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Chapter 9 Municipal Bankruptcy:

The New "New Thing"? Part II

By Henry C. Kevane

This is the second part of our overview on municipal bankruptcies, building on **last month's article**.

The U.S. Constitution authorizes Congress to enact uniform laws on the subject of bankruptcies. But the Constitution also establishes a limit on the scope of federal judicial power over the states. Municipal bankruptcies under Chapter 9 are thus carefully calibrated to both respect state sovereign control over municipal debtors and limit federal court interference with municipal affairs, property, and operations. As a result, the Bankruptcy Court in a Chapter 9 case has only a few key functions—to determine the eligibility of the municipality to file at the beginning of the case, and to consider the confirmation of a plan of adjustment at the end.

In between, the court's role is mainly confined to approving the assumption or rejection of agreements, adjudicating avoidance actions (except against bond- or note-holders, who are immune in a Chapter 9 case from preference actions), and considering the possible dismissal of the case if it has languished or if confirmation of a plan has been denied or refused. In addition, the court has certain duties under various provisions of the Bankruptcy Code that are specifically incorporated into Chapter 9. For example, if the municipality is also a health care business (common in California, with 72 local health care districts, 46 of which operate hospitals), section 333 of the Bankruptcy Code contemplates the court's appointment of an ombudsman to monitor the quality of the municipality's patient care.

Types of Municipal Debt

Once it passes the eligibility gauntlet, the municipality must then turn its attention to its exit strategy. The most common forms of debt in a municipal bankruptcy are, naturally, bond debt and public employee obligations. Municipalities will, of course, also have ordinary trade and vendor liabilities but these are generally limited in amount. Unlike long-term bond debt, other municipal liabilities are often subject to state debt limitation provisions. Generally speaking, these provisions restrict the ability of municipal entities (1) to incur, without a popular vote, indebtedness that exceeds anticipated fiscal year revenues, or a percentage thereof, or (2) to satisfy, without a popular vote, indebtedness incurred in one fiscal year from the revenues of a future fiscal year. The provisions operate as a form of balanced-budget, "pay-as-you-go" rule for municipalities, generally requiring that each fiscal year's obligations be paid out of the income and revenue attributable to that year. In some jurisdictions debts incurred in excess of the borrowing limitations may be unenforceable. In many cases, therefore, outstanding trade obligations are not a significant portion of a municipality's total pre-petition claims pool.

Thus, bond debt and public employee obligations are typically perceived as the principal moving parts in a municipality's restructuring effort. Approximately $2.8 trillion of state and local bond debt is currently outstanding in the U.S.; the aggregate amount of unfunded pension and other public employee benefits is similarly projected to be in the trillions. On the other hand, annual state and local tax revenues have declined dramatically during the Great Recession, in some instances by more than 10 percent on a year over year basis. Despite the growing gap between tax receipts and public debt, there have been only about 20 Chapter 9 filings over the past four years.

Although a Chapter 9 bankruptcy can provide the necessary "breathing spell" to recover from an unanticipated fiscal emergency, it cannot itself resolve long-term structural imbalances. Just as the Bankruptcy Court may not interfere with the municipality's governmental powers or revenues, the municipality must correspondingly comply with any regulatory or electoral approval necessary to carry out a plan of adjustment. A Chapter 9 debtor will thus continue to be buffeted by the same political forces and community dynamics that exist outside of bankruptcy. Consequently, cultivating taxpayer, union, and bondholder consensus over the terms of a plan can take time which, in turn, will increase the expenses of a Chapter 9 case.

Like a corporate debtor under Chapter 11, a municipal debtor must also pay all accrued administrative expenses in full as of the effective date of the plan.

