

BANKRUPTCY PRACTICE

Expert Analysis

Chapter 9 Update: Limiting Jurisdiction in Municipal Bankruptcies

Since the publication of our two-part municipal bankruptcy series (see NYLJ, March 4, 2010, and May 6, 2010), the strain of rising pension costs, declining tax revenues, and onerous debt obligations has become more acute for many struggling municipalities. Recent decisions regarding Bankruptcy Code section 904, which constrains a bankruptcy court's oversight of a municipality's assets and spending power, have affirmed the proposition that a municipal debtor has full discretion to modify its obligations without court approval. Most recently, the courts presiding over the Stockton and Jefferson County cases have clarified the scope of section 904 to afford a municipal debtor the unfettered right to pay creditors on account of their prepetition claims during the pendency of its chapter 9 case.

Statutory Background

Chapter 9 has evolved over the years to keep up with the advances of municipal finance while also ensuring that the provisions of it do not encroach upon the municipal debtor's sovereignty. In drafting chapter 9 and its predecessor under the Bankruptcy Act of 1898, chapter IX, Congress had to take care not to vio-

JOHN J. RAPISARDI is a partner and the co-head of the financial restructuring department of Cadwalader, Wickersham & Taft and an adjunct professor at Pace University School of Law. MICHAEL J. COHEN and THOMAS J. CURTIN, associates of the firm, assisted in the preparation of this article.

By
John J.
Rapisardi



late the Tenth Amendment, which bars Congress from interfering with the sovereign affairs of the states. Indeed, in the 1930s, the Supreme Court struck down a jurisdictional provision of the statutory predecessor to chapter 9 as unconstitutional because it permitted bankruptcy courts to interfere with municipal property or revenues if such property was not necessary "in the opinion of the judge for essential governmental services."¹

New York City's fiscal crisis in the 1970s served as the genesis for the liberalization of the municipal bankruptcy laws because, at the time, the existing municipal bankruptcy provisions were woefully inadequate to deal with the restructuring needs of a city as large and complex as New York. In 1976, Congress liberalized and broadened many of the provisions of chapter IX to their current form as set forth in chapter 9 of the Bankruptcy Code of 1978. In particular, Congress further broadened the jurisdictional limitations by enacting section 904 of the Bankruptcy Code, deleting the phrase

"necessary for governmental services" from the jurisdictional provision. In its current form, section 904 provides that, absent a chapter 9 debtor's consent, a bankruptcy court "may not...interfere with...(1) any political or governmental powers of the debtor; (2) any property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income producing property."² Section 904 is a keystone in the interplay between federal bankruptcy powers and municipal sovereignty, and imposes significant limitations on the court's ability to issue orders that would "interfere" with the debtor's use of its property or revenues.

Recent Decisions

Over the past year, multiple bankruptcy courts have addressed the interplay of section 904 with other provisions in the Bankruptcy Code and the Judicial Code, and all have broadly interpreted section 904 to prohibit any court interference with the debtor's use of its property during the pendency of its case.³

• *Jefferson County I.* The chapter 9 filing by Jefferson County, Ala., in November 2011—the largest such filing as measured by total liabilities (over \$3 billion)—was precipitated by a default on its sewer warrant obligations and declining revenue. The warrants were secured by the net revenues of the sewer system, which the county was obligated to transfer to a revenue fund

account. The indenture required the county to transfer such revenues to a debt service account controlled by the indenture trustee.

Prior to the commencement of the county's chapter 9 case, the indenture trustee for the county's sewer warrants commenced a state court action seeking to enforce the terms of the indenture. The state court appointed a receiver and granted partial summary judgment in favor of the indenture trustee, finding that the county breached the terms of the indenture. Subsequently, the county commenced its chapter 9 case, and the indenture trustee requested that the bankruptcy court find, among other things, (i) that the state court retained exclusive jurisdiction over the sewer system such that a receiver was entitled to continue to manage the sewer system and (ii) that the automatic stay imposed by the Bankruptcy Code did not apply to the receiver.

Among other things, the court held that abstention from the county's bankruptcy case was not warranted under section 904. The indenture trustee and the receiver argued that, because the receiver, acting in its sovereign capacity, controlled the entire sewer system at the instruction of the state court, section 904 prohibited the bankruptcy court from doing anything that would impair or limit the receiver's or the state court's exercise of control over the sewer system properties. The court disagreed and held that section 904 applies only to municipal debtors. The receiver, according to the court, was not the debtor and, therefore, "literal interpretation of section 904 does not sustain abstention from the County case."⁴ Furthermore, the court noted that the receiver did not act in a sovereign capacity because its actions were taken by it on behalf of a private party, the indenture trustee, seeking to enforce the county's obligations under the indenture. Therefore, the court held that the provisions of section 904 did not apply to the receiver. *Jefferson County I* clarifies that section 904 applies only to a chapter 9 debtor,

regardless of whether a third party controls the debtor's property.

