1942). See also *Mason v. Paradise Irrigation District*, 326 US 536, 90 L Ed 287, 66 S Ct 290 (1946) (52.521 cents on each dollar of principal). Also interesting is the decision in *Getz v. Edinburg Consol. Independent School District*, 101 F.2d 734 (CA5, 1939) which approved a plan pursuant to which refunding bonds which included accrued overdue interest were issued and 51% of moneys held in the sinking fund were permitted to be used to fund the maintenance of schools.

Of course, a plan cannot benefit some unfairly. Where some bondholders who purchased the bonds at bargain prices acquired an appreciable quantity of taxable property in the city, a plan which would result in the lowering of tax levies would not be approved. *Town of Belleair, Fla. v. Groves*, 132 F.2d 542 (CA5, 1942) cert den 318 US 769, 87 L Ed 1140, 63 S Ct 762 (1943).

148 11 U.S.C. § 942.

149 11 U.S.C. § 927(b).

150 11 U.S.C. § 945(a).

151 11 U.S.C. § 1144.

152 In re Sanitary & Improvement District No. 7, 98 BR 970 (BR Neb, 1989).

However, the new bonds and warrants to be issued to the holders under the plan received different scrutiny. The zero bonds had a call provision that permitted payment at less than par and permitted payments on the new warrants even if the bonds were taken out at less than par. In other words, the bondholders, as contemplated under the plan, could receive securities under the plan which would not be paid in full. Because of the state law requiring priority of the bondholders, the court held that such treatment was in violation of state law and the plan could not be confirmed. The case stands for the proposition that the plan can modify the existing prepetition debt, regardless of state law prohibitions, but the plan cannot contemplate the violation of the law going forward.

Chapter 9 is one mechanism for resolution of disputes regarding the allocation of resources of a financially troubled municipality. It is difficult to achieve a consensual plan after a contested confirmation hearing. As a result, a debtor should consider negotiation with trade and public debt and employee groups to work out the terms of the plan. To be confirmed, a plan must be fair. If creditors are unreasonably “crammed down” so that the distribution to public debtholders is less than justified, the municipality may find it difficult to have any plan confirmed. Further, the market will recall such unfair treatment the next time the municipality attempts to enter the market.

XXI. Conclusion - The Future of Chapter 9

As noted in the beginning of this Chapter 9 Primer, Chapter 9 was always intended to be the last resort for financially distressed municipalities. States and local governments have developed various mechanisms in order to address financial emergencies and to bridge economic downturns. These range from state statutes and provisions limiting debt and taxes or providing for refunding or refinancing of problem financing to legislation authorizing direct oversight and supervision by the state or its agencies over the budgeting and financial matters of a municipality. This oversight by the state can range from debt advisory commissions which are more passive, essentially collecting information and providing assistance to municipal bond issuers, to direct hands-on actions by an appointed receiver, emergency manager or financial control board empowered to take certain actions to rectify the situation and help the municipality put itself and its creditors on a path to success by dealing with the financial difficulties.

If all else fails, Chapter 9 is an admission that the municipality is not capable of righting its ship without a municipal debt adjustment. It has been used in the past, as noted, only 635 times since 1937 to January 31, 2012. For the most part, Chapter 9 has been used by small municipal utilities and special tax districts, and rarely by larger municipalities. Whether the future will lead to an increase in the use of Chapter 9 or whether pre-packaged Chapter 9s will be utilized, a popular format for corporate reorganizations in Chapter 11, is a question that time will best determine. For now, it is clear that local governments and states prefer to address and resolve the vast majority of their

financial problems without the use of Chapter 9 and, only in the gravest of circumstances, do they believe it is necessary for a municipality to use Chapter 9 as the last resort. While there are many reasons for this, the most significant is the desire by both the state or the local government to have continued credibility in the public market so that it may decide locally what infrastructure or essential governmental services it should have and fund that needed infrastructure, improvement or service with direct access to the municipal market at a low cost. Chapter 9 has been feared as creating a stigma that will leave a municipality of any significant size with a question mark as to its future financial credibility and with either limited access to the market or increased costs of financing.

The future of Chapter 9 is inextricably intertwined with how states and their municipalities decide to deal with their current and future financial distress. In order to provide some benefit and to encourage the review and analysis of how various states have attempted to address the issue of municipalities in distress, Chapman and Cutler LLP has compiled a 50 state survey and an analysis of how states and investors deal with local governments in financial distress. There is a 50 state survey, plus Puerto Rico and the District of Columbia, which is contained in the book *Municipalities in Distress?* providing a detailed analysis of (1) rights and remedies provided by states to investors; (2) state supervision and oversight mechanisms for financially distressed local governments; and (3) state authorization of municipalities to file Chapter 9. This study is to encourage review and discussion of what are the best practices for dealing with the financial emergencies of local governments through analysis of how various states approach the issue. We hope that the book, *Municipalities in Distress?*, stimulates additional analysis, inspires state legislators to examine and build on the approaches of other states and encourages investors to understand the rights and remedies they have and how rights and remedies, including financial oversight and Chapter 9, vary by state. Appendix G to this Primer, which is a chart from the book *Municipalities in Distress?*, summarizes the results of the 50 state survey with regard to the various forms of supervision and oversight mechanisms for financially distressed governments available as well as authorization of municipalities to file Chapter 9 and an overview of various rights and remedies provided by states to investors. For a more detailed analysis, you may want to consult *Municipalities in Distress?*.

Accordingly, the use of this Primer and the future of Chapter 9 will be directly affected by how state legislators and local elected officials, as well as investors in state and local government debt, local citizens and workers determine what are the best practices for municipalities of any size and whether Chapter 9 should be something other than the very last resort rarely used.

One method of making Chapter 9 more acceptable to the municipal market may be the approach used by Rhode Island in legislation which that state passed in 2011. The State of Rhode Island passed a law that provided a statutory lien to noteholders and bondholders, legislating that a local government's obligation to such debtholders would have a first lien on ad valorem taxes and general funds in order to ensure the continuing access to the municipal market for the state and its local governments. This legislation was the precursor to the filing of a Chapter 9 proceeding for Central Falls in 2011 and purportedly permitted Central Falls to move quickly to a plan without the

adverse effects and stigma of Chapter 9. Another approach may be the use of a municipal protection commission which would be a quasi-judicial body making use of techniques such as neutral evaluators or mediation, as California has recently provided for by statute. If that fails, the commission would have the ability to make a determination of what is sustainable and affordable and increase taxes or contributions by the local government or its workers. If necessary, for the health, safety and welfare of the municipality's citizens, the commission could reduce certain benefits, wages or debt claims to what is sustainable and affordable so that essential governmental services can continue to be provided at a designated level. Certainly in the dialogue that will follow by states, their legislatures, their local government elected officials, workers and taxpayers, a best practice should be developed that is politically and socially acceptable and financially sound. This effort will probably determine the future use of Chapter 9 for the years to come.

