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# Summary of Chapter 9 of the Bankruptcy Code

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## SUMMARY OF CHAPTER 9 OF THE BANKRUPTCY CODE

Below is a general summary of several principal provisions of Chapter 9 of the United States Bankruptcy Code, 11 U.S.C. §§ 101 et seq., as amended (the “Bankruptcy Code”). Chapter 9 of the Bankruptcy Code governs bankruptcy cases filed by municipalities. Several provisions of Chapter 9, including certain provisions addressed herein, may be open to more than one interpretation and there are very few published court decisions involving municipal bankruptcies. Thus, there is little case law interpreting and applying the provisions of Chapter 9.

It is also important to note that this memorandum does not constitute legal advice, an opinion of our firm or establish any attorney-client relationship. Instead, this memorandum contains a general summary of principal issues under Chapter 9 of the Bankruptcy Code. Moreover, some of the issues summarized herein are subject to interpretation and thus are not settled law. The application of Chapter 9 to any particular bankruptcy case will depend on a variety of factors, including the facts presented, the agreements among the related parties, the interpretation and application of different provisions and the discretion of the court. No attempt is made in this memorandum to apply the provisions of Chapter 9 summarized herein to any particular facts or circumstances or to address all issues that may be relevant to Chapter 9. Accordingly, this memorandum should be viewed as providing general information about bankruptcy issues, and it is subject in all respects to existing and developing case law.

### Eligibility to be a Debtor under Chapter 9

#### “Municipality”

An entity must qualify as a “municipality” as defined in the Bankruptcy Code to be an eligible debtor under Chapter 9. As defined in Section 101(40) of the Bankruptcy Code, a “municipality” is a “political subdivision or public agency or instrumentality of a State.” Decisional law addressing the definition of municipality provides certain criteria to determine whether a particular entity is a municipality for purposes of the Bankruptcy Code. *See In re Green County Hospital*, 59 B.R. 388 (S.D. Miss. 1986) (holding that a county hospital was a municipality within the meaning of the Bankruptcy Code because it was “clear that the hospital is subject to control by public authority, i.e., the board of supervisors”); *Ex parte York County Natural Gas Auth.*, 238 F. Supp. 964 (W.D.S.C. 1965) (natural gas authority was a “public agency” eligible for relief under Bankruptcy Act); *In re Connector 2000 Association, Inc.*, 447 B.R. 752 (Bankr. D.S.C. 2011) (nonprofit corporation organized to assist state department of transportation in its financings and construction of roads and transportation facilities constituted a municipality and an eligible debtor for purposes of Chapter 9 of the Bankruptcy Code); *In re Westport Transit District*, 165 B.R. 93 (Bankr. D. Conn. 1994) (concluding that an agency created by a town pursuant to enabling statutes to serve a town’s transportation needs was a municipality under the Bankruptcy Code based on control of government authority and agency’s status as a “body corporate and politic” under state law); *In re Sullivan County Regional Refuse Disposal District*, 165 B.R. 60 (Bankr. D.N.H. 1994) (concluding that refuse district is a municipality under the Bankruptcy Code based on designation under state law as “a body politic and corporate”); *In re Ellicott School Building Corporation*, 23 B.C.D. 1551 (Bankr. D. Colo. 1992) (concluding that the entity at issue was not a municipality under the Bankruptcy Code because “[n]o governmental entity exercises any right of control over the entity”); and *In re Pleasant View Utility District of Cheatham County, Tenn.*,

24 B.R. 632 (Bankr. M.D. Tenn. 1982) (concluding that a utility district was a municipality for purposes of the Bankruptcy Code based on its classification under state statutes as a “public corporation”); but see *In re County of Orange, Calif.*, 183 B.R. 594 (Bankr. C.D. Cal. 1996) (concluding that control by a government authority alone is not sufficient to classify an organization as a municipality; however, a municipality for purposes of the Bankruptcy Code includes an incorporated authority, commission, or similar public agency controlled by a government authority and that is organized for the purpose of maintaining or operating a revenue producing enterprise and financing its operations by issuing bonds payable solely out of the revenues derived by the agency); *In re Lombard Public Facilities Corporation*, 579 B.R. 493 (Bankr. N.D. Ill. 2017) (in an Amended Memorandum Opinion on Motions to Dismiss, bankruptcy court held that bond issuer created as a not-for-profit corporation and not actively managed by municipality is not a municipality for Bankruptcy Code purpose); *In re Las Vegas Monorail Co.*, 429 B.R. 770 (Bankr. D. Nev. 2014) (entity that lacked traditional government powers, a public purpose and state control of its operations was not a municipality). Public agencies or instrumentalities with the scope of the term “municipality” under the Bankruptcy Code also include “incorporated authorities, commissions, and the like which are organized for the purpose of constructing, maintaining and operating revenue-producing enterprises.” See 2 *Collier on Bankruptcy* ¶ 101.40[2] (15<sup>th</sup> Ed. Rev. 2007).

In addition, under the Bankruptcy Act, the predecessor to the Bankruptcy Code, cities, counties, school districts, school authorities, public hospitals and public commissions were considered municipalities and the legislative history related to the definition of municipality under the Bankruptcy Code indicates that the definition was intended to broaden the definition of municipality used under prior bankruptcy law. H.R. Rep. No. 686, 94th Cong., 1st Sess. 20 (1975), reprinted in 1976, U.S. Code Cong. & Admin. News 557; see also Dubrow, “Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?” 24 *The Urban Lawyer* 539 (1992).

Interpreting the phrase “of a state” in the definition of “municipality” to include only instrumentalities of a state within such definition and to exclude instrumentalities of municipalities may be incorrect. It may be possible to read the phrase “of a state” broadly to include within the definition of “municipality” an instrumentality of a municipality that is subject to control by a state or municipal authority. See *In re Sullivan County Regional Refuse Disposal District*, 165 B.R. at 73 (disposal districts formed by cities and towns were defined as “body politic and corporate” under state law and constituted municipalities); 2 *Collier on Bankruptcy* ¶ 101.40[3] & fn. 11 and fn. 12 (and cases cited therein).

### *Specific Authorization*

Prior to its amendment in October 1994, the Bankruptcy Code provided that a municipal entity could file bankruptcy under Chapter 9 of the Bankruptcy Code if such entity were “generally authorized” to be a debtor by state law or by a governmental officer or organization empowered by state law to authorize the entity to be a debtor under Chapter 9. The language “generally authorized” caused confusion among courts as to whether a state in fact authorized its municipalities to file bankruptcy. Some courts concluded that state statutes granting municipalities broad “necessary and proper” powers constituted sufficient authorization for municipalities to file bankruptcy under the Bankruptcy Code. To resolve the confusion among courts as to the meaning

of “generally authorized,” Congress amended this language to require that a municipality be “specifically authorized” to file bankruptcy. Based on Section 109(c)(2) of the Bankruptcy Code, the conditions a municipality must satisfy to be eligible to file bankruptcy under Chapter 9 now include the condition that the municipality be:

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.

