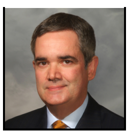
INSIDE THE MINDS

Chapter 9 Bankruptcy Strategies

A Big Stick, Rarely Used

Leading Lawyers on Navigating the Chapter 9 Filing Process, Counseling Municipalities, and Analyzing Recent Trends and Cases



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Introduction

The modern Chapter 9 predates the Bankruptcy Code by several years, though municipalities rarely take advantage of its potential benefits. In fact, despite the recent economic crisis, only twenty-four entities have filed for Chapter 9 since 2008, and in total, only 241 entities have filed since 1980. *See Annual and Quarterly US Bankruptcy Statistics*, AM. BANKR. INST., May 31, 2011, http://www.abiworld.org/statcharts/Chapter9through2Q2010.pdf. While this might suggest that Chapter 9 offers little value to municipalities, the truth is Chapter 9 can be a highly effective tool for municipalities to reduce and restructure their debt obligations.

We will begin this chapter with a brief history of Chapter 9 and then analyze the numerous benefits that Chapter 9 provides to a municipal debtor. The primary benefit of Chapter 9 is that it provides municipalities with breathing space to negotiate with creditors and resolve liquidity issues. To that end, the filing of a Chapter 9 petition effectively enjoins all prepetition creditors' collection efforts through the imposition of the automatic stay. Additionally, municipalities cannot be forced into bankruptcy, and only a municipal debtor can file a plan. These facts limit creditors' leverage in a Chapter 9. Furthermore, municipalities have significant leverage to reject collective bargaining agreements in bankruptcy. These and other benefits gird the Chapter 9 debtor with a versatile arsenal to keep its creditors at bay, whether as a threat prior to filing for bankruptcy or as a big stick during the case.

Next, we address the reasons why so few municipalities have filed for Chapter 9. Most of the reasons have nothing to do with the Bankruptcy Code. Instead, other factors keep municipalities from filing. Most notably, applicable state law limits which entities can file; only twenty-six states permit any of their municipalities to file for Chapter 9. Second, political realities cause elected officials to shy away from Chapter 9. Third, local governments fear the impact a Chapter 9 filing could have on the municipality's ability to secure ongoing financing post-bankruptcy and fear the unknown that awaits them, just as corporate debtors fear the unknowns associated with Chapter 11.

Finally, we provide a summary of several municipalities' recent efforts to avoid Chapter 9 and, for comparison purposes, a summary of the city of Vallejo's Chapter 9 case and the process leading up to the city of Central Falls' filing.

Chapter 9: A Brief History

Until the Great Depression, municipalities could not seek bankruptcy protection. However, in the wake of the economic crash, many municipalities could not service their bond debts because of overwhelming unemployment and economic devastation. *See Ashton v. Cameron County Water Improvement Dist.,* 298 US 513 (1936) (Cardozo, J., dissenting). In response, Congress passed the first municipal bankruptcy act (Chapter 9 of the Bankruptcy Act) in 1934 to alleviate this national emergency. The United States Supreme Court initially struck down the 1934 Act, but Congress passed revised legislation in 1937 that passed Supreme Court muster.

From the 1930s through the 1960s, few municipalities filed for Chapter 9. Most of these were small rural jurisdictions that filed in the face of the Great Depression. However, municipal finances became far more complex through the 1950s and 1960s. Municipalities found the original Chapter 9 too limited to use effectively and faced few options to restructure their debt. This limitation was underscored when New York City found itself facing default in 1975.

Chapter 9's Limits

The original Chapter 9 was an ineffective tool for a municipal debtor of New York City's size and complexity for a number of reasons. First, Chapter 9 required 51 percent of a municipality's creditors to accept a proposed plan of composition before the municipality could file its petition for bankruptcy. See Bankruptcy Act of 1898, § 83(a) (repealed 1979). Given the volume of New York City's bondholders and other creditors, this requirement would have been prohibitively expensive and time-consuming, if not impossible to meet.

