Chapter 9 Municipal Bankruptcy Primer

BY HAROLD L. KAPLAN AND MARK F. HEBBELN

WHILE THE CHAPTER 9 MUNICIPAL BANKRUPTCY PROVISIONS of the Bankruptcy Code have been available to municipalities and municipal entities (including cities, agencies, county hospitals, and other instrumentalities of states) since the code was adopted in 1978 (superseding prior municipal bankruptcy statutes), Chapter 9 has been used only sparingly. However, there seems to be a clear nationwide trend toward—and expectation of more—municipal entities finding themselves in severe financial distress, including missing bond payments. This may be further exacerbated by the recent financial weakness and limitation of a number of municipal bond insurers. Therefore, an increasing number of municipalities from all areas of the country may be compelled to at least consider and confront the option of taking advantage of Chapter 9, with its attendant complications and impact on bondholders who own municipal debt and trustees who may be called upon to enforce municipal debt obligations. Recent examples of municipalities in distress, which have been a particular wake-up call to bondholders and trustees, include Vallejo, Calif., which filed bankruptcy, and Jefferson County, Ala., and Harrisburg, Pa., both of which missed interest payments on bonds.

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These recent developments and actual Chapter 9 municipal bankruptcy filings have piqued interest in—and it has become increasingly incumbent upon bondholders, trustees, and others to gain an appreciation of—the nature of Chapter 9 bankruptcies in general and how municipal bonds in particular may be treated in such bankruptcies. This article is intended as a concise overview of the principles and statutory provisions governing municipal bankruptcies, with an emphasis on certain special real-world considerations that may not often be discussed in print but are particularly important to bondholders and trustees: the treatment in Chapter 9 of (1) special revenue bonds, (2) general obligation bonds, and (3) repurchase agreements and their collateral.

Overview of Chapter 9

The municipal bankruptcy provisions of Chapter 9 of the Bankruptcy Code permit a financially distressed municipality to seek protection from its creditors and relief from burdensome contracts while it proposes a plan for adjustment of its debts.

Eligible municipality. A "municipality," which is defined in Section 101(40) of the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State," may be eligible to file for relief under Chapter 9 if, *inter alia*, it

> (i) "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by state law, or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such chapter"
> (ii) "is insolvent"
> (iii) "desires to effect a plan to adjust such debts."[1]

Recent cases, such as *Las Vegas Monorail* and *NYC OTB*, each of which involves bond debt with trustees, have particularly focused on whether (i) an entity is a "municipality" and, if so, (ii) whether it is "specifically authorized" to file for Chapter 9 protection. For example, NYC OTB was found to be a "municipality" authorized to file under Chapter 9 by a specific gubernatorial executive order.[2]

Overlap with and differences from Chapter 11. In many ways, Chapter 9 is analogous to Chapter 11 of the Bankruptcy Code, and it incorporates numerous (but not all) provisions applicable to corporate reorganizations under Chapter 11.[3] As under Chapter 11, the automatic bankruptcy stay comes into effect, and the municipal debtor can, among other things, adjust contractual relationships and unexpired leases. This may include rejecting burdensome collective bargaining and other labor benefit agreements, as was the primary purpose of the recent, highly public and controversial City of Vallejo Chapter 9 filing, in which a bankruptcy court rejection of a labor agreement was approved by the U.S. District Court for the Eastern District of California.[4] Rejection of such labor agreements increasingly seems to be a prime objective for municipalities to consider filing under Chapter 9. A cash-strapped municipal debtor also has the power to borrow money as an administrative expense and to finance and continue operations during a Chapter 9 case. While, ultimately, the municipal debtor is expected to restructure its affairs pursuant to a plan of reorganization confirmed by the bankruptcy court, creditors and other parties have only limited leverage over a municipality to force a particular result.

Because of Congress' special solicitude for the needs of municipalities and because of perceived sovereign immunity/10th Amendment constitutional limitations placed upon the federal government and courts in overseeing the operations of municipalities, Chapter 9 leaves significant control with the municipality and places special limits on the bankruptcy court's involvement.[5] For instance, the court has no power to control or interfere with the municipal debtor's expenditures or use of property while the Chapter 9 case is pending. Moreover, a municipality under Chapter 9 cannot have a debt adjustment plan imposed on it and may not be subjected involuntarily to liquidation of its assets for distribution to creditors.