State law will vary on the issue of whether a municipality (or a particular municipality in such state) is specifically authorized to file Chapter 9 bankruptcy under the Bankruptcy Code. Some states have specifically authorized municipalities to be debtors under Chapter 9, some have not, some have authorized only certain municipalities to be debtors under Chapter 9 but excluded other types of municipal entities, and other states have conditioned the authority of its municipalities to file a case under Chapter 9 on various pre-conditions such as the consent of the governor or a particular state agency.

In at least one case addressing the “specifically authorized” requirement under Section 109(c)(2) of the Bankruptcy Code, a court has held that a state governor’s broad authority under state law to issue executive orders included issuing an executive order specifically authorizing the municipal debtor in the case to file bankruptcy, notwithstanding that no state statute specifically authorized the municipal entity to file bankruptcy or specifically authorized the governor to issue an executive order authorizing the filing. *In re New York City Off-Track Betting Corp.*, 427 B.R. 256 (Bankr. S.D.N.Y. 2010).

It is also important to recognize that state law concerning the authorization of a municipal entity to file bankruptcy can change. Thus, if a municipality is not specifically authorized to file bankruptcy at the time a bond issuance or other transaction closes, a state can subsequently amend its laws to authorize such entity, or municipalities generally, to file bankruptcy.

#### *Insolvency, Plan of Adjustment, Pre-Petition Negotiations*

In addition, to be eligible to file bankruptcy a municipality must also demonstrate that:

- (i) it is insolvent (i.e., it is generally not paying its debts as they become due, or is generally unable to pay its debts as they become due);
- (ii) it desires to effect a plan of reorganization; and
- (iii) either (a) it has obtained the agreement of creditors holding at least a majority in amount of claims of each class of claims that the municipality intends to impair under a plan, (b) it has negotiated in good faith with its creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of claims of each class of claims that such entity intends to impair under a plan or (c) is unable to negotiate with creditors because such negotiation is impractical.

The determination of whether a municipality is insolvent, and the elements on which to make such a determination, may vary from case to case. For example, the extent to which a

municipality's projected inability to pay its debts can provide a basis to satisfy its "insolvency" has not been fully determined by case law.

In addition, it may not be proper to consider a municipality's restricted funds in determining whether the municipality is solvent and able to pay its debts as they become due. Certain municipalities, including cities and counties, have various types of restricted funds and accounts that are dedicated to a specific use, are segregated either into a separate account or on applicable financial statements, and are not part of the general fund moneys. Thus, it is possible that a court would conclude that a municipal debtor's restricted funds not be considered (and thus not be counted as an asset or as property that is available to pay debts) in determining whether such entity is insolvent for purposes of a bankruptcy filing. *See, e.g. In re City of Vallejo*, Case No. 08-1244 (9<sup>th</sup> Cir. BAP June 26, 2009) (finding City's financial statements failed to reflect its true financial condition because many City accounts were restricted by law and not available for general operations and thus not part of solvency analysis).

A bankruptcy court may dismiss a petition filed under Chapter 9 for failure to comply with or satisfy the conditions set forth above, although dismissals are rare. For example, a Chapter 9 petition may be dismissed if the municipality is not truly insolvent, if it has not negotiated with its creditors prior to filing the petition (unless such negotiation is excused by impracticability) or if the municipality evidences no real desire to effect a plan. At least one case has held that the "impracticability" of negotiating with creditors can be established by the particular circumstances presented and does not need to be based on an attempt by a municipality to engage in such negotiations. *In re Valley Health System*, 383 B.R. 156 (Bankr. C.D. Cal. 2008) (municipality satisfied statutory prerequisite for Chapter 9 filing without first negotiating with creditors where voters rejected an initiative proposed to solve liquidity problems and delay in filing would risk loss of municipality's assets).

Objections to a municipal debtor's eligibility to file a case under Chapter 9 of the Bankruptcy Code have become a common part of many municipal bankruptcy cases. In some cases, a municipality's eligibility to become a debtor under the Bankruptcy Code has been decided relatively early in the case (within a few months), while in other cases the determination of eligibility has resulted in lengthy proceedings (lasting one year or more). As noted above, dismissals of Chapter 9 bankruptcy cases are rare.

### **Notice to Creditors**

At the commencement of a case under Chapter 9, a municipality must file with the court a list of all creditors which is as complete and accurate as practicable. Creditors of the municipality include all parties holding a claim against the municipality. "Claim" is broadly defined to include any right to payment, whether secured or unsecured, liquidated or unliquidated, fixed or contingent, matured or unmatured.

Each holder of such a claim against a municipality should be provided with notice of the commencement of a bankruptcy case by the municipality. Notice of the bankruptcy case must also be published in certain newspapers in accordance with the Bankruptcy Code.



## Scope of Municipal Authority

Unlike the provisions of Chapter 11 of the Bankruptcy Code, which generally govern business reorganizations and grant the bankruptcy court extensive powers over a debtor's property and affairs, Chapter 9 does not grant the bankruptcy court the power to interfere with the governmental affairs or the revenues of a municipal debtor. Section 904 of the Bankruptcy Code provides that the bankruptcy court may *not*, unless the municipality consents or its plan of adjustment so provides, interfere with:

- (i) any political or governmental powers of the municipality;
- (ii) any property or revenues of the municipality; or
- (iii) the municipality's use or enjoyment of any income-producing property.

Essentially, a municipal debtor will have the authority to operate in the same manner post-petition as such municipality operated pre-petition and will retain the same powers and discretion that it had prior to the filing of the case. This authority includes the ability of a municipal debtor to spend funds post-petition without bankruptcy court approval. Chapter 9 contemplates that, during the continuance of the case, a municipality will continue to operate under the same direction, and in essentially the same manner, as the municipality operated pre-petition. Several cases have noted that Chapter 9, unlike Chapter 11, is designed to meet the special needs of the municipal debtor and that a dissatisfied creditor's primary remedy in a Chapter 9 bankruptcy may be to pursue dismissal of the case. *In re Richmond School District*, 133 B.R. 221 (Bankr. N.D. Cal. 1991); *Silver Sage Partners, Ltd., v. City of Desert Hot Springs*, 339 F.3<sup>rd</sup> 782 (9<sup>th</sup> Cir. 2003).