Second, Chapter 9 did not allow a municipal debtor to obtain additional financing through certificates of indebtedness, preventing the municipality from obtaining capital when it was most needed. *See Id.* at §§ 116(2), 344. Finally, Chapter 9 did not allow a municipality to accept or reject executory contracts, including collective bargaining agreements, rendering a bankruptcy of little use. *See Id.* at §§ 116(1), 313(1).

In response to this crisis, Congress amended Chapter 9 in 1976 to remedy these shortcomings and allow large municipalities such as New York City to file for bankruptcy relief. For example, the 1976 amendments provided for an automatic stay upon the filing of a petition and allowed municipalities to file for bankruptcy protection if prepetition negotiations with creditors were impracticable. *See Id.* at §§ 84(3), 85(e)(1). In 1978, Congress incorporated this revised municipal bankruptcy scheme into the new Bankruptcy Code under Chapter 9, which has been amended only modestly over the intervening thirty years.

The Big Stick: Understanding the Benefits of Chapter 9

The scheme created by Congress in the 1970s can be an effective restructuring tool for a municipal debtor for a number of reasons, including its limited court oversight, significant flexibility for municipalities to drive the Chapter 9 case, flexible standards to cram down a plan on dissenting creditors, and simplified rejection of union collective bargaining agreements. Chapter 9 can be a more potent restructuring tool than even Chapter 11, and lenders have a significant incentive to work with municipalities to avoid a Chapter 9 filing.

Bankruptcy Courts' Oversight

Congress and the courts have long had concerns about the constitutional implications of Chapter 9. Under the Tenth Amendment to the United States Constitution, "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." The Supreme Court found the proposed 1934 Act unconstitutional because "nothing . . . tends to support the view that the federal government, acting under the bankruptcy clause, may impose its will and impair state powers–pass laws inconsistent with the idea of sovereignty." *See Ashton v. Cameron County Water Improvement Dist.,* 298 US 513, 531 (1936).

To address this concern, Congress enacted Section 904 of the Bankruptcy Code as part of Chapter 9, which limits the bankruptcy court's power to interfere with the municipal debtor's ability to use its property, raise taxes, and make expenditures. *See* 11 U.S.C. § 904 (2011). Congress also enacted Section 109(c)(2), which limits Chapter 9 to those entities that are expressly authorized to file under state law. *See Id.* at § 109(c)(2). As a result, municipal debtors are subject to far less court oversight than corporate debtors and generally conduct their affairs without seeking court approval. This gives creditors little ability to influence municipal affairs during the course of a case and provides few leverage points for creditors.

Debtors Not Limited to Exclusivity Period

There is no exclusive period in Chapter 9, or to put it more accurately, exclusivity lasts for the duration of the bankruptcy since only the municipality may file its own plan of debt adjustment, as Chapter 9 plans are called. As such, lenders cannot force a municipal debtor to confirm a plan by any specific time and creditors cannot file a competing plan, which has the potential to give municipal debtors almost unfettered control over how and when to emerge from bankruptcy.

While the Bankruptcy Code requires a municipality to file its plan of debt adjustment with the Chapter 9 petition, or by a later date as fixed by the court (*see* 11 U.S.C. § 941 (2011)), a bankruptcy court is not required to dismiss the case for failure to comply with this requirement. *See Id.* at § 930. Even if the municipality files a plan on the petition date, Chapter 9 does not specify any required steps or timing to advance the confirmation process. Without exclusivity or a competing plan to apply pressure, the municipality can proceed at whatever pace it desires. Thus, lenders have a significant incentive to work with municipalities to avoid a Chapter 9 filing, giving municipalities a big stick prior to filing and significant leverage during the case to modify outstanding debt.

The Standards for Cramdown in Chapter 9

The relaxed standards for cramdown heighten the municipality's leverage during a Chapter 9 case. Chapter 9, like Chapter 11, permits a debtor to "cramdown" a plan of debt adjustment on dissenting creditors. As in

Chapter 11, a class of impaired claims is deemed to have accepted the plan if one-half of the total number of claims in the class and two-thirds of the total dollar amount of claims in the class accept the plan. Additionally, if a class of impaired claims rejects the plan, the plan can still be confirmed if at least one class of impaired claims accepts the plan, and the plan does not unfairly discriminate and is fair and equitable with respect to the rejecting classes. This process is referred to as "cramdown."