Appendix A

Changes in the Sources of Tax Revenues for State and Local Government from 1992 - 2008

General State and Local Governments Revenues 1922-2008: Totals and Percentage Distribution

	1922	1927	1932	1936	1940	1968	2008
Amount of Gen. Rev. (billions of dollars)	4.8	7.3	7.3	8.4	9.6	101.3	2425.8
Percent Distribution							
Property Tax	69.5	65.1	61.7	48.8	46.1	27.4	16.7
Sales Tax	3.2	6.5	10.3	17.7	20.6	22.6	18.5
Income Tax	2.1	2.2	2.1	3.2	4.0	9.7	14.8
Other Tax	9.2	10.0	10.6	10.2	10.6	7.0	4.5
Misc. Rev.	13.7	14.7	12.0	8.9	8.9	16.3	25.7
Federal Aid	<u>2.3</u>	<u>1.6</u>	<u>3.2</u>	<u>11.3</u>	<u>9.8</u>	<u>17.0</u>	<u>19.8</u>
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bureau of the Census – John Petersen “Municipal Defaults Eighty Years Makes a Big Difference 5/21/11” p. 9
George Mason University

Property, income and sales taxes made up over 70% of state and local governments revenues in 1922-1940 but only 50% of state and local governments revenue by 2008. More diverse and varied tax base in 2008 with more federal assistance.

Property taxes which made up over 60% of the revenues of state and local governments between 1922-1932 was only 16.7% of revenue by 2008 with increases in sale, income other, miscellaneous and federal aid making up the difference.

Appendix B

The GDP Strength of States Compared to the PIIGS of Europe

The Myth That the Strength of the State Economies Resembles That of the PIIGS

Will any U.S. state become the next Greece or one of the PIIGS (Portugal, Italy, Ireland, Greece and Spain)?

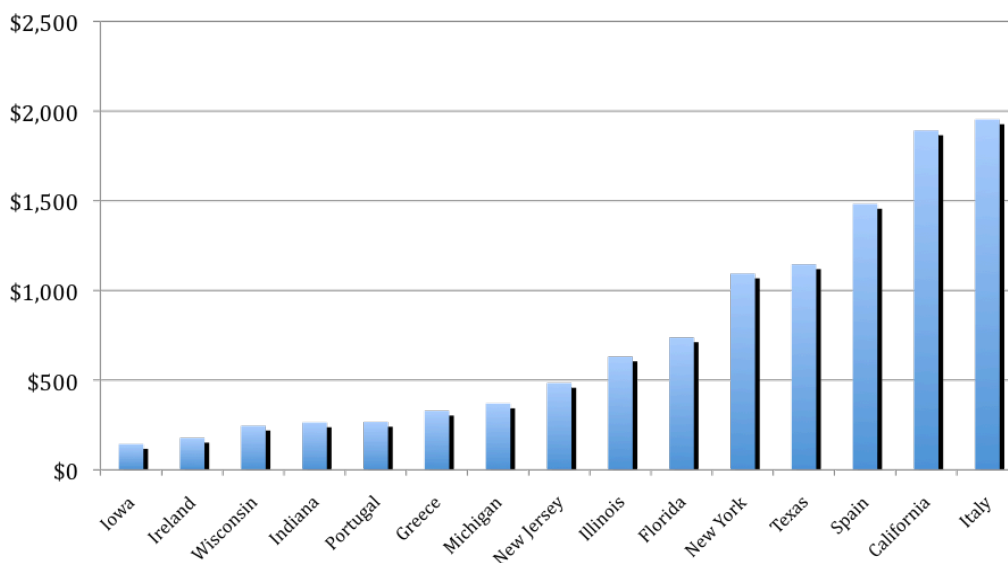
The per capita GDP of each of California, Texas, Florida, New York, Illinois and New Jersey (certain “Major U.S. States”) is higher than Portugal, Greece, Italy and Spain.

The percentage of debt to revenue ratio is lower for Major U.S. States than Portugal, Italy and Greece.

The percentage of debt to GDP is lower for certain Major U.S. States than Spain, Ireland, Portugal, Greece and Italy.

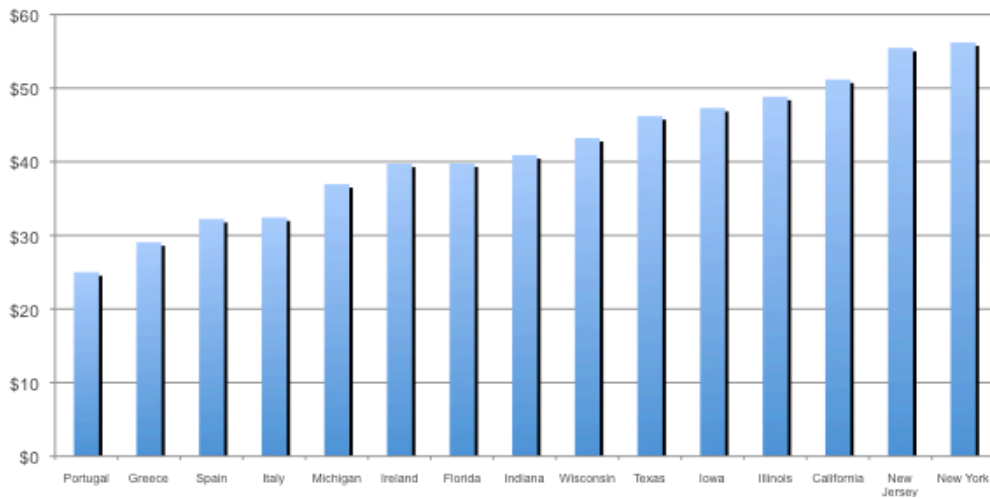
Market perception can be different than reality. Look at Credit Default SWAPs (“CDS”) for certain Major U.S. States and the PIIGS, where Italy, Spain, Ireland, Portugal have lower CDS spreads than New Jersey, New York, California and Illinois.