Courts have thus far interpreted Section 904 fairly broadly, which in effect limits a bankruptcy court's ability to enter orders affecting a municipal debtor's operations or revenues. See *Assured Guaranty Corp. v. In re The Financial Oversight and Management Board for Puerto Rico (In re The Financial Oversight and Management Board for Puerto Rico, et al.)*, No. 18-1165 (1<sup>st</sup> Cir. Mar. 26, 2019) (initial memorandum decision), *rehearing denied* (1<sup>st</sup> Cir. July 31, 2019) (rehearing memorandum decision) (each holding under PROMESA that pledged "special revenues" to be generated by or to come into the possession or control of a municipal debtor are not exempt from the automatic stay under Section 922(d) based, in part, on the scope of Section 904 prohibiting interference with a municipal debtor's revenues) (together, *Assured v. Puerto Rico*)<sup>1</sup>; *In re Kennewick Public Hospital District* case, No. 17-5195 (E.D. Wa. Feb. 22, 2018) (in a lease financing transaction in which municipal debtor as lessee is delinquent in payments, district court grants debtor's request to stay an order that would have permitted the lessor to pursue

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<sup>1</sup> PROMESA is legislation enacted by Congress that includes, among other things, provisions permitting the Commonwealth of Puerto Rico and certain of its agencies and municipalities to file a reorganization proceeding substantially similar to reorganization proceedings under Chapter 9 of the Bankruptcy Code. PROMESA incorporates substantially all of Chapter 9 of the Bankruptcy Code, which governs bankruptcy cases of municipal debtors, and thus holdings thereunder will be applicable to the Bankruptcy Code. For more information on PROMESA, see my separate articles: <https://www.law360.com/articles/863010/promesa-and-the-future-of-puerto-rico-part-1> and <https://www.law360.com/articles/863012/promesa-and-the-future-of-puerto-rico-part-2> (Law360 login required).

remedies, reasoning that Section 904 limits the circumstances under which relief can be granted against a municipal debtor).

## **Automatic Stay**

### *Generally*

Upon the filing of a petition by a municipality under Chapter 9, all creditor action against the municipal debtor is automatically stayed or enjoined by operation of law, subject to certain limited exceptions (including the exception relating to certain pledged “special revenues” discussed below). The automatic stay in municipal debt adjustment cases is more expansive than the stay applicable to cases under Chapters 7, 11, 12 and 13 of the Bankruptcy Code. Under Chapter 9, for example, actions against an officer or inhabitant of the municipality that seek to enforce a claim against the municipality and actions seeking the enforcement of a lien on or arising out of taxes or assessments owed to the municipality are stayed. Creditors are thus prohibited from commencing or continuing collection actions against a municipal debtor or certain actions against officers of the municipality during the pendency of the bankruptcy proceedings. The stay would also preclude a creditor from commencing a mandamus action (generally an action to enforce performance of an officer’s official duties) against an officer of a municipal debtor, absent relief from the automatic stay. Creditors of a municipal debtor may seek relief from the automatic stay in the same manner as is provided under other Chapters of the Bankruptcy Code (generally, upon a motion by the creditor and a hearing to determine if the requirements for relief from the stay as set forth in the Bankruptcy Code have been met). Relief from the automatic stay may be of questionable value for bondholders or bond trustees respecting bonds of the municipality, however, as the power to execute and levy against municipalities or to exercise other remedies against a municipality or its officials may be limited by state statutes or case law.

### *“Special Revenues” Exception*

One of the few exceptions to the automatic stay in a municipal bankruptcy case relates to pledged “special revenues.” A general discussion of this exception and certain legislative history is below. However, as also discussed below, the scope and application of this exception has been significantly limited by the *Assured v. Puerto Rico* decisions discussed below. Accordingly, the exception to the automatic stay applicable to pledged “special revenues” may be very limited (and certainly more limited than portions of the legislative history may imply) and may not apply to a municipality’s future special revenues, especially if the *Assured v. Puerto Rico* decisions apply or are followed.

Section 922(d) of the Bankruptcy Code provides that a bankruptcy case commenced by a municipality under Chapter 9 does not operate as a stay of the application of pledged “special revenues” to the payment of indebtedness secured by such revenues. The legislative history of Section 922(d) indicates that the intent of Congress in enacting Section 922(d) was to minimize the effect of a municipal bankruptcy on revenue bonds issued by such municipality and, therefore, to promote the purchase of revenue bonds from municipalities. The legislative history provides:

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

a pledge of revenues survives under Section [928], it would be needlessly disruptive to financial markets for the effectuation of the pledged revenues to be frustrated by an automatic stay. Further the use of an automatic stay may be contrary to Section 904 and interfere with the government affairs and the municipality's use or enjoyment of income producing property.

*See Dubrow*; S. Rep. No. 106, 100th Cong., 1st Sess. 21 (1988). The report of the Senate Judiciary Committee similarly stated that:

[T]he automatic stay that becomes effective against creditors of a municipality is made inapplicable to the payment of principal and interest on municipal bonds paid from pledged revenues. In this context, pledged revenues include funds in the possession of the bond trustee as well as other pledged revenues.

*See Dubrow*; S. Rep. No. 106, 100th Cong., 1st Sess. 13 (1988).

The legislative history of Section 922(d) also indicates that this Section was intended to avoid unnecessary delay and expense involved in obtaining relief from the automatic stay. The Senate Judiciary Committee report states:

The automatic stay is extremely broad, preventing any post-petition collection activities against the debtor. This provision is overly broad in Chapter 9, requiring the delay and expense arising from a request for relief from the automatic stay to accomplish what many state statutes mandate: the application of pledged revenues after payment of operating expenses to the payment of secured bonds.

*See Dubrow*; S. Rep. No. 106, 100th Cong., 1st Sess. 11 (1988).

The definition of "special revenues" in Section 902(2) of the Bankruptcy Code is, generally speaking, intended to narrowly apply only to certain defined revenues that serve as a source of payment and as security for revenue bonds issued by municipalities. The definition includes five categories of special revenues, as follows:

(i) *Receipts Derived From the Ownership or Operation of a Municipality's System or Projects.* This category, generally speaking, includes receipts from the operation of transportation, water, sewage, waste or electric systems. For example, municipalities may own and operate transportation facilities such as school bus systems and rail lines or utilities. The revenues from such facilities may constitute special revenues. 6 *Collier on Bankruptcy*, ¶ 902.03[2] at 902-5 (15th ed. 1994). In order for the revenues from these facilities to qualify as special revenues, however, the facilities and revenues must be used primarily for their defined purpose. *Id.* at 902-5.

(ii) *Special Excise Taxes on Particular Activities or Transactions.* Examples of special excise taxes included in this category are excise taxes on hotel or motel rooms, a meal tax or an excise tax imposed on the sale of alcoholic beverages that are specifically identified



and pledged to a revenue bond issue. However, a general state sales tax cannot be included in the definition of a “special excise tax” for purposes of Section 902(2). *Id.* at 902-6.

(iii) *Incremental Tax Receipts.* This category encompasses the incremental tax receipts from a benefited area where, for example, a financed project causes surrounding property values to increase. The owners of such property may be required to pay increased property taxes on account of such project or improvement. The amount of the increase in property taxes may thus constitute special revenues falling within the category of “incremental tax receipts.” Some examples of specific projects where incremental tax receipts may constitute special revenues are electric systems, convention centers, athletic stadiums, public housing projects and bridges and highways. *Id.* at 902-6. These projects may have the effect of increasing taxes to the surrounding area by raising property, sales and income tax revenues. Also, some specific projects such as stadiums or convention centers may generate revenue from the project itself. In these instances, the revenues, if specifically identified and pledged as collateral for revenue bonds that are issued to finance the improvement, may be segregated from a municipality’s use for general purposes and may constitute special revenues. *Id.* at 902-6.