To confirm a plan of debt adjustment, 11 U.S.C. § 943 requires that a municipal debtor demonstrate that the plan is in the best interests of creditors. This is slightly different from the best-interest test espoused in Chapter 11. Under Chapter 11, the plan of reorganization is in the best interests of the creditors if creditors would receive as much under the plan as they would if the debtor was liquidated under Chapter 7.

By contrast, under Chapter 9 liquidation value is not a benchmark against which a creditor's recovery is measured because unlike an ordinary business, a municipality cannot liquidate. Therefore, in applying a different best interests test in Chapter 9, courts have concluded that a plan is in the creditor's best interest if it provides a better recovery than other alternatives available to the creditors, such as the state law remedies available to a creditor outside of municipal bankruptcy. This standard provides municipalities with extraordinary flexibility in restructuring municipal debt.

In addition, to confirm a plan of debt adjustment, a municipal debtor must prove that the proposed plan is "fair and equitable." *See* 11 U.S.C. §§ 901, 1129(b)(2)(A),(B) (2011). Under Chapter 11, a plan of reorganization is "fair and equitable" with respect to secured creditors if such creditors (1) retain their liens on their prepetition collateral and receive deferred payments on account of their claims; (2) are given the right to credit bid their claims if their collateral is sold free and clean of their liens and have those liens attach to the proceeds of such sale; or (3) receive the indubitable equivalent of their claims. *See id.* at § 1129(b)(2)(A). Similarly, a plan of reorganization is "fair and equitable" with respect to unsecured creditors if such creditor receives or retains property with a present value equal to their claims or if the holders of a junior class of claims receive nothing under the plan on account of their junior claims. *See id.* at § 1129(b)(2)(B).

In Chapter 11 cases, the definition of "fair and equitable" goes to the heart of disputes over collateral value, the appropriate interest rate for the post-confirmation debt secured by liens retained by a secured creditor, and whether plan consideration constitutes an "indubitable equivalent" of a secured creditor's claim. These issues are typically resolved in Chapter 11 by comparing a creditor's treatment under the plan to what it would receive in a liquidation, valuing the corporation as a going concern, and determining whether the value of replacement collateral is the indubitable equivalent of a secured creditor's claims.

In a Chapter 9 case, however, the "fair and equitable" analysis is not as straightforward because liquidation is not an option, a municipality's going concern is not readily ascertainable, and state law may restrict a municipality from granting replacement liens on municipal property. As such, some courts have responded to the differences in Chapter 9 by implementing a more subjective "fair and equitable" test that looks to whether the plan "embodies a fair and equitable bargain, openly arrived at and devoid of overreaching." *See Town of Belleair, Fla. v. Groves*, 132 F.2d 542, 543 (5th Cir. 1942). This means generally that the plan is "fair and equitable" in Chapter 9 if "the amount to be received by the bondholders is all that they can reasonably expect in the circumstances. *See Lorber v. Vista Irrigation Dist.*, 127 F.2d 628, 639 (9th Cir. 1942) (citations omitted). This subjective standard, coupled with the politically charged nature of any Chapter 9 case, would tend to make this critical analysis all the more complicated for a bankruptcy court.

Rejection of Union Contracts

Chapter 9 permits a municipal debtor to reject union contracts under a relatively modest standard, which is far less rigorous than in Chapter 11. Indeed, some observers view Chapter 9 as a potential union-busting tool. This lower standard has the potential to leave unions with little negotiating leverage. The City of Vallejo used this tool effectively, renegotiating its collective bargaining agreements and reducing its salary and benefit obligations. However, despite the allure of Chapter 9 as a union-busting tool, politics may negate this potential advantage. Unions often represent powerful interests that few politicians seek to anger by unilaterally rejecting collective bargaining agreements.

Why Do More Municipalities Not File?

Despite the numerous benefits, few municipalities have actually filed for Chapter 9. Municipalities shy away from Chapter 9 for a number of reasons. Most notably, Chapter 9 has strict eligibility requirements, preventing certain distressed municipalities from filing for Chapter 9. Also, the political risks of filing are significant; elected officials fear elevated costs for future financing and unknown results in Chapter 9, mainly due to a relative paucity of other cases.