GDP of Selected US States and European Countries
(Billions of 2009 USD)



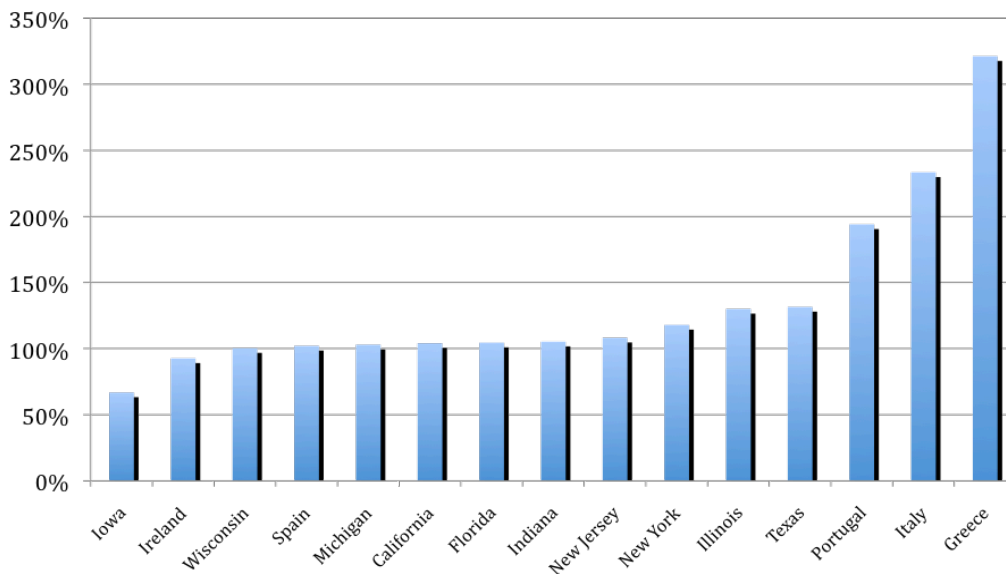
Source: US Bureau of Economic Analysis; OECD.

GDP per capita of Selected US States and European Countries
(Thousands of 2009 USD)



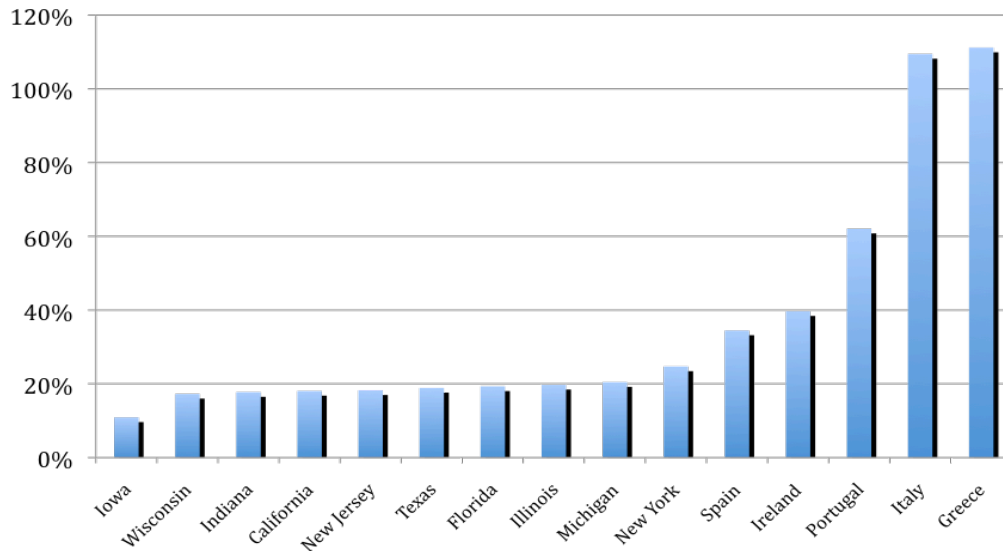
Source: US Bureau of Economic Analysis; US Census Bureau; OECD.

Debt-to-Revenue Ratio of Selected US States and European Countries
(2008 Figures)



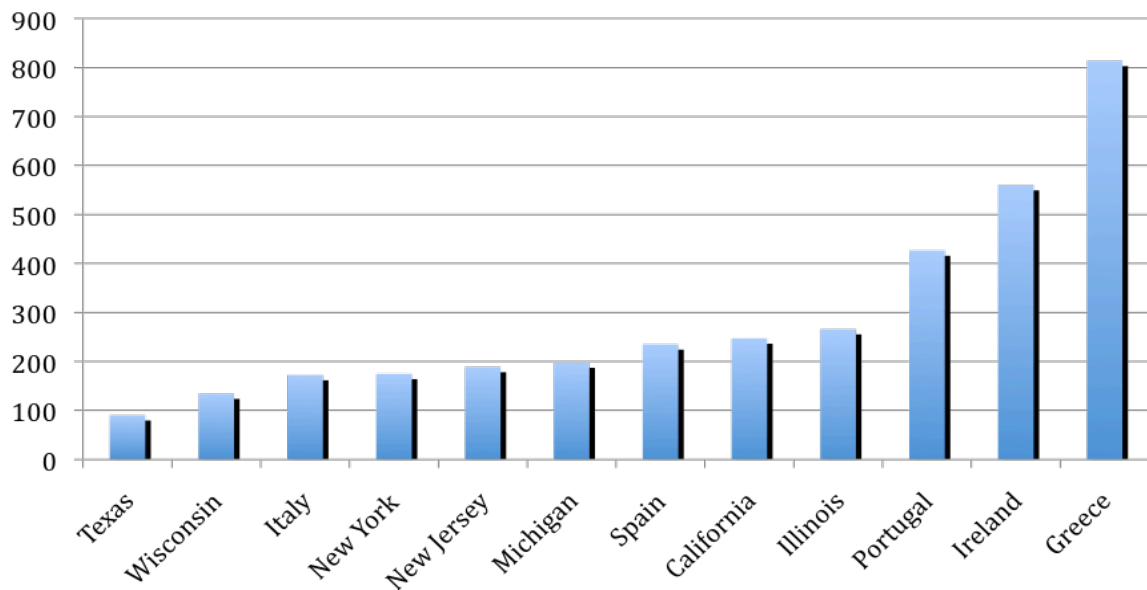
Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

*Debt-to-GDP Ratio of Selected US States and European Countries
(2008 Figures)*



Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

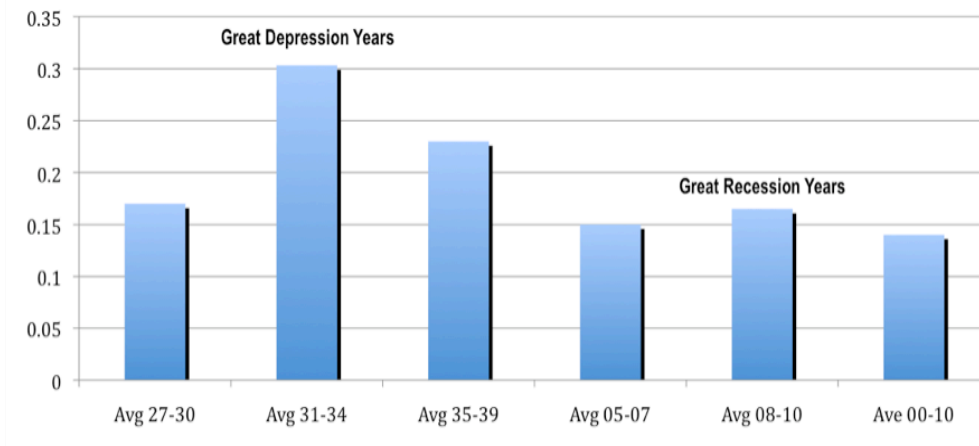
*Credit Default Swap Spreads (bps) of
Selected US States and European Counties*



Source: Bloomberg (February 8, 2011).