(iv) *Revenues Derived From Particular Functions of the Debtor.* This category may include, for example, regulatory fees, user charges and stamp taxes imposed for the recording of deeds. If a municipality specifies and pledges these revenues to a revenue bond issue, the revenues may be protected under Section 902(2). *Id.* at 902-7.

(v) *Taxes Levied To Finance a Particular Project.* This category may include, for example, a tax levied to finance the construction of a stadium. Such tax receipts qualify as special revenues, however, only when the tax is restricted and identified to a specific project or system. *Id.* at 902-7. An example of special revenues under this category may be a levy of an additional sales or property tax by a municipality to finance the construction of a convention center. The test for determining whether revenues constitute special revenues under this category is, among other things, whether the nature and scope of the restrictions placed on the use of the tax revenues are sufficient and whether the revenues have been specifically identified and pledged as collateral for the revenue bonds. *Id.* at 902-7. This category does not include receipts from general property, sales or income taxes (other than tax increment financing) levied to finance the general purposes of the debtor.

The definition of “special revenues” is a developing issue under case law and thus may be limited by case law. The category of “special revenues” generally does *not* include general property, sales or income taxes. Such revenues remain general revenues of a municipality with some exceptions (e.g., a city may impose an additional sales tax to finance a particular project, or an additional property tax may be levied in certain cases to repay a particular revenue bond issue). Generally, revenues from a particular source that may be used for purposes other than the payment of particular revenue bonds will not constitute “special revenues.” Moreover, general obligation bonds of a municipality that are secured by a revenue pledge can have elements of both secured and unsecured debt in a Chapter 9 bankruptcy case of the issuing municipality and may not be entitled to the protections afforded to revenue bonds payable and secured solely by (and only to the extent of) special revenues.

There is very little case law interpreting or applying the definition of “special revenues” under the Bankruptcy Code. The scope of this definition, and the application of the exception to the automatic stay, are thus not settled law and may depend on developing case law. The examples of special revenues noted in this memorandum are intended to illustrate the types of revenues that may constitute special revenues, but are not supported by case law. In addition, based on the absence of case law on this issue, it is uncertain whether funds owned by a municipal debtor that are generated by private entities or by a project owned by private entities, rather than by the municipality itself or by a project owned by or tax revenues of the municipality, could constitute special revenues.

It is also important to note that the special revenues at issue must be effectively pledged under applicable law and may need to be separately identifiable from other revenues or general funds of the debtor. A general pledge of a municipality’s full faith and credit, or its pledge or promise use or raise its general tax revenues, to pay a particular obligation does not constitute a “pledge” (such as a security interest or lien) in the specific revenues.

Although the language and scope of “special revenues” and the exception from the automatic stay permitting continued application of special revenues appear broad, the court in *Assured v. Puerto Rico* limited the scope and application of a municipal debtor’s special revenues Section 922(d). In the *Assured v. Puerto Rico* case, the First Circuit held that creditors of a municipal debtor secured by a pledge of special revenues, including bondholders, a bond trustee or paying agent in a municipal bond financing, cannot compel the municipal debtor to transfer such special revenues post-bankruptcy (with the possible limited exception of applying special revenues actually held by such creditor upon the bankruptcy filing). Consequently, a post-petition action to transfer or otherwise enforce a lien in pledged special revenues, absent the consent of the Chapter 9 debtor or obtaining an order granting relief from the automatic stay, will be viewed under this decision as violating the automatic stay. (The United State Supreme Court denied a writ of certiorari.) These decisions did not address the definition or scope of “special revenues” or invalidate the lien granted in such revenues, but held that timely payment of pledged special revenues could not be compelled without first obtaining the municipal debtor’s consent or relief from the automatic stay. Moreover, these decisions also did not address what happens to pledged special revenues that are not transferred post-bankruptcy but remain subject to a valid lien.

Although the *Assured v. Puerto Rico* decision addressed only the First Circuit and Puerto Rico, the Bankruptcy Code is federal law and circuit-level decisions on bankruptcy matters are often given broad effect in other circuits. However, it is certainly possible that courts in other jurisdictions could disagree with the *Assured v. Puerto Rico* decision and hold that the special revenues provisions of the Bankruptcy Code were intended to apply to and exempt from the automatic stay the entire future stream of special revenues.

It is important to note that issues concerning the scope, pledge and application of “special revenues” will be presented in the context of a distressed municipal debtor. It is possible that a court may narrowly interpret the special revenues provisions in this context, especially if it will enable the debtor to provide ongoing municipal services or services that are deemed important or essential.

Aside from the *Assured v. Puerto Rico* ruling, it is possible that a court may temporarily stay the transfer of special revenues until it has had an opportunity to review the revenues, the terms of transaction documents pursuant to which such special revenues will be transferred and related issues. A court may also determine whether, or the extent to which, special revenues are effectively pledged under applicable law. For example, it has been argued in at least one municipal bankruptcy case that only special revenues in the possession of a bond trustee should be considered as being “pledged” to such trustee for purposes of the Section 922(d) exclusion from the automatic stay.

In addition, the protections afforded to special revenues and a creditor’s lien thereon will also be subject to expenses of the debtor or the related project or system, such as operating and maintenance expenses. A court may need to determine the scope of such operating and maintenance expenses in a particular case, which could include such costs as a debtor’s legal fees associated with the bankruptcy case.

Moreover, as noted above, a creditor’s ability to execute and levy against municipalities or to exercise other remedies against a municipality or its officials may be limited by state statutes or case law. For example, notwithstanding the protections afforded to special revenues under the Bankruptcy Code, a creditor’s ability to appoint a receiver over a particular project or system, or to enforce a municipal debtor’s pre-bankruptcy contractual requirement to set user rates consistent with a specified rate covenant in bond documents, may be limited.

While the issue has not been decided in court, some commentators have proposed that it may be possible to modify or impair the treatment of special revenues in a confirmed plan of adjustment. Other commentators argue that the protections afforded to special revenues under Section 922(d) cannot be impaired under applicable plan confirmation provisions of the Bankruptcy Code.

Last, many states have statutes which by their express terms limit a municipal debtor’s use of certain revenues to the payment of specific bond debt. It is unclear whether these statutes would continue to limit a debtor’s ability to apply such revenues while in a bankruptcy case or under a confirmed plan.