• *Jefferson County II*. On Dec. 19, 2012, the U.S. Bankruptcy Court for the Northern District of Alabama held that the exception to the automatic stay under section 959 of the Judicial Code (28 U.S.C. §959) does not apply to a municipal debtor because of the jurisdictional limitations imposed on courts by section 904.⁵ Section 959(a) provides that "trustees, receivers, or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property."⁶ This decision resolved a dispute between the city of Birmingham and Jefferson County over the county's decision to close an inpatient care unit at a county-owned hospital in Birmingham.

Chapter 9 has evolved to keep up with the advances of municipal finance while also ensuring that the provisions of it do not encroach upon the municipal debtor's sovereignty.

The city argued that the county's closure of the inpatient care unit without having another health care option in place for indigent citizens would violate the Alabama Health Care Responsibility Act (AHCRA). The city also argued that section 959 of the Judicial Code permitted the city to sue the debtor and certain of its officers to enforce the provisions of AHCRA.

The court disagreed, holding that, consistent with the Tenth Amendment's reservation of certain powers to states, Bankruptcy Code section 904 prohibits a bankruptcy court from interfering with a municipal debtor's political or governmental powers, property, and revenues without the debtor's consent. The court found that the absence of fed-

eral court control over a municipal debtor supported the proposition that Judicial Code section 959 should not be applied to constrain a chapter 9 debtor's ongoing operation of its assets, such as the county's operational decisions regarding the hospital unit.⁷ Accordingly, the court held that section 959 does not apply to chapter 9 cases and rejected the city's attempt to enjoin the county's closure of the hospital unit.

• *Stockton I*. In the face of severely declining tax revenues and rising pension costs, the city of Stockton, Calif., filed for chapter 9 on June 28, 2012. Along with its chapter 9 petition, Stockton implemented a pendency plan, pursuant to which the city would reduce certain benefits of the retirees during the pendency of the case. A group of retirees objected to Stockton's unilateral reduction of retiree benefits under the pendency plan and filed an adversary proceeding seeking to enjoin the city from unilaterally reducing their benefits, contending that such a reduction in benefits violated the Contracts Clause of the U.S. Constitution.

On Aug. 6, 2012, Judge Christopher Klein of the U.S. Bankruptcy Court for the Eastern District of California dismissed the retirees' proceeding, holding that, under its pendency plan, a chapter 9 debtor has the power to modify and impair certain creditors' interests during the pendency of a chapter 9 case with little, if any, limitation or oversight from the bankruptcy court.⁸ Klein stated that section 904 expressly "forbids the court from using any of its powers" to interfere with any property or revenues of the debtor. The court noted that section 904 contains such broad language that the court cannot use remedies that it may otherwise employ in chapter 11 (e.g., "no inherent authority power, no implied equitable power, no Bankruptcy Code section 105 power, no stay, no order, no writ") to interfere with a municipality regarding its political powers or the use of its property.⁹

As applied to this case, the court found that an injunction would prohibit

Stockton from using the “contents of its treasury,” which brought the proposed relief within the ambit of section 904(2).¹⁰ Accordingly, the court held that section 904 prohibited the court from granting injunctive relief because “section 904 prevents any federal court” from interfering with the debtor’s property and revenues.¹¹

• *Stockton II*. On Feb. 5, 2013, Klein held that section 904 gives a chapter 9 debtor the freedom to decide whether to ignore or to follow the compromise approval procedure set forth in Rule 9019 of the Federal Rules of Bankruptcy Procedure.¹² Accordingly, the court held that a municipal debtor is not required to seek court approval under Rule 9019 before entering into settlements with its prepetition creditors.

The history and plain language of section 904 compelled the court to conclude that the “bankruptcy court cannot prevent a chapter 9 debtor from spending its money for any reason, even foolishly or in a manner that disadvantages other creditors, unless the municipality consents to such judicial oversight.”¹³ According to the court, a municipal debtor’s settlement authority would necessarily fall within the purview of section 904 because it would involve the use of the municipality’s property and revenues. The court’s power to disapprove that settlement would constitute “the power to interfere,” and the power to interfere with a municipality’s property is precisely what Congress has withheld from the scope of federal courts’ authority in chapter 9 cases.¹⁴ Accordingly, the court found that based on section 904, a municipal debtor “can pay any debt in full without permission of this court.”¹⁵

The court disagreed with creditors who argued that a spate of unapproved settlements would lead to a creeping plan of adjustment. While the court acknowledged this possible outcome, the court ultimately concluded that “the day of reckoning comes at the plan confirmation hearing.”