*State and Local Governments Debt to GDP Percentage
Has Improved from that of the Great Depression*

Ratio of State-Local Debt to GDP: Late 1920s, 1930, and 2000s



Source: John Petersen: "Municipal Defaults Eighty Years Makes a Big Difference 5/21/11" p. 16 George Mason University

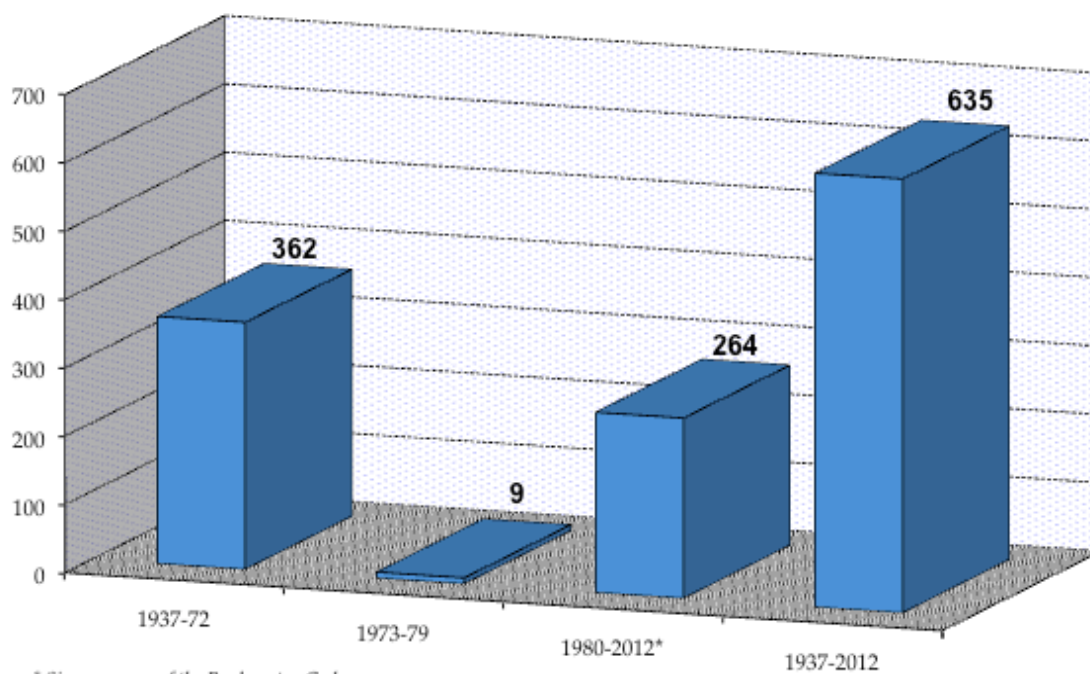
Even much talked about individual states (such as California, Illinois, Michigan, New Jersey, New York and Texas) have GDP to Debt Ratios significantly lower than the 30% average during the Great Depression years.

The current trend is reduced borrowing and debt issuance by state and local governments.

Appendix C

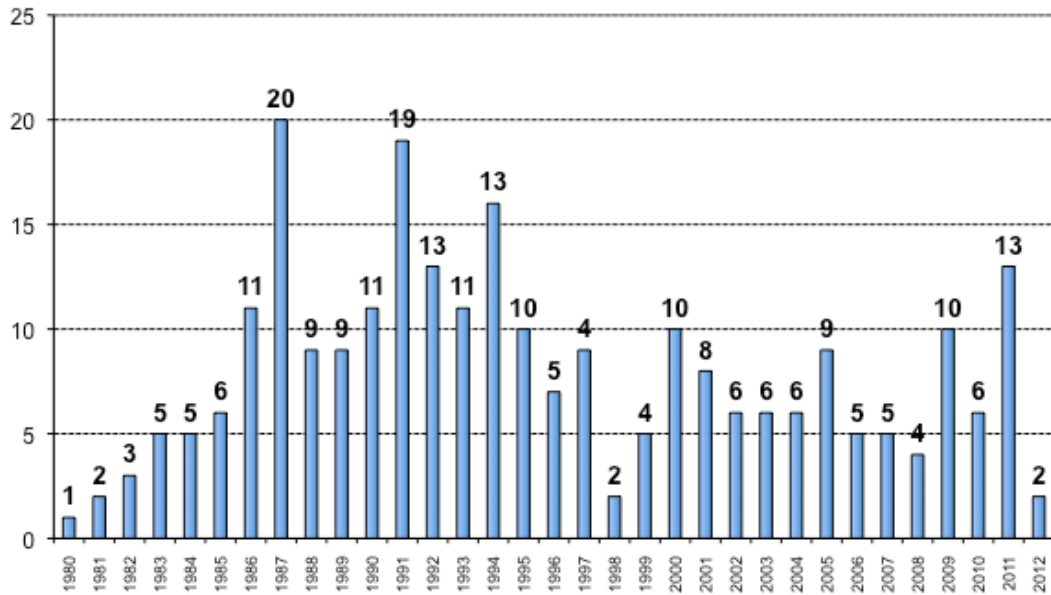
Chapter 9 Filings by Number, by Year, by State and by Type

Frequency of Municipal Bankruptcies • 1937-2012
(as of 1/31/2012)