### *Financial Contracts Exception*

Another exception to the automatic stay in a municipal bankruptcy case relates to certain qualified financial contracts. The financial contract provisions of Sections 555, 556, 559, 560, 561 and 562 of the Bankruptcy Code, which provide certain protections to counterparties under qualifying financial contracts, are applicable in Chapter 9 cases filed by municipal debtors. Under these Sections, generally speaking, certain parties to qualifying “securities contracts,” “commodities contracts,” “forward contracts,” “repurchase agreements” and “swap agreements” are entitled to exercise a contractual right to liquidate such contracts based on the bankruptcy filing of the counterparty to such contracts. Moreover, such contracts may be terminated or liquidated by the nondebtor party notwithstanding the automatic stay arising in, and certain transfers made under such contracts before a bankruptcy filing may be insulated from being avoided or unwound in, a bankruptcy case by or against the debtor counterparty.

## Security Interest in “Special Revenues”

### *Continuing Lien Based on “Special Revenues” Characterization*

Section 552(a) of the Bankruptcy Code generally avoids or terminates pre-petition liens granted by a debtor as to funds acquired by the debtor after a bankruptcy case is filed. However, Section 928(a) of the Bankruptcy Code provides that, notwithstanding Section 552(a) of the Bankruptcy Code, pledged special revenues acquired by a municipal debtor after the filing of a bankruptcy case remain subject to a lien granted by such debtor prior to the bankruptcy case. The legislative history of Section 928 explains Congress’ purpose in enacting this Section. It states that:

Under section 552(a) of the Bankruptcy Code, made applicable to chapter 9 cases by section 901, property acquired by a debtor after filing bankruptcy is not subject to any lien created prior to bankruptcy. In a municipal bankruptcy, this means that the lien created by a revenue bond issued prior to bankruptcy is extinguished. The post-petition revenues generated by the asset financed would then not be used to repay holders of revenue bonds. Instead, the revenues would go into the general treasury, for distribution to all creditors of the municipality—including the special revenue bondholders—on a pro rata basis. Since the general treasury funds in a municipal bankruptcy situation will generally be inadequate to pay all creditors in full, this could mean that revenue bondholders will ultimately receive much less than what they thought to be the value of their lien interest.

[However,] one of the purposes of revenue bonds is to ensure that if the asset financed fails, general taxpayer funds will not be used to repay the debt. The effect of section 552, which could result in general treasury funds being used to repay revenue bondholders, would be to defeat this purpose. In some states, it might even run afoul of state constitutions and statutes if general treasury funds are used to repay specific revenue bond obligations. Special revenue bonds of a bankrupt municipality would essentially be turned into general obligation bonds—but without the authorization by popular vote usually required before a municipality can issue a general obligation bond. There may also be a danger that the municipality’s general debt limit could be exceeded.

[Section 928] would eliminate this problem by making special revenues still subject to a post-petition lien in a chapter 9 bankruptcy, notwithstanding section 552(a).

*See Dubrow*; H.R. Rep. No. 100-1011, 102nd Cong., 1st Sess. 4 (1988). For example, pursuant to Section 928(a) of the Bankruptcy Code, a lien in revenues constituting special revenues that is granted by a municipal issuer of revenue bonds in favor of an indenture trustee should not be avoidable in a bankruptcy case of such municipality. In addition, as noted above, a creditor’s lien in special revenues will be subject to the operating and maintenance expenses of the debtor, which will vary from case to case.

### *Continuing Lien Based on “Statutory Lien” Characterization*

It is also worth discussing that a “statutory lien” in revenues, similar to a lien in special revenues, may survive post-bankruptcy and not be terminated by operation of Section 552. Thus, a true statutory lien in an asset or in certain revenues can provide significant protection to a creditor secured by such an asset or revenues.

Under the Bankruptcy Code, the term “statutory lien” means:

[a] lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute.

See Bankruptcy Code Section 101(53). The language in this Section specifying that a statutory lien is a lien “arising solely by force of a statute on specified circumstances or conditions” is important in that the Section distinguishes a “statutory lien” from other liens or security interests (such as consensual liens or judicial liens) that do not constitute a “statutory lien” for purposes of the Bankruptcy Code. As explained in one leading commentary:

[t]he essence of the definition in section 101(53) is the need, or lack of need, for an agreement or judgment to create the lien. If the lien arises by force of statute, without any prior consent between the parties or judicial action, it will be deemed a statutory lien . . . . *If the creation of the lien is dependent upon an agreement, it is a security interest even though there is a statute which may govern many aspects of the lien.* The fact that a statute describes the characteristics and effects of a lien does not by itself make the lien a statutory lien.

2 *Collier on Bankruptcy* ¶ 101.53 (emphasis added; citations omitted). Thus, whether a statutory lien is created by a statute will depend on the applicable statute at issue.

As a general rule, tax or other revenues generated or acquired by a municipal debtor after the commencement of a bankruptcy case are not subject to a pre-bankruptcy consensual security interest granted under an indenture or other security agreement. Such a lien, absent some other form of protection, may be terminated or “cut off” as to after-acquired or post-petition revenues by the effect of Section 552 of the Bankruptcy Code.

Section 552(a) of the Bankruptcy Code provides:

Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

See Bankruptcy Code Section 552(a). Section 101(50) of the Bankruptcy Code defines “security agreement” as an “agreement that creates or provides for a security interest.” 11 U.S.C. § 101(50).



A statutory lien is generally considered as a lien that is not created by a security agreement, but by operation of law under a statute, and thus not subject to the foregoing provisions of Section 552(a). Instead, revenues of a municipal debtor generated or acquired by such debtor post-petition are generally considered to remain encumbered by the statutory lien post-petition. Thus, a statutory lien could protect a bond trustee's lien interest in post-petition revenues of a municipal debtor that are encumbered by such lien and enhance the trustee's claim or ability to ultimately recover such revenues secured by the lien. However, even if a "statutory lien" in revenues or other collateral exists and is not terminated by Section 552, collateral subject to a statutory lien remains subject to the automatic stay.

It is important to distinguish a statutory lien from other types of liens. A consensual lien or security interest is one created by an action or voluntary grant of a security interest by the grantor. Consensual liens arise under or are dependent on an agreement between the applicable parties. Statutory liens, on the other hand, arise by operation of a statute itself and do not arise or depend on a security agreement, the affirmative grant of a security interest by the grantor or a court order imposing a judicial lien.