Bond Debt

Moreover, certain common forms of municipal bond debt are mostly unaffected by a Chapter 9 filing. First, the legislative history to Chapter 9 clarifies that industrial revenue bonds, issued by municipalities purely as conduits for private entities, are excluded from Chapter 9. 121 Cong. Rec. H39412 (daily ed. Dec. 9, 1975). In other words, according to the legislative history, claims that arise under tax-exempt industrial revenue bonds, nominally issued by a municipality to finance corporate infrastructure projects but actually sold on the basis of the corporation's private credit (not tax receipts or other municipal revenues), are *not* claims that are subject to adjustment by the municipal debtor in the Chapter 9 case. Nor, correspondingly, are the amounts paid by the corporation to the holders of the bonds (via the municipal conduit), included among the assets of the municipality. The municipality is strictly a vehicle for the issuance of such bonds and they are neither debts nor property of the debtor.

Second, bonds secured by *statutory* liens on tax revenues remain secured following the commencement of the case. Under state law, a secured party may obtain a security interest (i.e., a lien created by agreement) in after-acquired property of the debtor. Section 552 of the Bankruptcy Code, however, operates to terminate the reach of such a security interest in post-petition property, unless such property constitutes proceeds of the pre-petition collateral. Generally speaking, thus, a secured creditor's recovery will be dependent upon the value of pre-petition collateral and the proceeds thereof, not any property acquired by the debtor's estate after the commencement of the bankruptcy case. Although section 552 of the Bankruptcy Code applies in a Chapter 9 case, by its terms it only truncates a lien created under a security agreement, not a lien that arises by operation of law, "without consent or negotiation as to its terms or nature." In many cases, the liens securing bonds issued pursuant to municipal financing schemes are created automatically by statute, rather than by contract. *In re County of Orange*, 189 B.R. 499 (C.D. Cal. 1995) (reversing bankruptcy court: pledge of tax revenues was a statutory lien). In those instances, post-petition tax receipts will continue to serve as collateral for the bondholders and may not be freely diverted for the general purposes of the debtor. As a result, notwithstanding the intervening Chapter 9 case, the bondholder will continue to enjoy the rights of a secured creditor in after-acquired taxes.

Third, and more importantly, the Bankruptcy Code confers unique protections on the holders of revenue bonds. By some recent estimates, revenue bonds account for approximately two-thirds of average annual municipal debt issuance. Unlike general obligation bonds, secured by the full faith, credit, and taxing power of the issuer, a revenue bond is secured solely by income generated by the project or facility financed with the proceeds of the bond. Ordinarily, a revenue bond might be deemed a riskier investment than a general obligation bond because the holder of the revenue bond faces the risk of project failure and lacks recourse to municipal receipts other than the specific revenue stream dedicated by the issuer. (Moreover, as a public facility, bondholders generally lack the ability to foreclose on the physical asset itself.) Changes to the Bankruptcy Code in 1988, however, rendered the rights of a revenue bondholder in Chapter 9 comparatively more favorable than the rights of a general obligation bondholder.

If the revenue bond qualifies as a "special revenue" obligation under section 902(2) of the Bankruptcy Code, then (a) the scope of any accompanying lien will survive the commencement of the case notwithstanding section 552, (b) the indebtedness will continue to be serviced notwithstanding the automatic stay under section 362, and (c) any prepetition payments will be immune from preference recovery (as noted, this protection applies to all bonds and notes in a Chapter 9 case not just special revenue bonds). Of course, the risk of project failure will still affect the bondholder's ultimate recovery—if, however, the special revenues are adequate and ongoing, the bondholder need not be unduly concerned with the state of the municipality's general finances. The special revenues generated by the project will, however, remain subject to the project's necessary operating expenses and the bondholder will have no recourse against the municipality or its general taxing power in the event of a revenue shortfall (neither of which should come as a surprise to a bondholder since these conditions are generally consistent with the disclosures made in the offering statements for revenue bonds).