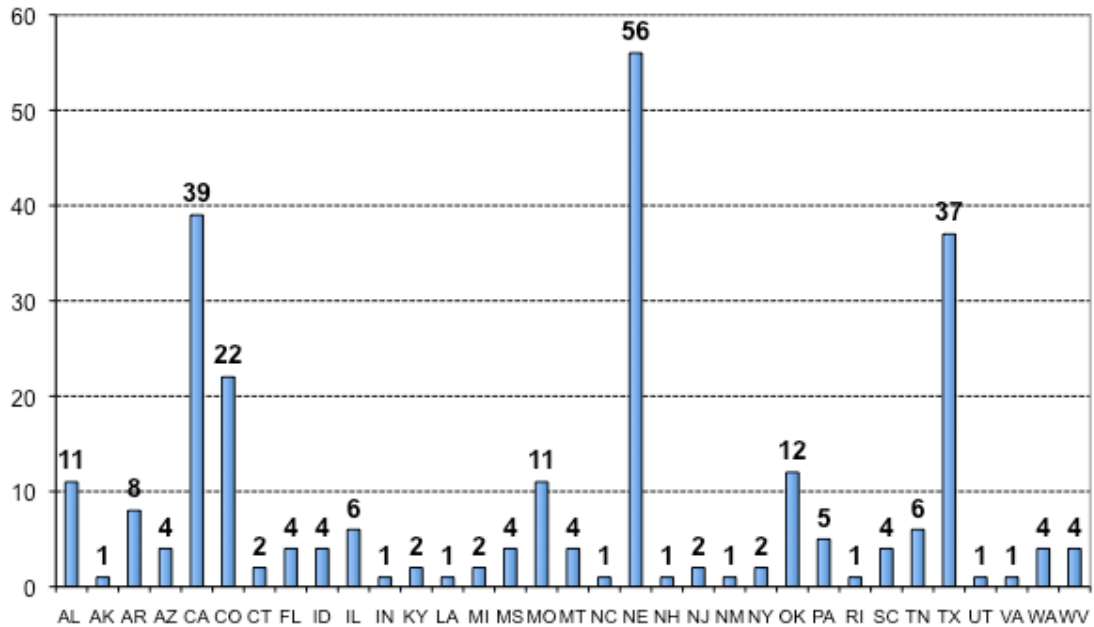


* Since passage of the Bankruptcy Code.

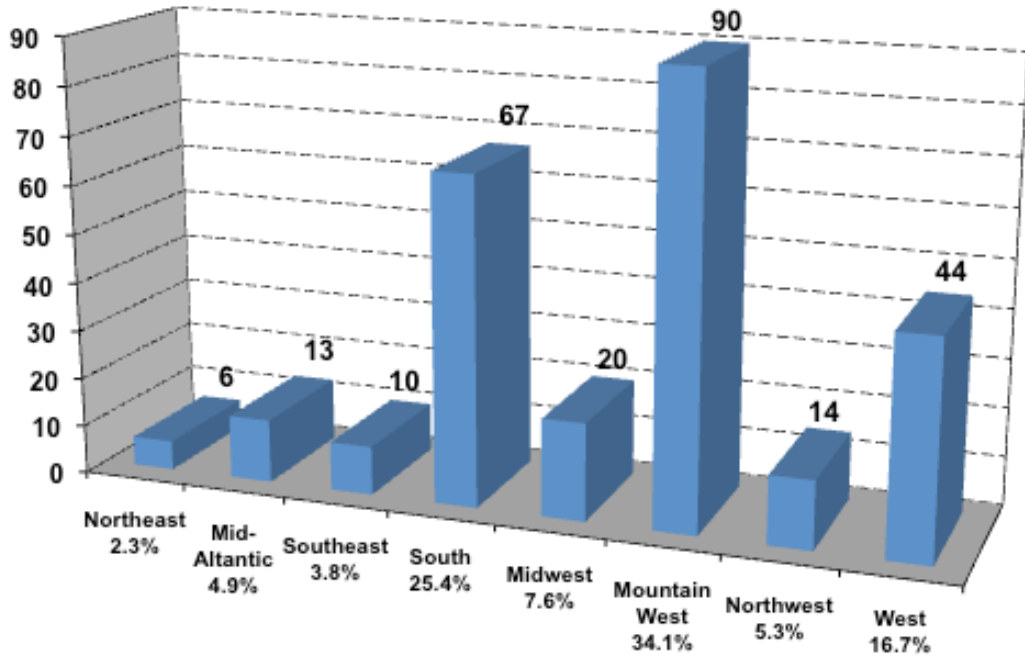
Chapter 9 Filings by Year • 1980-2012
(as of 1/31/2012)



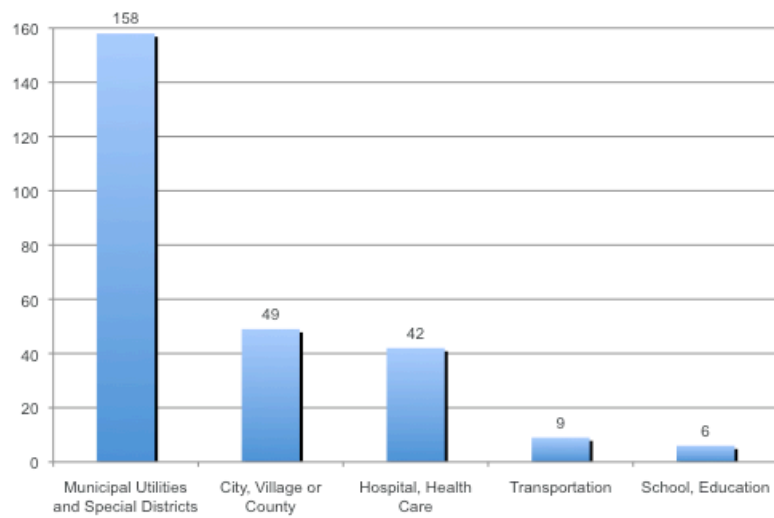
Chapter 9 Filings by State • 1980-2012
(as of 1/31/2012)



Chapter 9 Filings by Region • 1980-2012
(as of 1/31/2012)



Chapter 9 Filings by Type • 1980-2012
(as of 1/31/2012)



Appendix D

Who May File Chapter 9 and What States Authorize Their Municipalities to File Chapter 9

Chapter 9 – Who Can File?

To be a Debtor in a Chapter 9, an entity must be:

An entity that is a municipality;

Specifically authorized under State law to be a Debtor. Twelve States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, ID, MN, MO, MT, NE, OK, SC, TX, WA), another twelve States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (CA, CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI) Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IA) has an exception to the prohibition. The remaining 21 are either unclear or do not have specific authorization;

Insolvent;

Willing to effectuate a plan; and

Either have obtained the agreement of creditors holding majority amount of the claim of each class that the municipality intends to impair or have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors or a creditor is attempting to obtain a preference.

*General Analysis of State Specific Authorization for
Municipalities to File a Chapter 9 Case*

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities.