Strict Eligibility Requirements

Chapter 9 is restricted to a limited number of potential entities. To qualify for Chapter 9 bankruptcy protection, an entity must qualify as a municipality; have specific state authorization; be insolvent; desire to effect a plan to adjust its debts; and negotiate with its creditors in good faith. *See* 11 U.S.C. § 109(c) (2011).

Defining "Municipality"

The key question for entities seeking Chapter 9 protection is what constitutes a municipality? The Bankruptcy Code defines a municipality as a "political subdivision or public agency or instrumentality of a State," (*see* 11 U.S.C. §101(40) (2011)); that definition has been interpreted to include cities, town, villages, counties, taxing districts, municipal utilities, and school districts. States, however, cannot file for Chapter 9.

Some courts have taken a narrow view of who may file. Most notably, in 2010 the Bankruptcy Court for the District of Nevada held in a Chapter 11 case that the Las Vegas Monorail was not eligible for Chapter 9, because the monorail did not engage in traditional governmental functions such as taxation and education, Nevada lacked day-to-day control over the monorail, which was run by a separate entity, and state law did not treat the monorail as an instrumentality of Nevada. *See In re Las Vegas Monorail Co.*, 429 B.R. 770, 795-800 (Bankr. D. Nev. 2010).

State Law Authorization

In addition, state law must specifically authorize a municipality to file for Chapter 9. *See* 11 U.S.C. § 109(c)(2) (2011). Only eighteen states explicitly empower municipalities to file for Chapter 9 (Alabama, Arizona, Arkansas, California, Colorado, Florida, Idaho, Iowa, Minnesota, Missouri, Montana, Nebraska, New York, Oklahoma, Oregon, South Carolina, Texas and Washington) and eight other states attach preconditions to filing (Connecticut, Kentucky, Louisiana, Michigan, New Jersey, North Carolina, Ohio and Pennsylvania). Twenty-three states and the District of Columbia have no authorization statute (Alaska, Delaware, District of Columbia, Hawaii, Illinois, Indiana, Kansas, Maine, Maryland, Massachusetts, Mississippi, Nevada, New Hampshire, New Mexico, North Dakota, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin, and Wyoming) and Georgia explicitly prohibits its municipalities from filing for Chapter 9. Thus, even a municipality may file only in half the states and roughly, a third of those states impose significant restrictions on a filing. These two requirements reduce substantially the number of entities eligible to file for Chapter 9.

Other Requirements

To qualify for Chapter 9, a municipality also must be insolvent, as measured by a cash flow test and not the standard balance sheet test. *See* 11 U.S.C. § 109(c)(3) (2011). While not a high legal threshold, this financial requirement by definition weeds out many potential filers. *See In re City of Bridgeport*, 129 B.R. 332, 339 (Bankr. D. Conn. 1991) (dismissing the city of Bridgeport's Chapter 9 petition because the city was not insolvent).

The municipality must also "desire[] to effect a plan to adjust [its] debts." *See Id.* § 109(c)(4). Courts have found that to meet this requirement, the municipality must show that its purpose in filing the Chapter 9 petition is to resolve claims, rather than to "buy time or evade creditors." *See Int'l Ass'n of Firefighters, Local 1186 v. City of Vallejo (In re City of Vallejo),* 408 B.R. 280, 295 (B.A.P. 9th Cir. 2009). Finally, a municipality must negotiate with its creditors prior to filing or demonstrate that doing so would not be worthwhile.

Only if a debtor satisfies these requirements is it entitled to file a petition under Chapter 9 of the Bankruptcy Code. These strict eligibility requirements all but guarantee that, regardless of financial need or economic logic, many distressed entities will not be able to file for bankruptcy under Chapter 9.

Political Risks

Elected officials fear the political impacts of filing for Chapter 9. It is hard to imagine an elected official with a desire to be re-elected or run for higher political office filing a municipality for bankruptcy unless absolutely unavoidable. The potential negative advertising is easy to construct. It is likely that the only elected officials who can take advantage of the Bankruptcy Code are those who are out of viable alternatives. So long as political concerns take priority over the benefits of a potential Chapter 9 filing, it will only be used by municipalities in utter *extremis*.