There are five categories of special revenues listed in section 902(2) of the Bankruptcy Code. Congress intended to "define special revenues to include the revenues derived from a project or from a specific tax levy, where such revenues are meant to serve as security to the bondholders." H.R. Rep. No. 100-1011, at 6–7 (1988). Although Congress specified discrete categories of special revenues, the categories are susceptible to some flexibility. *See In re Heffernan Memorial Hospital District*, 202 B.R. 147 (Bankr. S.D. Cal. 1996) (general tax receipts restricted in use to a specified financing project might qualify as special revenues). There is little applicable case law on the subject and the only guidance is contained in the legislative history which contains some general examples of various special revenues, including: (a) receipts from the operation of water, sewage, waste or electric systems, (b) highway or bridge tolls, (c) user fees, (d) special excise taxes, including hotel/motel taxes, alcoholic beverage taxes, meal taxes and license fees, and (e) proceeds from project financing.

Financing Leases

Financing arrangements based on lease transactions also enjoy certain protections under Chapter 9. Like debtors under the reorganization provisions of the Bankruptcy Code, a municipality in Chapter 9 can also wield the potent options to reject, assume, and assign unexpired leases under section 365 of the Bankruptcy Code. Generally speaking, an unexpired lease includes any lease that has not terminated by the expiration of its stated term either prior to or during the commencement of the bankruptcy case. The Bankruptcy Code establishes a 120-day deadline to assume or reject a nonresidential real property lease, and also caps any claim for damages following the rejection of a lease. Municipal financing leases, however, are unique instruments. For purposes of state law limitations on the issuance of debt, such instruments are usually considered true leases, subject to periodic rental payments and the potential for surrender of the leased property in the event of non-use by the municipality. In some states, the leases are not considered debt because of their contingent or installment nature, meaning that each periodic payment is in exchange for a corresponding, contemporaneous right of occupancy. In other states, financing leases may escape characterization as long-term indebtedness because they bear the risks of "abatement" or "non-appropriation."

The world of municipal finance, on the other hand, typically views such lease instruments as debt obligations, bearing traditional attributes of governmental safety and liquidity and usually enjoying favorable tax treatment. For this reason (as with the exclusion of conduit financing from the reach of Chapter 9), a special rule of construction has been added to Chapter 9 to prevent the potential treatment of municipal financing leases as true leases subject to potential assumption or rejection under section 365. Section 929 provides that "a lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent." This rule will override the assumption or rejection deadlines and rental claim limitations under the Bankruptcy Code and thereby preserve, for the "lender/lessor," the right to seek full recovery on the outstanding amount of the debt.

Public Employee Wages, Pensions, and Benefits

If traditional municipal bond debt is largely off limits in a Chapter 9 case, what other restructuring options does the municipality have during times of flagging tax receipts and diminished federal funding? By some measures, the largest component of municipal budgets is public employee wages, pensions, and benefits. Recent headlines in several states hint at looming battles between public employees and budget-sensitive local officials. Is Chapter 9 a possible tool to re-balance the sources and uses of government revenues?

The recent experience of the City of Vallejo suggests that Chapter 9 can be used to re-calibrate public employee benefits. Shortly after filing its Chapter 9 petition, the city sought to reject its collective bargaining agreements with certain public employee unions pursuant to section 365 of the Bankruptcy Code (which is expressly incorporated into Chapter 9). The unions opposed the rejection on the grounds that sections 903 and 904 (the cornerstones to the constitutionality of Chapter 9), elevated state labor laws as an obstacle to rejection. These state laws would impose certain procedural and substantive requirements on the mid-term modification or termination of public employment contracts.