There are two published bankruptcy decisions addressing the differences between a statutory lien and a consensual lien in the context of a municipal financing. These two cases are *Alliance Cap. Mgmt. LP v. County of Orange (In re County of Orange)*, 179 B.R. 185 (Bankr. C.D. Cal. 1995), and the related district court case of *Alliance Cap. Mgmt. LP v. County of Orange (In re County of Orange)*, 189 B.R. 499 (C.D. Cal. 1995). In the *County of Orange* district court decision, the district court held that the lien securing the County obligations at issue pursuant to a California statute authorizing the County to pledge assets to secure such obligations constituted a statutory lien. See *County of Orange*, 189 B.R. at 503 (the applicable statutory language provided, "The repayment of money borrowed . . . constitutes a first lien and charge against the taxes, revenues and other income collected . . ."). As described in the *County of Orange* district court decision, "[A] statutory lien is only one that arises automatically, and is not based on an agreement to give a lien or on a judicial action." *County of Orange*, 189 B.R. at 502 (citing S. Rep. No. 95-989, at 27 (1978)). The district court further explained, "The difference between statutory liens and security interests is sometimes obscure. Security interests commonly find authorization and clarification in existing state statutes." *Id.* A "statutory lien arises 'solely' by force of a statute." *Id.*; accord *Badger Mountain Irr. Dist. Secured Bondholders' Comm. v. Badger Mountain Irr. Dist. (In re Badger Mountain Irr. Dist.)*, 885 F.2d 606, 608 n.2 (9th Cir. 1989). Thus, whether a statutory lien is created by a statute will depend on the applicable statute at issue. A statute that references a lien on property or revenues of a governmental bond issuer, authorizes a pledge or confirms the validity or priority of a lien may not, if the lien does not arise by operation of law, create a statutory lien. Instead, a statute expressly creating the lien by its own terms would be required to create a statutory lien.

Given the protection of Section 928(a) respecting special revenues and the protection provided by a statutory lien, a determination of whether revenues constitute "special revenues" and were effectively pledged, or whether a statutory lien exists over certain revenues or collateral, may become important in a municipal bankruptcy case. A municipal debtor thus could challenge these issues to maximize its available revenues.

In the bankruptcy cases of Detroit, Michigan and Sierra Kings Health Care District in California, bondholders advanced arguments in favor of a statutory lien securing the applicable bonds. Such bondholders and the related debtor entered into settlement agreements to settle related issues, which were approved by the bankruptcy courts. In the case of Sierra Kings, the settlement agreement stated that the particular bondholders benefitted from a statutory lien on certain revenues of the debtor. In the case of Detroit, the related unlimited tax general obligation bonds were subject to a more complex settlement agreement, but that settlement agreement also contained agreements concerning the existence of a statutory lien to the extent applicable under a specified statute. Although these results were based on settlement agreements, rather than a litigated result or independent findings by the court, the settlements tend to show that creditors who benefit from statutory liens may obtain better treatment or negotiating leverage in a municipal debtor's bankruptcy case.

While a statutory lien creates enhanced prospects for recovery, a claim secured by a statutory lien may be able to be restructured by a municipal debtor. For example, in many Chapter 11 cases of corporate debtors, a confirmed plan of reorganization could restructure a claim secured by a lien, by providing for a reduction in the interest rate or a longer term of payment, as long as the secured creditor ultimately receives the value of its collateral securing its claim. If the value of collateral is contested, a resolution of the value would be based on a determination by the bankruptcy court, often based on expert testimony or appraisals depending on the nature of the collateral. Thus, it is possible that a court in a Chapter 9 case could allow similar modifications to the rate or the term or duration of a claim of a bond trustee secured by a statutory lien, as long as the value of the related collateral secured by a statutory lien will ultimately be received. Many of these issues have not been litigated or applied in a Chapter 9 case, including with collateral that is a dedicated tax revenue stream (which in many cases is required by state statute to be levied to pay bonds or restricted by statute to being used by a municipality to pay specified bonds and not other debt).

A statutory lien, by itself, also does not provide protection from covenant changes by a municipal debtor. For example, a municipal debtor could seek a bankruptcy court's permission to modify or reject an additional bonds test. If additional bonds are issued under an indenture, the result could be in effect a reduction or dilution of collateral securing a greater amount of bond debt.

Certain states have legislation creating a statutory lien in specified instances or respecting certain municipal entities or revenues. It should be noted that if such legislation is enacted by a state, its application is likely not retroactive to bonds issued before such enactment.

### *Call Protection*

In many municipal revenue bond financings, a bond indenture or other document may preclude a prepayment or early redemption of the related revenue bonds unless such prepayment or redemption is made with a specified prepayment or optional redemption premium. It is unclear whether the protections afforded to special revenues under the Bankruptcy Code could preclude a prepayment or early redemption of revenue bonds without the "make whole" premium or, alternatively, whether a Chapter 9 plan of a municipal debtor could (similar to the ability of a

Chapter 11 debtor) effect a prepayment or early redemption of secured revenue bonds without paying the “make whole” premium specified in the bond documents.

### **Special Revenue Bonds as Nonrecourse Obligations**

In Chapter 11 reorganizations, nonrecourse debt can be converted into recourse debt in certain circumstances pursuant to Section 1111(b) of the Bankruptcy Code. Section 927 generally specifies that obligations payable solely from special revenues of a municipal debtor will not be converted post-petition under Section 1111(b) into recourse debt of the municipality. The effect of Section 927 of the Bankruptcy Code is that other assets and revenues of a municipal debtor need not be utilized for the satisfaction of revenue bonds that are payable only from a specified revenue source.

### **Executory Contracts and Unexpired Leases**

A municipality, like a Chapter 11 debtor, is given authority under Section 365 of the Bankruptcy Code to assume or reject executory contracts, unexpired leases and collective bargaining agreements. As a condition to assuming an executory contract or unexpired lease, a municipal debtor is required to cure monetary defaults, if any, under the contract or lease and provide adequate assurance that it will be able to perform the contract or lease in the future. If the debtor rejects a contract or lease, such rejection is generally treated as a breach which gives rise to a pre-petition unsecured claim for damages (and damages under a lease may be limited by the Bankruptcy Code).

#### *Collective Bargaining Agreements*

Unlike a Chapter 11 debtor, a municipal debtor in Chapter 9 is not required to satisfy the conditions under Bankruptcy Code Section 1113 for rejecting collective bargaining agreements (which Section requires, among other things, that a Chapter 11 debtor first present a proposal to the applicable union representatives containing proposed modifications of the agreement and related employee benefits that will still permit the debtor to reorganize and meet in good faith with the union representatives). However, a municipal debtor seeking to reject a collective bargaining agreement must establish that the related collective bargaining agreement is a burdensome contract, that under the applicable circumstances the equities of rejection weigh in favor of rejecting the contract and that the municipality engaged in reasonable efforts to negotiate a voluntary modification of the contract but such efforts are not likely to resolve the issues relating to the contract. *See, e.g., In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal. 2009); *aff’d*, 432 B.R. 262 (E.D. Cal. 2010); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 526 (1984). *See also In re County of Orange*, 179 B.R. 177, 184 (Bankr. C.D. Cal. 1995) (state law requirements and equities may be considered in connection with the rejection of union contracts). The ability of a municipal debtor to reject collective bargaining agreements, and not satisfy the pre-conditions set forth in Section 1113 of the Bankruptcy Code, is an important issue in municipal bankruptcy cases, given that collective bargaining agreements often contain substantial liabilities of and future costs to a municipality.