Increased Borrowing and Administrative Costs

Filing for Chapter 9 could also raise the cost for future borrowing by the municipality, at least in the near term. Some critics exaggerate this concern, asserting that a municipality will never again be able to borrow. This risk is overstated; just as post-bankruptcy commercial debtors have little difficulty obtaining future financing, municipalities should be able to obtain post-bankruptcy funding as well.

Additionally, the administrative costs associated with a Chapter 9 bankruptcy are significant. For example, the city of Vallejo has paid over $10 million in legal fees and other administrative costs during its Chapter 9 case. *See* Alison Vekshin & Martin Z. Braun, *Vallejo's Bankruptcy 'Failure' Scares Cities Into Cutting Costs*, BLOOMBERG, Dec. 14, 2010, http://www.bloomberg.com/news/2010-12-14/vallejo-s-california-bankruptcy-failure-scares-cities-into-cost-cutting.html. As a result, only a true reformer campaigning on a promise to clean up a particular financial disaster, or perhaps a person appointed for that purpose, is likely to consider filing a large municipality for Chapter 9.

Fear of the Unknown

While all potential debtors fear bankruptcy because they do not know how it will play out, this fear is particularly acute in Chapter 9 because few municipalities have filed and applicable precedent is scant. However, potential political impact aside, public officials should not fear the legal process. Chapter 9 provides municipalities with extraordinary leverage and control over the bankruptcy process and a rare opportunity to curtail sharply their debt obligations.

Analyzing Recent Chapter 9 Cases

In recent years, a number of municipalities have considered alternatives to bankruptcy for as many as three years or more without taking any decisive action, which is consistent with elected officials' desire to avoid Chapter 9 at all costs. In contrast to municipalities such as Jefferson County, Alabama, and Harrisburg, Pennsylvania, the city of Vallejo (California) filed for Chapter 9 and, after several years, confirmed a plan to restructure its debt obligations and modify its collective bargaining agreements. Most recently, Central Falls, Rhode Island, filed for Chapter 9 in August of 2011 due to overwhelming retiree obligations; that case is in the early stages.

To follow is a summary of several municipalities' recent efforts to avoid Chapter 9 and, for comparison purposes, a summary of the city of Vallejo's Chapter 9 case and the process leading up to the city of Central Falls' filing.

Jefferson County, Alabama

Jefferson County's financial woes predate the 2008 market crash. The county has been working to restructure more than $3 billion in sewer debt, primarily funded by auction rate securities, since early 2008, and in 2009 former Birmingham Mayor Larry Langford was convicted of, *inter alia*, bribery, conspiracy, fraud, and money laundering in connection with the sewer project. *See* Jay Reeves, *Larry Langford, Birmingham, Ala., Mayor, Convicted of Taking Bribes*, HUFFINGTON POST, Oct. 28, 2009, http://www.huffingtonpost.com/2009/10/28/larry-langford-birmingham_n_337922.html. In the aftermath of the market crash, the market for auction rate securities froze, and the county was unable to refinance or meet its obligations.

In the subsequent three years, the county has negotiated a string of debt forbearances while trying to resolve the debt consensually. In 2009, in an effort to help pay down the debt, the county passed an occupation tax that would have provided one-third of the county's general fund reserves. In late 2010, an Alabama state judge appointed a receiver for the county's sewer system. On March 16, 2011, the Supreme Court of Alabama struck down the new local occupation tax as unconstitutional, limiting the county's ability to bring in revenues and pay its debts. See *Jefferson County v. Weissman*, No. 1100293, 2011 WL 892375 (Ala. Mar. 11, 2011).

In the first half of 2011, Jefferson County retained FTI Consulting Inc., to advise it of its options, to analyze its budget, and to recommend next steps. FTI found that the county lacked adequate reporting systems and capabilities and that the recent invalidation of the occupation tax created a severe cash flow and liquidity issue for the county. *See Report of FTI Consulting to Jefferson County, Alabama,* at 5, Apr. 11, 2011. FTI recommended a variety of cost-cutting approaches for the county and encouraged it to consider Chapter 9 to modify certain obligations. *Id.* at 20.