The Bankruptcy Court and the appellate court each rejected this contention, finding that California's broad statutory permission to file a Chapter 9 case necessarily entailed an acknowledgement that section 365 might be used to assume or reject executory contracts. *In re City of Vallejo*, 432 B.R. 262 (E.D. Cal. 2010). Hence, by specifically consenting to Chapter 9 relief for its cities, counties, and districts, the state also consented to the subordination of those state laws and policies in conflict with the benefits of federal bankruptcy protection. This decision is consistent with the legislative history to Chapter 9—Congress noted that collective bargaining agreements "may be rejected despite contrary State laws. . . . It is intended that the power to reject collective bargaining agreements will preempt state termination provisions but not state collective bargaining laws." S. Rep. No. 95-989, at 111 (1978). Section 1113 is not incorporated into Chapter 9, however—hence, the standards articulated by the Supreme Court in *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984), govern the balancing of the equities that is required in order to reject a collective bargaining agreement. Since there is no "estate" created upon the commencement of a Chapter 9 case, the municipality must show that continued performance under the agreement impairs its ability to formulate a plan of adjustment.

Plan of Adjustment Requirements

Of course, the rejection of a collective bargaining agreement, or other unilateral changes to employee benefits or pensions, might trigger claims for damages, which would then be subject to adjustment under a plan. Although many of the statutory requirements to confirm a Chapter 9 plan of adjustment are borrowed directly from Chapter 11, the feasibility, "best interests of creditors," and "fair and equitable" requirements have unique meanings under Chapter 9 (since there are no shareholders of a municipality, nor may its assets be liquidated). *See* H.R. Rep. No. 95-595, at 263 (1977) ("[A] municipality is generally not a business enterprise operating for profit, and there are no stockholders. These differences dictate some modifications of the standards governing the proposal and confirmation of a plan.").

Under Chapter 11, the feasibility requirement is intended to test a debtor's ability to meet the obligations created by the plan (i.e., make distributions to creditors), without an ensuing liquidation or the need for further financial reorganization. The feasibility requirement under Chapter 9 is similar, although the debtor's ability to make the payments contemplated by the plan is measured with reference to the municipality's contemporaneous ability to sustain its ongoing governmental functions, not avoid a subsequent bankruptcy. In other words, can the municipality both distribute the plan consideration and meet its governmental functions?

The "best interests of creditors" and "fair and equitable" requirements are intended to protect, respectively, dissenting creditors and dissenting classes of creditors. In Chapter 11, the best interests test provides a floor for payments under a plan, ensuring that creditors will receive at least as much under the plan as they would realize in a Chapter 7 liquidation. A Chapter 9 case, however, may not be converted to Chapter 7 nor may the assets of a municipal debtor be involuntarily liquidated. Hence, under Chapter 9, the best interests test has been construed to mean that the plan offers a better alternative than dismissal of the bankruptcy case. If plan recoveries are superior to state law creditor remedies then the plan is generally considered in the "best interests of creditors."

The "fair and equitable" requirement, naturally, only comes into play if a class of creditors rejects the plan. Under Chapter 11, the requirement embodies the absolute priority rule, ensuring that any senior class that has rejected the plan is paid in full *before* a junior class may receive or retain property under the plan. There are, however, no holders of equity interests in a municipality and, hence, strict application of the "fair and equitable" test to a dissenting class of unsecured creditors (who are senior to shareholders in a corporate context) is not practicable under Chapter 9. Although there are varying interpretations, the legislative history to Chapter 9 suggests that, in order to be fair and equitable, a plan of adjustment must provide creditors with the "going concern" value of their claims—this standard entails a comparison of the reasonably expected revenues, expenditures, and taxing powers of the municipal entity.

Conclusion

Although Chapter 9 has seemingly re-entered the mainstream, there are still many aspects of Chapter 9 that may preserve its reputation as the remedy of last resort. The eligibility requirements are daunting, several common categories of municipal debt are largely immune from restructuring, and the modification of public employee wages, benefits, and other obligations may create and accelerate claims that would then require treatment and voting under a plan. Chapter 9 was born out of the extraordinary hardships of the Great Depression; it remains to be seen whether the Great Recession will generate situations of similar distress.

Henry C. Kevane *is managing partner at the San Francisco office of Pachulski Stang Ziehl & Jones LLP.*