#### *Pension Obligations*

Similar to collective bargaining agreements, a municipality's pension benefit plans often contain significant liabilities of a municipality. A court in a particular bankruptcy case may need to determine whether a municipal debtor's rejection of pension or retirement plans is subject to the same criteria as summarized above for rejecting a collective bargaining agreement or whether the claims of retirees are general unsecured claims. If a municipal debtor in Chapter 9 case is permitted to reject pension plan agreements or restructure the agreements in a plan of adjustment, related retirees of the municipal debtor may be treated like other general unsecured creditors and future benefits could be reduced or otherwise adversely affected, except possibly to the extent the pension plan obligations are secured by collateral or payable from funds held in a trust. *See generally, In re City of Prichard, Ala.*, No. 09-15000 (Bankr. S.D. Ala. March 10, 2010) (order denying retiree's motion for priority administrative expense claim). In many states, state statutes or a state constitution may preclude modification or reduction of pension or retiree benefits. The extent to which a municipal debtor in such a state can modify or reduce pension or retiree benefits under the Bankruptcy Code, and the extent to which the Bankruptcy Code may preempt such state law, is not fully resolved. In addition, whether a plan of adjustment of a municipal debtor that impairs unsecured bondholders but does not impair unsecured pension obligations satisfies the "fair and equitable" confirmation requirement of the Bankruptcy Code is also not fully resolved.

## **Municipal Leases**

Municipalities often finance the acquisition of equipment or the construction of certain projects through a lease structure instead of issuing long-term debt. Under such a lease structure, the municipality may often lease the related equipment or project from a lessor that is an affiliate of the municipality or an entity formed to engage in financings "on behalf of" such municipality. The leases in these financings will often contain a provision providing for its termination each year, without penalty to the municipality, unless funds are appropriated by the municipality to make required lease payments for the following year. These leases are often referred to as non-appropriation leases (or in some states, as abatement leases under which a municipality can affirmatively terminate the lease each year). The lessor under such lease will often issue revenue bonds to finance its acquisition of the equipment or its construction of the related project, and the lease payments due from the municipality will generally match the amounts due on the lessor's revenue bonds. Such a lease structure enables many municipalities to effectively finance the use or acquisition of equipment or the construction of projects without, among other things, issuing long-term debt that may require voter approval or that would otherwise need to be considered in connection with a municipality's debt limitations. The lease and related revenue bonds, however, are often intended by the parties to effectively operate as a long-term financing by the municipality and the bonds may be sold in the tax-exempt bond market. In addition, municipalities may also enter into non-appropriation leases directly, not using a revenue bond structure, under which the municipality is the direct lessee of the related equipment.

A clause in such a municipal lease providing for its termination if the municipal lessee fails to appropriate funds could lead a court to conclude that such lease is a "true lease" instead of a "financing lease" of the municipality. If the lease were treated as a true lease instead of a financing arrangement in a bankruptcy case of the municipality, the lease could be rejected by the municipality and the ability of holders of the related revenue bonds to recover the remaining amounts owed on the revenue bonds could be significantly limited. Such a result may be contrary to the parties' intention and the revenue bond holders' expectation that the municipal obligation

relating to the lease and the revenue bonds be treated in substance as a long-term financing of the municipality. Accordingly, Section 929 of the Bankruptcy Code specifies that a lease under which a municipal debtor is the lessee should not be treated as a “true lease” in the bankruptcy case of the municipal lessee solely because the lease is subject to termination upon a failure of the municipal lessee to appropriate rent. Section 929 of the Bankruptcy Code may also effectively override state statutes that would otherwise provide for the termination of a lease in the event the municipality fails to appropriate rent. In addition, if a lease is treated as a financing lease rather than a true lease, a municipal debtor would not be subject to the often burdensome requirement under Section 365 of the Bankruptcy Code to cure all defaults and provide adequate assurances of future performance under the lease as a condition to assuming the lease and maintaining the use of the equipment subject thereto.

It is important to note, however, that Section 929 does not determine whether a particular lease of a municipality constitutes a true lease or a financing lease. The limited scope of this Section is to preclude a finding that a lease constitutes a true lease solely because it will terminate upon a failure of the municipal lessee to appropriate rent. A court could still conclude in an appropriate case that a lease containing elements of a true lease (other than termination for nonappropriation of rent) constitutes a true lease.

A finding that a lease constitutes a true lease, and not a financing or debt arrangement, could have significant consequences. For example, a finding that a lease is a true lease could trigger a municipal debtor’s obligation to assume or reject the lease under Section 365 of the Bankruptcy Code and could provide the lessor with true lease remedies under applicable state law.

### **Post-Petition Financing**

During the continuance of a Chapter 9 bankruptcy case, a municipal debtor will have the same powers as such municipality had prior to filing bankruptcy and, unlike a Chapter 11 debtor, the municipality needs no court authority to borrow additional funds during the Chapter 9 proceeding. Additionally, as an incentive to post-petition lenders, the bankruptcy court in a municipal bankruptcy case may authorize a municipal debtor to obtain new credit by:

- (i) granting the lender an administrative priority (which provides for payment of post-petition debt before payments are allocated to unsecured pre-petition creditors);
  - (ii) granting a lien on property of the municipality that is not yet encumbered;
- or
- (iii) granting a junior lien on already-encumbered property.

If the municipality is unable to obtain credit either on its own or based on these provisions, then the bankruptcy court may in certain circumstances grant a superior lien on already-encumbered property or revenues. However, secured creditors whose collateral is subordinated in this manner will be entitled to adequate protection of their interests.

Although a municipality may not need bankruptcy court authorization to borrow funds, a municipal debtor may nevertheless need to satisfy any state law requirements or conditions to incurring debt. In addition, a post-petition lender may require a bankruptcy court order for various



reasons, including to confirm the municipal debtor's authority to incur the debt, to address the validity and priority of liens granted to the lender or to address remedies available for a municipal debtor's violation of the post-petition loan terms or an agreed post-petition budget, if any. However, as stated above, a municipal debtor may spend funds post-petition without bankruptcy court approval. Thus, unlike a Chapter 11 case, a bankruptcy court order in a Chapter 9 case will not be able to control the debtor's post-petition budget or spending.

### **Avoidance Powers**

Upon the filing of a bankruptcy petition, a municipal debtor obtains all the powers of a bankruptcy trustee to avoid preferential transfers and set aside fraudulent conveyances and certain post-petition payments or transfers. Should the municipality refuse to exercise these avoiding powers, the bankruptcy court may, on the request of a creditor, appoint a trustee to exercise such powers, but the trustee's authority will be limited to the exercise of these avoidance powers.

However, Section 926(b) provides that certain transfers of a debtor's property are not subject to the preference provisions of Section 547 of the Bankruptcy Code. Section 926(b) 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" as a preferential transfer under Section 547. Thus, a municipal debtor's pre-petition payments to holders of its bonds or notes should not be avoidable as preferences.