In sum, current Chapter 9 seems to provide eligible municipalities all of the substantive and procedural benefits of Chapter 11 without most, if not all, of its limitations or burdens. Having said that, municipal bondholders and trustees are not totally exposed or unprotected in Chapter 9 municipal bankruptcies, particularly in relation to their special revenue bond rights and expectations.

Municipal Bond Enforcement and Treatment in Chapter 9

General obligation bonds are to be treated as general debt of the municipality in the Chapter 9 case and, therefore, the municipality can take advantage of the automatic stay and will not generally make or be required to make payments of either principal or interest on account of such bonds during the Chapter 9 case. The obligations created by such bonds will be subject to ultimate negotiation and resolution or restructuring under the Chapter 9 plan of reorganization.

Special revenue bonds, on the other hand, in large part because of amendments to the Bankruptcy Code adopted in 1988 designed to remedy gaping holes in the original Chapter 9 protections of bondholders and municipalities (which deficiencies became evident in operation in the first several years after Chapter 9 came into effect, as discussed in the inset box below), should continue to be secured and serviced during the pendency of the Chapter 9 case to the extent of the continuing collection, availability, and payment of ongoing special revenues.

The 1988 Municipal Bankruptcy Amendments Fix for Special Revenue Bonds

It became evident almost immediately upon Chapter 9 coming into effect in 1979—and, particularly, as practitioners worked through early possible municipal insolvency scenarios such as for Washington Public Power Systems (WPPSS) in the mid-1980s—that original Chapter 9 incorporated certain general Bankruptcy Code provisions that may have been workable in dealing with commercial lending in Chapter 11s (where loans are generally structured and secured by collateral of a current

value so as to be sufficient to cover the entire debt), but which would be devastating to the treatment of special revenue bonds in municipal bankruptcies (where such bonds are predicated on the pledge and payment of a long-term stream of special revenues, and as opposed to any particular lien or mortgage rights on existing assets or property).[6]

The Municipal Bankruptcy Amendments of 1988 were the product of successful lobbying, started almost a decade before, by various municipal organizations and the municipal bond industry, to "clarify" or correct uncertainties relating to municipal revenue bonds. These uncertainties were caused, in large part, by the fact that Section 901 of the Bankruptcy Code incorporated sections 547, 552, and 1111(b) into Chapter 9 municipal bankruptcy cases. Application of those sections (which may have worked in a corporate Chapter 11) in a municipal bankruptcy presented the troubling possibility that (i) the pledge of postpetition revenues that secured and were committed to pay revenue bonds as the primary source of payment would be invalidated under Section 552[7]; (ii) that bonds, which were intentionally structured to be nonrecourse against the municipality and which were to be paid only from the tax or other revenues of a specific project, would be treated in bankruptcy as general obligations of the issuing municipality because of the application of Section 1111(b)[8]; and (iii) that any payments on bonds within the statutory 90-day preference period would be subject to disgorgement under Section 547 (the preference section).[9] These possibilities confused and threatened the position and expectations of investors in special project revenue bonds, as well as municipalities—accounting for across-the-board lobbying by the entire municipal bond industry.[10]

Congress, in addressing these perceived problems with Chapter 9 via the Municipal Bankruptcy Amendment of 1988, did not eliminate the application of sections 552, 1111(b), and 547 from Chapter 9, but adopted new amended sections, such as amended sections 922 and 926-928 (discussed in the main text below), specifically clarifying, modifying, or amending Chapter 9 so as to remedy the identified pre-existing problems and to specifically provide in the amendments, applicable principally to "special revenue" bonds, (i) protections of bondholders' rights to revenue collateral, (ii) limits on preference attack, and (iii) prevention of such bonds being turned from nonrecourse into recourse general obligations of the municipality.

Treatment of Special Revenue Bonds Under Current Chapter 11

Pursuant to the 1988 amendments, "special revenues" came to be and are defined in Section 902(23) of the Bankruptcy Code, to mean the following:

- 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;
- special excise taxes imposed on particular activities or transactions;
- incremental tax receipts from the beneficial area in the case of tax-increment financing;
- other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or
- taxes specifically levied to finance one or more projects or systems, excluding receipt from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.