Subsequently, Jefferson County proposed a restructuring of the sewer debt to reduce its obligations to approximately $2 billion, while raising sewer rates by eight percent. On July 26, 2011, the county voted to retain bankruptcy counsel but deferred a vote scheduled for July 28, 2011, to consider whether to file for Chapter 9. As of publication, Jefferson County continues to weigh its options and has not yet filed for Chapter 9. However, even if the county does eventually file, it will come after more than three years of negotiations, evincing a clear desire by the county to avoid bankruptcy at any cost and a lack of leverage by the creditors.

Harrisburg, Pennsylvania

Like Jefferson County, the city of Harrisburg, Pennsylvania, has faced financial distress springing from a specific system or project that dates back several years.

Harrisburg incurred $242 million in debt on an incinerator project, including bonds, a swap agreement, and a note, all secured by the proceeds of the incinerator. The city of Harrisburg, as well as the surrounding county, guaranteed the debt and the incinerator project defaulted on its obligations in late 2010.

At that time, Harrisburg could not meet its guaranty obligations. Subsequently, a number of entities have sued Harrisburg for payment of the guaranty obligation, and sued the entity charged with operating the incinerator, the Harrisburg Authority, for failure to meet its loan obligations. In late 2010, Harrisburg retained counsel to recommend next steps, including proceeding under Chapter 9 or under a state law, known as Act 47, for the rehabilitation of Pennsylvania municipalities.

In March 2011, Harrisburg's advisors issued reports recommending strategies for restructuring the city's obligations. *See, e.g.,* Cravath, Swaine & Moore LLP, *Evaluation of Alternatives Available to the City of Harrisburg to Address Its Current Financial Situation,* March 31, 2011, http://remote.cravath.com/Harrisburg.pdf. In June, the state issued a required report under Act 47, making recommendations for how the city should restructure its obligations. *See Municipal Financial Recovery Act Recovery Plan,* City of Harrisburg, June 13, 2011.

Subsequently, Harrisburg has done little, at least publicly, to resolve its debt woes, probably because its lenders lack the leverage to force municipalities to take action to restructure their debts. The creditors cannot force an involuntary Chapter 9, and courts typically prevent creditors from foreclosing on municipal property to avoid the disruption of governmental services. *See, e.g., Monell v. Dep't of Soc. Servs.,* 436 US 658, 673 (1978); *Barkley v. Levee Comm'rs*, 93 US 258 (1876).

Vallejo, California

The city of Vallejo, with approximately 120,000 residents, is the largest municipality to file for bankruptcy in recent years. Vallejo primarily sought relief from its labor obligations and filed in 2008. Vallejo remained in bankruptcy for more than three years before finally emerging in July 2011. In addition to demanding significant attention from Vallejo's top employees and presumably having detrimental effects on the city's elected officials, the bankruptcy cost the municipality more than $10 million in administrative costs.

Despite these burdens, Vallejo's plan of debt adjustment included the following beneficial changes: reduced payments to certain bondholders by as much as 50 percent; reduced health care obligations, and renegotiated union contracts. *See* Jane Wells, *A New Chapter for Vallejo,* CNBC, July 28, 2011, http://www.cnbc.com/id/43932782. Vallejo, however, was unable to reduce its pension obligations.

Central Falls, Rhode Island

The city of Central Falls, Rhode Island, is the latest entity to file for Chapter 9. Central Falls entered receivership more than a year prior to filing because the small city was unable to pay more than $80 million in retirement benefits to police officers and fire fighters. The receiver worked aggressively to conserve cash in recent months, closing the town's library and other public facilities. Nevertheless, in October 2011, the retiree pension funds will run out of cash and Central Falls cannot refill the pension fund's coffers due to limited cash. As a result, the city requested that retirees accept reduced benefits in an effort to "save the city." *See* Erika Niedowski, *Central Falls Bankruptcy Decision Set for Monday*, BOSTON.COM, July 29, 2011, http://www.boston.com/news/local/rhode_island/articles/2011/07/29/central_falls_retirees_not_ready_to_accept_cuts/.