12 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Idaho Code Ann. § 67-3903
Minn. Stat. Ann. § 471.831
Mo. Ann. Stat. § 427.100
Mont. Code Ann. § 7-7-132
Neb. Rev. St. § 13-402
Okla. Stat. Ann. tit. 62 §§ 281, 283
S.C. Code Ann. § 6-1-10
Tex. Loc. Gov't Code § 140.001
Wash. Rev. Code § 39.64.040

12 States that *conditionally* authorize municipal bankruptcies:

Cal. Gov't Code § 53760
Conn. Gen. Stat. Ann. § 7-566
Fla. Stat. Ann. § 218.01 and §218.503
Ky. Rev. Stat Ann. § 66.400
La. Rev. Stat. Ann. § 39-619
Mich. Comp. Laws § 141.1222
N.J. Stat. Ann. § 52:27-40
N.C. Gen. Stat. Ann. § 23-48
N.Y. Local Finance Law § 85.80
Ohio Rev. Code Ann. § 133.36
53 Pa. Cons. Stat. Ann. § 11701.261
R.I. Gen. Laws §45-9-7

3 States with limited authorization

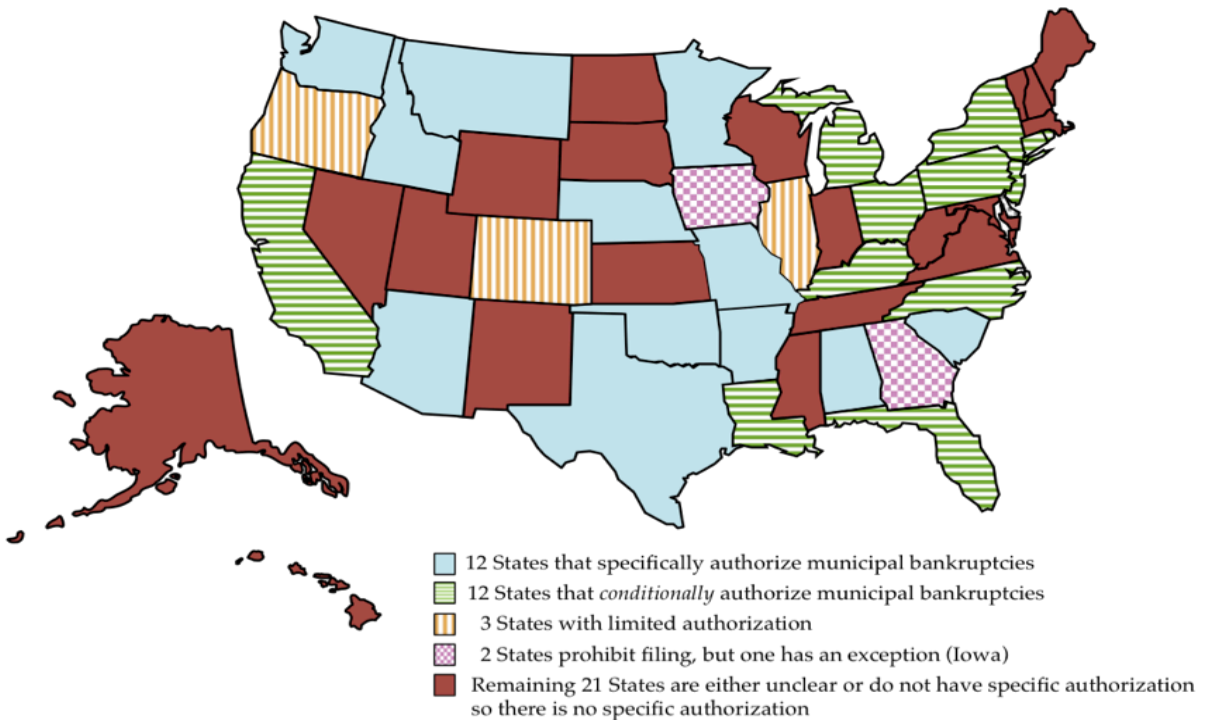
- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that “any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition...” (CRS § 37-32-102 (Drainage & Irrigation District))
- Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 3855/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

2 States prohibit filing but one has an Exception

The 21 Remaining States are either unclear or do not have specific authorization. AK, DE, HI, IN, KS, ME, MD, MA, MS, NE, NH, NM, ND, SD, TN, UT, VA, VT, WV, WI, WY.

- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

General Analysis of State Specific Authorization for
Municipalities to File a Chapter 9 Case



Appendix E

Key Differences Between Chapter 9 and Chapter 11

Chapter 9

- Only the municipality can initiate a Chapter 9 if authorized by state law.
- Only the municipality can file a Plan of Debt Adjustment.
- The Plan of Debt Adjustment can only adjust debt. It cannot liquidate the municipality.
- A Labor Agreement can be rejected in a Chapter 9 if the Labor Agreement burdens the municipality and the equities balance in favor of rejection. This is a lower standard than a Chapter 11.
- There is no limitation on damages on real estate leases held by a Trustee or Municipal Building Authority for a lease financing and the lease financing will be treated as a secured debt financing.
- Payments to defease or pay current interest or principal on bonds or notes within the 90 day preference period before a Chapter 9 filing are not capable of being voided or deemed a preference .
- There are no priorities ahead of unsecured claims for prepetition claims due to employee wages, pensions, accrued vacations, healthcare and other employment benefits.
- "Special Revenues" and "Statutory Liens" are not limited or terminated by a Chapter 9 filing and are intended to continue to be paid to secured creditor and are unimpaired by the Chapter 9 filing (there is no Chapter 11 provisions comparable).

Chapter 11

- The corporation (voluntary) or its creditors (involuntary) can initiate a Chapter 11 case if the corporation is a moneyed entity (not a non-for-profit) and insolvent.
- The corporate debtor (during the exclusive period) or any creditor (after the exclusive period) may file a Plan of Reorganization or Liquidation.
- A corporate plan can be for reorganization or liquidation.
- Section 1113 of the Bankruptcy Code sets forth the requirements for sharing information with employee representatives and workers and the process of information sharing, and the proposal by the debtor prior to the rejection of the Labor Agreement. It is a higher standard than Chapter 9.
- There is a limitation of the greater of one year's rent or 15% of the remaining terms of the lease not to exceed three years for lease damages in a corporate Chapter 11. It is not treated as secured debt of the corporate debtor if it is a true lease.
- Payment of principal or interest not secured by collateral could be voided or deemed a preference during the 90 day period prior to filing a Chapter 11 if the holder would receive more than what it would be entitled to in a Chapter 7 liquidation.
- There is a priority ahead of unsecured claims of up to \$11,725 per employee for pre-petition wages, benefits, accrued vacation and healthcare benefits.
- Accounts receivable and inventory created post petition are not covered by the pre-petition lien of a secured lender and the pre-petition lien is terminated except for "proceeds" of the pre-petition lien.

Chapter 9

- A Bankruptcy Court cannot interfere with any restrictions or requirements of state law regarding a municipality's exercise of its governmental powers (including payment of statutory liens). The Bankruptcy Court cannot interfere with the property, revenue and affairs of the municipality.
- The municipality can sell its assets, incur debt, borrow money and engage in governmental affairs without the necessity of having to obtain the approval of the Bankruptcy Court.