Bankruptcy Code Section 926(b) provides that any transfer of the municipal debtor's property to a noteholder or bondholder on account of a note or bond cannot be avoided as a bankruptcy code preference.

The current favorable treatment of special revenue bonds, as defined in the Bankruptcy Code, results from the following provisions:

- **Right to continued payment of postpetition revenues.** Section 928 of the Bankruptcy Code, as added in 1988, provides that any postpetition "special revenues" acquired or assessed by a municipal debtor remain subject to any prepetition lien imposed on such revenues, subject to any operating expenses relating to such revenues. Section 928 thus preserves the bondholders' lien on and right to payment from "special revenues, as defined in the statute, generated postpetition, and thus should allow continued payment of special revenue bonds postpetition.
- **Protection from preference attack and the "insolvency" standard.** Bondholders do not generally have to worry about the threat of preference liability under the Bankruptcy Code with respect to revenue pledges received from a municipality or with respect to any prepetition payments on account of, or pledges securing, bonds or notes, whether special revenue or general obligations.

  Bankruptcy Code Section 926(b) provides that any transfer of the municipal debtor's property to a noteholder or bondholder on account of a note or bond cannot be avoided as a bankruptcy code preference. An additional defense against preference exposure (which is predicated on debtor insolvency and the subject payment or transfer being made) is provided by the inclusion in Bankruptcy Code Section 101 of a special, more limited definition of

"insolvent" applicable only to municipalities. Under this definition, a municipality is deemed "insolvent" only if it is "(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or (ii) unable to pay its debts as they become due." This limited definition of "insolvent" also affects the application of other provisions of the Bankruptcy Code, including the eligibility of a municipality for Chapter 9 relief.

- **Special revenue bonds not allowed general obligation treatment.** Special revenue bonds, which are nonrecourse and payable only from a designated source, do not become general obligations of a municipal debtor by operation of 1111(b) of the Bankruptcy Code. Rather, Bankruptcy Code Section 927 effectively eliminates the theoretical transformation of revenue bonds into general obligation bonds and, with other services, preserves the municipality's original bargain. It also bolsters the "Chinese Wall" to which investors look to protect their general or special project investments from attack by bondholders who financed other projects on a special revenue basis.
- **The right to sell and apply securities collateralizing repurchase agreements.** A final relevant issue to investors and trustees, which arose at the outset of the 1994 Orange County Chapter 9 case (which involved the right of securities firms and financial institutions that are parties to repurchase agreements with the municipality to unilaterally and immediately apply securities which such firms may hold as collateral to satisfy their loans under repurchase agreements with the municipality), was further clarified by other amendments to the Bankruptcy Code adopted in 2005 that specifically incorporate previously unincorporated Section 559 (and certain other related provisions) into Chapter 9.[11] Thus, Chapter 9 includes not only Bankruptcy Code Section 559, which authorizes, without further court order, the exercise of a contractual right to liquidate a repurchase agreement (and its underlying collateral) because of and upon bankruptcy or insolvency, but also Bankruptcy Code Section 362(b)(7), which allows for the set-off of any mutual debt and claim under or in connection with a repurchase agreement. Together these sections seem to allow the early liquidation of repurchase agreements upon a municipal bankruptcy or insolvency, and to allow the set-off and application of funds or collateral in the normal course under the repurchase agreement without violation of the automatic stay under Section 362.

Conclusion

While it may still be unclear whether Chapter 9 will become a more prevalent occurrence for municipalities in distress, this primer is intended to provide trustees (and investors) a refresher on some of the basics that, among other things, make Chapter 9 different from Chapter 11, and even more favorable to municipalities, while providing a somewhat balanced treatment and protections in Chapter 9 for bondholders and trustees.[12] ■

Endnotes

[1]11 U.S.C. 109 (c).

[2]NY. Exec. Order No. 2009-27 (Sept, 1, 2009), www.state.ny.us/governor/executive_orders/exeorders/eo_27.html.

[3]11 U.S.C. 901.

[4]No. 2:09-cv-2603-JAM, Bankr. Case No. 08-26813-A-9 (June 14, 2010 Order).