After the retirees rejected these proposals, Central Falls filed for Chapter 9 in August 2011. The impact of Central Falls' filing is unclear, particularly given a recently enacted state law that, among other things, purports to change the nature of a general obligation bond from an obligation backed solely by the full faith and credit of the issuer to a secured obligation backed, in addition, by a pledge of taxes and other revenues in the issuer's general fund. *See An Act Relating to Towns and Cities - Indebtedness of Towns and Cities*, H 5736A (R.I. 2011); *see also* Michael Corkery, *Bondholders Win in Rhode Island*, WALL ST. J., Aug. 4, 2011, http://online.wsj.com/article/SB10001424053111903885604576486610528775994.html. But this law raises a number of constitutional and bankruptcy-related issues.

First, the Rhode Island law seems designed to take advantage of the treatment given to "special revenue" bonds under Chapter 9. "Special

Revenues" include, *inter alia*, receipts derived from certain projects, systems, services or functions of the debtor, special excise taxes and certain other taxes, but exclude (among other things) general property taxes. *See* 11 U.S.C. § 902(2) (2011). Under Section 928 of the Bankruptcy Code, special revenue bonds continue to be secured and serviced during the Chapter 9 case. *See Id.* at § 928.

By contrast, a municipality is not required to service its general obligation bonds during a Chapter 9 case. However, applying the statute to the Central Falls bonds could be viewed as a change in the classification of the general obligation bonds, *post-issuance*, thus raising constitutional contract clause questions. Further, even if the classification is not changed, the question arises as to whether the state law creating priority within the same class of claims will be respected in bankruptcy.

Sections 901 and 1129(b)(1) of the Bankruptcy Code guarantee equality of treatment between similarly situated creditors, such as general unsecured creditors holding general obligation bonds and other general unsecured creditors. *See* 11 U.S.C. §§ 901, 1129(b)(1) (2011). The bankruptcy court in *Vallejo* dealt with a similar issue regarding Vallejo's ability to reject its collective bargaining agreements and observed, *in dicta*, that bankruptcy law preempts state labor law by operation of the Supremacy Clause of the US Constitution. See *In re City of Vallejo*, 403 B.R. 72, 76-77 (Bankr. E.D. Cal. 2009) ("Assuming for the sake of argument that California law superimposes its labor laws onto Section 365, such law would be unconstitutional."), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010). It remains to be seen, however, how the Central Falls' bankruptcy court or others will rule on similar issues. As such, the Central Falls bankruptcy likely will be the subject of intense debate and scrutiny for years to come.

Conclusion

Municipalities such as Jefferson County and the city of Harrisburg have stared bankruptcy in the face for years but resisted filing. Those municipalities should give consideration to a Chapter 9 filing. Both jurisdictions could use the threat of Chapter 9 to pressure lenders into settlement, and to some extent, they have tried to do so. Chapter 9 provides significant leverage to municipalities, something they may need to complete an effective restructuring.

However, it is a big stick that many elected officials are reluctant to use for fear of political consequences. But by embracing the potential leverage offered by Chapter 9 and working with legal and financial advisors with experience in restructuring, municipal finance, pensions, and collective bargaining, municipalities may gain the upper hand in negotiations and achieve greater success in an out-of-court restructuring.

Key Takeaways

- Chapter 9 is an effective tool for municipalities to reduce and restructure their debt obligations because it provides municipalities with breathing space to negotiate with creditors and resolve liquidity issues through the imposition of an automatic stay.
- Lenders have a significant incentive to work with municipalities to avoid a Chapter 9 filing; lenders cannot force a municipal debtor to confirm a plan and creditors cannot file a competing plan, which gives municipal debtors control over how and when to emerge from bankruptcy.
- Filing for Chapter 9 may raise the cost for future borrowing by the municipality, at least in the near term, but this risk is overstated; just as post-bankruptcy commercial debtors have little difficulty obtaining future financing, municipalities should be able to obtain post-bankruptcy funding as well.
- No politician wants to be the one to call for a Chapter 9, but the threat of filing for Chapter 9 could give municipalities significant leverage in negotiating debt restructuring.