The scope of Section 926(b) has not been resolved in case law. Municipalities often use various forms of financing that are not expressly designated a "bond" or "note." These include, for example, different forms of leases, sale agreements and certificates of participation that, in effect, are financings and not true leases or sales. It can be argued that Section 926(b) should apply to these other forms of municipal financing and that this Section was not intended to be limited solely to a transfer on account of an obligation expressly designated a "bond" or "note." However, as noted, case law has not addressed or resolved the scope of Section 926(b).

### **Plan of Adjustment**

A municipality must file a plan for the adjustment of its debts either with its bankruptcy petition or at such later date as the bankruptcy court may fix. The provisions for confirming a plan of adjustment in Chapter 9 are largely incorporated from Chapter 11. A municipal debtor may modify its plan at any time prior to confirmation, provided that such modification is consistent with the requirements of Chapter 9.

A plan of adjustment proposed by a municipal debtor will classify each claim. Claims of a substantially similar nature typically are placed in the same class. Revenue bondholders whose bonds are payable out of funds from the same source may be placed into the same class. Revenue bonds having different maturity dates may also be placed into the same class. Generally speaking, revenue bondholders may be considered to have a secured claim equal to the value of the pledged revenues. Additionally, as mentioned above, pledged special revenues acquired by a municipality post-petition should remain as security for the related revenue bonds. The class or classes of unsecured creditors typically will include general obligation bondholders, unpaid employees, if applicable, and trade creditors.

*Certain Contents of a Plan*

A debtor's plan of adjustment must, among other things:

- (i) designate classes of claims, specifying any class of claim or interest that is not impaired under the plan. A class of claims is not impaired if the plan does not alter the legal, equitable or contractual rights of the claim holder. Thus, if the plan provides for curing any default, reinstating the original terms and compensating the holder for any actual damages incurred, then the claim will not be deemed impaired. Unimpaired classes are not entitled to vote on the plan;
- (ii) specify the treatment of any class of claims or interests that is impaired under the plan;
- (iii) specify the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such claim or interest; and
- (iv) provide the means for implementing 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 any new securities.

*Soliciting Creditors to Accept a Plan*

A municipal debtor may not solicit creditors to accept or reject its plan of adjustment unless, at the time of or before such solicitation, the holder receives a copy of the plan or a summary of the plan and a written disclosure statement. The disclosure statement provides background information and an explanation of the plan and must receive the approval of the bankruptcy court after notice and a hearing. At the hearing on the disclosure statement, the bankruptcy court will consider any objections to the disclosure statement. The disclosure statement will be approved by the court only if the court finds that the disclosure statement contains adequate information (or information that would enable a hypothetical investor to make an informed judgment about the plan).

*Confirmation of a Plan*

The standards for confirming a Chapter 9 plan of adjustment are generally similar to the standards for confirming a plan of reorganization under Chapter 11 of the Bankruptcy Code. The bankruptcy court must hold a hearing on confirmation, at which hearing any party in interest may object to confirmation (or file an objection before a specified deadline). In a Chapter 9 proceeding, a special tax payer may also object to confirmation of a plan. A "special tax payer" is the record owner of real property against which a special tax or assessment has been levied, which special

tax is the sole source of payment of an obligation issued by the debtor to defray the cost of improvements related to the real property.

Creditors which are impaired by the plan may vote to accept or reject the plan. In order to acquire the right to vote on a plan, a creditor must either file a proof of claim under the Bankruptcy Code or be listed as a creditor in the list of creditors filed by the municipality upon commencement of the case, unless the municipality lists the claim as disputed, contingent or unliquidated. If each class of creditors has voted to accept the plan, then the plan may be accepted. A class of claims has accepted the plan if at least two-thirds in amount and more than one-half in number of holders of claims of each class actually voting on the plan vote to accept the plan. In addition, generally speaking, the plan may be approved if at least one class of impaired claims has accepted the plan and the bankruptcy court has determined that “the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.” As an additional condition of confirmation, the plan must be feasible and in the best interest of creditors. The feasibility standard for confirmation of the plan refers to the ability of the debtor to make the payments proposed under the plan. A Chapter 9 plan may be considered feasible, for example, if expected tax revenues can support the plan payments.

A confirmed plan of adjustment binds the debtor and all creditors, even if the creditor’s claim was not allowed or the creditor did not accept the plan. However, a creditor with neither notice nor actual knowledge of the case may not be bound by the plan and such creditor’s debt may not be discharged.

If confirmation of the plan is denied by the bankruptcy court, then the bankruptcy court *must* dismiss the case. Mandatory dismissal provides an incentive to municipalities to formulate a confirmable plan in the first instance. A case may also be dismissed after confirmation of the plan if the municipality defaults under the plan. The bankruptcy court may retain jurisdiction over the Chapter 9 case for a period necessary to ensure successful execution of the plan. When the administration of the case has been completed, the bankruptcy court will close the case.

## **Committees**

The appointment of a committee of unsecured creditors in a Chapter 9 case is not required, but it is permitted. However, in a Chapter 9 case the municipal debtor is not required to pay the fees of the committee or its legal, financial or other professionals. Thus, absent an agreement or arrangement otherwise, members of a committee of unsecured creditors in a Chapter 9 case will need to compensate the professionals retained by the committee.

Other committees, such as retiree committees, have been organized or appointed in Chapter 9 bankruptcy cases.

## **Involuntary Cases**

Municipalities may be debtors only under Chapter 9 of the Bankruptcy Code. Pursuant to Section 303(a) of the Bankruptcy Code, involuntary bankruptcy proceedings may not be commenced under Chapter 9.

## **Discharge of Municipal Debt**

Although relatively few Chapter 9 cases have been filed, there generally has not been a significant reduction or forgiveness of principal owed by municipal debtors in connection with such bankruptcy cases. However, while some municipal bankruptcy cases have resulted in bondholders either being unimpaired or receiving principal and interest over a longer period of time, municipal bankruptcy cases are increasingly being used to, among other things, restructure or discharge certain debt, including certain bond debt, pension obligations and other liabilities.

### **Arguments to Invalidate Bonds**

Although not premised on the Bankruptcy Code, a few municipal entities have challenged the validity of certain bond issues under applicable state law bond requirements. For example, the City of Detroit and the Commonwealth of Puerto Rico, in their respective bankruptcy cases, challenged or threatened to challenge the validity of certain bond issues. Detroit asserted, in sum, that agreements of the City supporting payments on certain pension certificates should be viewed as debt, as opposed to being service contracts of the City. The City argued that such obligations, when viewed as debt, violated the City's debt limitations and were invalid and unenforceable obligations. Puerto Rico similarly asserted that certain of its bonds improperly exceeded its Constitutional debt limit and thus were not valid obligations. Counterarguments were advanced by bondholders or bond trustees, which included arguments respecting the appropriate remedies to be imposed even if the municipality's arguments were to succeed. While ultimate rulings on these issues were not reached by courts, such arguments reflect not only the type of issues that can be raised by a distressed municipal debtor, but also the potential ability to bring bondholders to the "bargaining table" by presenting them, in effect, with an all-or-nothing proposition.