[5]The 10th Amendment of the U.S. Constitution provides as follows: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

[6]In municipal finance, liens are generally not given or available on tangible property such as the project being financed, but are instead given on and in revenues, which at any time are less than outstanding bond indebtedness. In any case, courts will not generally permit municipal bondholders to foreclose on municipal assets such as the city sewer system or similar public works, even assuming such assets would have real market value in a foreclosure. "When a municipality or a taxing district is insolvent, the creditors cannot foreclose their mortgage; or cause public property to be sold and the proceeds distributed." H.R. Rep. No. 517, 75th Cong. 1st Sess. 3-4 (1937) (The prohibition against foreclosing on or seizing municipal property is extensive).

[7]Under Section 552, a lien on after-acquired property does not attach to property acquired by the debtor after the filing for relief (i.e., postpetition) unless such property constitutes collateral held prior to the filing for relief (i.e., prepetition) or the proceeds of that collateral. Application of Section 552 to Chapter 9 cases arguably would cut off and defease the bondholders' lien on and right to payment from its sole source of payment and security—for any postpetition revenues except to the very limited extent such revenues were the proceeds of existing collateral.

[8]Section 1111(b) establishes certain rights of partially secured creditors to treat or turn nonrecourse project debt into recourse general obligation debt. Section 1111(b) thus, if applicable in a Chapter 9, might allow a partially secured bondholder (i.e., one whose lien on specific revenues is presently insufficient to support payments on the revenue bonds) to have recourse against the municipality for the deficiency as if the bondholder held a general obligation bond—a clearly unintended result from the perspective of the municipality.

[9]Section 547, the Bankruptcy Code preference section, to the extent made applicable to Chapter 9 cases originally by Section 901, poses another troubling issue. Section 547 allows a debtor to avoid any transfer of property to a creditor upon an antecedent debt within 90 days before the filing of the debtor's petition which enables such creditor to receive more than it would obtain in a liquidation. Thus, a pledge of revenues or the payment of principal and interest to revenue bondholders within the 90 days before bankruptcy arguably could be a preference subject to repayment to the municipal debtor. This problem was exacerbated by the fact that, particularly with the limitations of Section 552, a bondholder is seldom sufficiently secured to defend successfully against a preference attack through proof that it was overcollateralized. Thus, the specter of preference liability could further inhibit the investment quality of revenue bonds of any troubled municipality and even further undermine the municipality's financial stability.

[10]See the report of the Senate Judiciary Committee on Section 1863. The Senate report on Section 1863 further indicated that the pre-1988 problems "first came to light as a result of the financial crisis confronting the city of Cleveland, Ohio, in 1979. Cleveland needed additional financing, but lenders were unwilling to lend for a variety of reasons, including the incorporation into Chapter 9 of the general bankruptcy concept of Section 552 of the Bankruptcy Code. By 1983, the rest of the financial community's attention was focused on these provisions by the default on billions of dollars of special project revenue bonds relating to five nuclear power plant projects by Washington Public Power Supply System (WPPSS) and by the threat that WPPSS might file for bankruptcy under Chapter 9. The bonds for WPPSS projects 1, 2, and 3 were underwritten through so-called net billing agreements by a federal agency, the Bonneville Power Administration, and therefore seemed to be protected; however, projects 4 and 5 were underwritten through so-called participants' agreements by public and private utilities in the Northwest. In 1983, the Washington Supreme Court invalidated these agreements as to the Washington public utilities. *Chemical Bank v. Washington Public Power Supply System,* 99 Wash. 2d 772, 666 P.2d 329 (1983). The project 4 and 5 bonds therefore seemed to be seriously exposed.

[11]Pub. L. No. 109-8 (2006). At the same time sections 555, 556, 559, 560, 561, 562, and 1123(d), relating largely to financial, securities, and commodity contracts and agreements, were incorporated into Chapter 9 through Section 901.

[12]This article is a summary of certain issues relating to municipal bankruptcies under Chapter 9. Many of the issues referenced above have been discussed in detail in an article co-authored by Harold L. Kaplan and Joseph U. Schorer in "The Bankruptcy Code Amendments of 1988" in *DePaul Business Law Journal* 101 (1989), pages 138-153.

ABOUT THE AUTHORS

HAROLD L. KAPLAN and **MARK F. HEBBELN** are partners at Foley & Lardner LLP in Chicago. Reach Kaplan at (312) 832-4393 or via e-mail at hkaplan@foley.com. Reach Hebbeln at (312) 832-4394 or via e-mail at mhebbeln@foley.com.