Chapter 11

- The corporate debtor cannot take any action outside the ordinary course of business without Bankruptcy Court approval.
- The corporate debtor cannot borrow money, sell assets or expand or contract its business without Bankruptcy Court approval.

Appendix F

Priorities of Payment of Claims in a Chapter 9 and How Municipal Bond Debt is Treated in a Chapter 9 Proceeding

Summary of Chapter 9 Priorities

Type of Claim	Explanation
1. Obligations secured by a statutory lien to the extent of the pledged revenues collected. ^{ab}	Debt (Bonds, Trans, Rans) issued pursuant to statute that itself imposes a pledge. (There may be delay in payments due to automatic stay – unless stay is lifted – but ultimately will be paid.)
2. Obligations secured by Special Revenues (subject to necessary operating expenses of such project or system) to the extent of the pledged revenues collected. ^{ab} These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.	Special Revenue Bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specially levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor. ^b There should be no delay in payment since automatic stay is lifted under Section 922(d).

a Chapter 9 incorporates Section 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. (But see Nos. 3 and 4) incorporates Section 364(d) of the Bankruptcy Code which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.

b A security interest or pledge of revenues created prior to the Chapter 9 filing that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing Post-Petition Lien under Section 552 of the Bankruptcy Code.

Type of Claim	Explanation
3. Secured Lien based on Bond Resolution or contractual provisions that does not meet test of Statutory Lien or Special Revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof. ^b	Under language of Sections 522 and 928, liens on such collateral would not continue postpetition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or Debtor. You may expect the creditor to argue that pursuant to Section 904, the Court cannot interfere with the property or revenues of the Debtor, and that includes the grant of security to such secured creditor.
4. Obligations secured by a municipal facility lease financing.	Under Section 929 of the Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5. Administrative Expenses (which would include expenses incurred in connection with the Chapter 9 case itself). ^c Chapter 9 incorporates Section 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under Section 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to Section 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.

c These expenses strictly relate to the costs of the Bankruptcy. Because the Bankruptcy Court cannot interfere with the government and affairs of the municipality, general operating expenses of the municipality are not within the control of the Court, are not discharged and will remain liabilities of the municipality after the confirmation of a plan or dismissal of the case.

	Type of Claim	Explanation
6.	Unsecured debt includes:	
	A. Senior Unsecured Claims with benefit of subordination paid to the extent of available funds (without any obligation to raise taxes) which include any of B, C, D, or E below.	
	B. General Obligation Bonds	Secured by the “full faith and credit” of the issuing municipality. Postpetition, a court may treat general obligation bonds without a statutory lien or Special Revenues pledge as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease.
	C. Trade	Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services. ^d
	D. Obligations for Accrued but Unpaid Prepetition Wages and Pensions and other Employee Benefits	These do not enjoy any priority, unlike in a Chapter 11. ^e
	E. Unsecured portion of secured indebtedness.	Any debt subordinated by statute or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive pro rata distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.
	F. Subordinated Unsecured Claims	

d Section 503(b)(9) provides for a priority claim to be paid on Confirmation of a Plan for the value of goods provided prepetition within 20 days of the Petition Date.

e Chapter 9 does not incorporate Section 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collective bargaining agreements (making the standard less restrictive, *i.e.*, “impairs ability to rehabilitate”), or Sections 507(a)(4) and (5), which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacation, severance, sick leave or contribution to pension plans of currently \$11,725 per employee.

Summary of Basic Treatment of Bonds and Notes in Chapter 9

Type of Bonds/Notes	Bankruptcy Effects
General Obligation Bonds	<p>Post-petition, a court may treat general obligation bonds without a statutory lien as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease.</p> <p>Pre-petition, general obligation bonds are backed by the unlimited taxing power of the municipality (its “full faith and credit”) and are historically subject to conditions such as voter authorization, limitations on particular purposes, or debt limitation to a percentage of assessed valuation on the power of municipal entities to incur such debts.</p>
General Obligation Bonds plus Pledged Revenues	<p>Assuming that the general obligation pledge is an actual pledge of revenue and to the extent that it may be classified as a Statutory Lien or Special Revenues, this secured issuance will be respected to the degree it is consistent and authorized under state law. A Pledge of Revenues that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing Post-Petition Lien under Section 552 of the Bankruptcy Code. This position may be questioned under Section 904 of the Bankruptcy Code given the prohibition that the Court not interfere with the Government Affairs or Revenues of the Municipality.</p>
Special Revenue Bonds	<p>A pledge on special revenue bonds will survive a bankruptcy filing.</p> <p>Pre-petition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of operations and maintenance costs) that are pledged to bondholders. The contemplated remedy for default often focuses on a covenant to charge rates sufficient to amortize the debt. Defaulted bondholders are expected to seek mandamus in court to require the municipal borrower to raise its rates.</p>
Revenues subject to Statutory Lien	<p>Assuming the pledge is authorized under state law through a statutory lien, the Bankruptcy Court should respect that statutory lien. Thus, as long as the revenues are subject to a statutory lien, payments to the bondholders should be protected post-petition.</p>

G.O. Bond without any pledge of revenue or special constitutional priority can be treated like any other unsecured claim of vendors, workers, pension; however, in Medley, Florida in 1968, there was a distinction made to pay bond indebtedness on schedule and stretch out the payments to other unsecured creditors over a 10-year period since failure to make payment on the Bonds might cause the municipality to lose access to the market or to pay a significantly higher price for access that would justify a better treatment for bond indebtedness for the benefit of all.

As noted in *Faitoute Iron & Steel Co. et al. v. City of Asbury Park, N.J.*, 316 U.S. 502 (1942), discretion must be exercised in dealing with secured claims so that, while the Court recognized New Jersey’s Depression-era Municipal Finance Commission Act of 1931 could impair municipal debt, there was recognition that a secured claims, tax anticipation and revenue notes stand on an entirely different footing from other municipal obligations and, in relation to them, no claim is affected by the Municipal Finance Commission Act. The Plan adopted by Asbury Park paid general obligation bondholders a compromise payment (less in amount and a delay in payment).

Appendix G

Overview of 50 State Survey of Rights and Remedies Provided by States to Investors in Municipal Bond Debt, State Oversight and Supervision of Financial Emergencies and Authorization to File Chapter 9 Bankruptcy

Scorecard for Other Mechanisms for State to Address Financial Distress of Its Local Governments

Virtually all States have some statutes providing for:

Ability to refund. (All states have some provision for Refunding Bonds.)

Debt limitations (at least 49 have some form of debt limitation).

Appointment of receivers (at least 43 states).