Although the municipal debtor has unfettered discretion to enter into settle-

ments with its creditors during the pendency of its case, the court noted that an unfair settlement with a substantial creditor would likely make it difficult for the debtor to later confirm a plan of adjustment. Specifically, if any impaired class of claims does not accept the plan, then the city would be required, pursuant to Bankruptcy Code sections 943 and 1129(b), to prove that the plan “does not discriminate unfairly” and that the plan is “fair and equitable” with respect to the non-accepting impaired class. Furthermore, the city would also bear the burden of proving that the plan is proposed in good faith. According to the court, evidence of untoward settlements would be probative of these issues and would likely cast into doubt the confirmability of any proposed plan of adjustment.

Analysis

The Stockton and Jefferson County decisions illustrate the difficult position encountered by many creditors during the pendency of a chapter 9 case and further underscore the free reign that a municipal debtor enjoys during such period. *Stockton II*, however, should serve as a reminder that chapter 9 debtors will have to account for their actions during the chapter 9 case on the “day of reckoning,” which will occur at the time that confirmation of a plan of adjustment is sought.

Presumably, if a court finds that a debtor entered into any untoward settlements with its creditors during the pendency of its case, it would likely cast into doubt the confirmability of the plan of adjustment. Specifically, a municipal debtor must establish that its plan of adjustment satisfies a broad panoply of statutory provisions in the Bankruptcy Code, including: (i) section 943(b)(7), which requires that a plan is in the best interests of creditors and is feasible; (ii) section 1129(a)(2), which requires that the “proponent of the plan complies with the applicable provisions of this title”; and (iii) section 1129(a)(3), which requires that a debtor file its plan in good faith.

If the plan of adjustment violates any of these provisions, a bankruptcy court could reject the plan of adjustment and instruct the debtor to draft a plan that would be more acceptable. Furthermore, as the court noted in *Stockton II*, if a plan of adjustment is not confirmable because the debtor entered into unfair settlements with other prepetition creditors, the court may dismiss the case pursuant to section 930(a)(5). Ultimately, a municipal debtor might not want to risk having its case dismissed or prolong the confirmation of its plan of adjustment due to its inequitable behavior during the pendency of its case.

Conclusion

Based on the recent clarification of the scope of section 904, it will be interesting to see how courts continue to apply the section in other instances. Even though the *Jefferson County* and *Stockton* decisions may seem disheartening for creditors in chapter 9 cases, creditors should bear in mind that a municipal debtor will be held accountable for its actions once it seeks confirmation of its plan of adjustment.

.....●●.....

1. *Ashton v. Cameron Cnty. Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936) (emphasis added). Congress later deleted the phrase “in the opinion of the judge” from the statutory limitation on judicial interference with the municipal debtor’s property. The Supreme Court ruled that this prohibition was constitutional. *United States v. Bekins*, 304 U.S. 27 (1938).

2. 11 U.S.C. §904.

3. While a plethora of cases have dealt with section 904 over the past year, such cases’ broad interpretation of section 904 is not novel. Indeed, courts have previously recognized that, consistent with the Tenth Amendment, a bankruptcy court may not interfere with a municipal debtor’s use of its property. See, e.g., *In re New York City Off-Track Betting*, 434 B.R. 131 (Bankr. S.D.N.Y. 2010); *In re Addison Comty. Hosp. Auth.*, 175 B.R. 646 (Bankr. E.D. Mich. 1994).

4. *In re Jefferson County, Ala.*, 474 B.R. 228, 289 (Bankr. N.D. Ala. 2012) (*Jefferson County I*).

5. *In re Jefferson County, Ala.*, 484 B.R. 427 (Bankr. N.D. Ala. 2012) (*Jefferson County II*).

6. 28 U.S.C. §959(a).

7. *In re Jefferson County, Ala.*, 484 B.R. at 462.

8. *In re City of Stockton, Cal.*, 478 B.R. 8 (Bankr. E.D. Cal. 2012) (*Stockton I*).

9. *Id.* at 13.

10. *Id.*

11. *Id.*

12. *In re City of Stockton, Cal.*, No. 12-32118, 2013 WL 611060 (Bankr. E.D. Cal. Feb. 5, 2013) (*Stockton II*).

13. *Id.* at *4.

14. *Id.*

15. *Id.*