Mandamus or remedies upon default to require payment of debt or levying taxes. (All 50 states have mandamus and at least 28 states have some provision for foreclosure, 23 states provide for a statutory right to such an accounting and at least 18 states have other remedies.)

Statutory liens or special revenues. (All 50 states have some form of special revenue and at least 30 states have statutory liens.)

Analysis of 50 State Survey of Rights and Remedies Provided by States to Investors in Municipal Bond Debt and Authorization to File Chapter 9 Bankruptcy

(This is an analysis of a 50 State Survey by Chapman and Cutler LLP)

General Overview of Municipal Insolvency Provisions

STATE	MUNICIPAL BANKRUPTCY AUTHORIZATION	DEBT LIMITATION	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDING BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTING	FORECLOSURE	INJUNCTION	MANDAMUS	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTORY LIENS
ALABAMA	Y (Bonds only)	X		X	X			X	X	X		X	
ALASKA	N				X	X (taxing limits); (appointment of trustee)		X		X		X	X
ARIZONA	Y	X		X	X			X		X	X (any action necessary)	X	
ARKANSAS	Y	X		X	X	X (taxing limits and appointment of an assessor)				X		X	X
CALIFORNIA	Conditional (Use of a Neutral Evaluator or declaration of fiscal emergency)	X	X (California Debt and Investment Advisory Commission)	X	X	X (negotiations)	X	X	X	X	X (bondholder action and any other action and special tax bonds)	X	X
COLORADO	Limited	X		X	X		X		X	X	X (bondholder action)	X	X
CONNECTICUT	Conditional	X		X	X	X (appointment of a trustee; revenue set-aside)			X	X	X (bondholder action/garnishment and contractual remedies)	X	X
DELAWARE	N	X			X					X		X	
DISTRICT OF COLUMBIA	N	X	X (District of Columbia Financial Responsibility and Management Assistance Authority)		X		X		X	X	X (declare all bonds due and payable)	X	
FLORIDA	Conditional		X (Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program)	X	X		X		X	X		X	X
GEORGIA	N (specifically prohibited)	X		X	X	X (debt compromise)				X	X (court action to enforce collection)	X	
HAWAII	N	X		X	X		X	X		X		X	
IDAHO	Y	X	X (debt readjustment plans for certain districts)	X	X	X (Bond Guaranty Act)	X	X		X		X	X
ILLINOIS	Limited	X	X (Financially Distressed City Law and Financial Planning and Supervision)	X	X			X	X	X	X (appropriate relief)	X	X
INDIANA	N	X	X (Distressed Political Subdivision Protections)	X	X	X (redemption bonds)	X	X	X	X		X	X
IOWA	N, with exception	X		X	X	X (moratorium)				X		X	X
KANSAS	N	X		X	X		X	X		X		X	X
KENTUCKY	Conditional	X	X (county restructuring)	X	X	X (taxing limits); (appointment of trustee)	X		X	X		X	X
LOUISIANA	Conditional	X		X	X			X		X		X	X
MAINE	N	X		X	X	X (earmarking)		X		X	X (attachment and any action necessary)	X	X
MARYLAND	N	X		X	X					X		X	X
MASSACHUSETTS	N	X	X (ad hoc state intervention)	X	X	X (state bond payment intervention)				X		X	X
MICHIGAN	Conditional	X	X (Emergency Financial Management and Local Government and School District Fiscal Accountability Act)	X	X					X		X	X
MINNESOTA	Y	X			X	X (back-up payment procedures for municipalities and school districts)				X	X (appropriate remedies to enforce bondholder rights)	X	

STATE	MUNICIPAL BANKRUPTCY AUTHORIZATION	DEBT LIMITATION	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDING BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTING	FORECLOSURE	INJUNCTION	MANDAMUS	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTORY LIENS
MISSISSIPPI	N	X		X	X	X (municipal borrowing)	X	X	X	X	X (other appropriate remedies)	X	X
MISSOURI	Y	X		X	X		X	X		X	X (other appropriate remedies)	X	
MONTANA	Y, but no counties	X		X	X					X	X (limited remedy and interest penalty; suits in equity)	X	
NEBRASKA	Y	X		X	X	X (debt compromise)		X		X		X	
NEVADA	N	X	X (local government financial assistance; audit enforcement)	X	X	X (third-party agreements)	X	X	X	X		X	X
NEW HAMPSHIRE	N	X		X	X	X (emergency financial assistance)				X	X (contractual remedies)	X	
NEW JERSEY	Conditional	X	X (Local Government Supervision Act; Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act)	X	X		X	X		X		X	X
NEW MEXICO	N	X		X	X					X		X	
NEW YORK	Conditional	X	X (Emergency Financial Control Board, Municipal Assistance Corporation; New York Financial Control Board)	X	X	X (appointment of a trustee)	X	X		X		X	X
NORTH CAROLINA	Conditional	X	X (local government debt monitoring; local government fiscal management)	X	X			X		X		X	X
NORTH DAKOTA	N	X		X	X					X		X	X
OHIO	Conditional	X	X (fiscal watch; fiscal emergencies; and financial planning and supervision commission)	X	X		X	X	X	X	X (general remedies provision, including appointment of trustee and action to declare bonds not paid from property taxes immediately payable)	X	
OKLAHOMA	Y	X		X	X	X (settlement of debt)	X			X		X	
OREGON	Limited	X		X	X	X (Municipal Debt Advisory Commission & refunding bond cram-down)		X		X		X	
PENNSYLVANIA	Conditional	X	X Financially Distressed Municipalities Act; Intergovernmental Cooperation Act)	X	X	X (appointment of a trustee)	X			X		X	
PUERTO RICO	N	X		X	X	X (first lien provisions)	X			X		X	
RHODE ISLAND	Conditional	X	X (fiscal overseer; municipal receiver; budget commission)	X	X	X (bond issuance requirements; bond payment guarantee)	X	X		X		X	
SOUTH CAROLINA	Y	X		X	X		X	X		X	X (any appropriate action)	X	X
SOUTH DAKOTA	N	X		X	X					X		X	X
TENNESSEE	N			X	X		X			X		X	X
TEXAS	Y	X	X (municipal receivership)	X	X			X		X		X	X
UTAH	N	X		X	X					X	X (contractual remedies)	X	
VERMONT	N	X		X	X			X		X		X	X
VIRGINIA	N	X		X	X					X	X (any contractual remedy)	X	X
WASHINGTON	Y	X		X	X	X (designation of trustee)		X	X	X		X	
WEST VIRGINIA	N	X		X	X		X	X	X	X		X	X
WISCONSIN	N	X		X	X	X (deficiency protection)		X		X		X	
WYOMING	N	X		X	X		X	X	X	X		X	
TOTAL		49		17	47	52	24	23	28	15	52	17	30

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