ABOUT THE AUTHORS

John J. Rapisardi, *a partner at Cadwalader, Wickersham & Taft LLP, co-chair of the Financial Restructuring Department, and a member of the firm's Management Committee, has more than twenty-eight years of domestic and international restructuring experience across a variety of industries, including automotive, casinos, chemical, health care, retail, real estate, satellite, sports franchises, textile, and telecommunications.*

Consistently commended as one of the leading restructuring lawyers in the US by Chambers USA*, the 2010 guide described Mr. Rapisardi as "key to the firm's work for LyondellBasell," with "an eminent national reputation for his expertise in domestic and international restructurings and an extraordinary knowledge and skill set." Similarly the* US Legal 500 *named Mr. Rapisardi among their Elite Leading Lawyers and noted that he is "a first rate restructuring lawyer – he combines knowledge of the law with the correct demeanor necessary to press his client's agenda without allowing his ego to interfere with success" and "superb and fantastic." Mr. Rapisardi has also been named as a highly recommended international restructuring counsel in* PLC Cross-border Restructuring and Insolvency Handbook *and is included in* Best Lawyers in America.

The Deal *named Mr. Rapisardi to its quarterly list of Top Lawyers in Bankruptcy Law, where his matter activity by value of assets for the fourth quarter of 2010 placed him in ninth position. Recognized by the Global M&A Network as Restructuring Advisor of the Year, Mr. Rapisardi also received a Turnaround Atlas Award for his work in 2008/2009. In 2009, he received the Annual Leadership Award from Pace University School of Law. Additionally, he was named to Turnarounds & Workouts list of Outstanding Restructuring Lawyers for 2009.*

As a leader of Cadwalader's prestigious Financial Restructuring team, Mr. Rapisardi has helped the team garner top recognition in the US News & World Report *as a National Tier One firm for bankruptcy law, in* Law360 *as a 2010 Bankruptcy Group of the Year and in the* Financial Times Innovative Lawyers Report *in which the firm was one of only three firms ranked as "standout" for exceptional work in 2010 in the automotive sector for advising the US Treasury Department Presidential Auto Task Force in the historic restructuring of General Motors and Chrysler and in the restructuring category for its work on the Chapter 11 of petrochemical giant LyondellBasell. The Financial Restructuring team is also continually ranked among the top firms by* Chambers, IFLR, *and* Legal 500.

Mr. Rapisardi has advised investors and financial institutions and written extensively on the subject of lender rights and remedies under the new Chinese Bankruptcy Code. He is co-author of The PRC Enterprise Bankruptcy Law: The People's Work in Progress *(Beard Group, Inc., 2008) and, for the past fifteen years, has been a regular bankruptcy columnist for the* New York Law Journal.

A Beta Gamma Sigma graduate from the College of Business Administration at Fordham University, Mr. Rapisardi received his LLM from New York University and his JD from Pace University where he served on the Pace Law Review *After law school, Mr. Rapisardi clerked two years for the then chief bankruptcy judge of the Southern District of New York.*

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*Mr. Stromfeld is the founder and head of Cadwalader's "historically famed ... leading municipal derivatives practice" (*Chambers USA*). He has advised clients in connection with a number of distressed municipal credits, and represented the International Swaps and Derivatives Association (ISDA) in designing credit default swaps on municipal entities. He also served as counsel to ISDA on an amicus brief filed in the Second Circuit Court of Appeals, which cited the brief in reversing the lower court's interpretation of ISDA's credit derivatives documentation.*

US Legal 500 *recognized Mr. Stromfeld as "first class, a true expert, in the municipal derivatives field" and named him among their Elite Leading Lawyers. He has also been recognized as a ""Capital Markets/Derivatives specialist" by Euromoney Guide to the World's Leading Securitization Lawyers, in the inaugural and each subsequent edition of* SuperLawyers *(New York), and in the inaugural and each subsequent annual publication of* Chambers Global - The World's Leading Lawyers and Chambers USA –America's Leading Lawyers. *He has also been recognized as a leading lawyer by* IFLR 1000.

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Douglas S. Mintz *is special counsel in Cadwalader, Wickersham & Taft LLP's Financial Restructuring Department, resident in the Washington, D.C. office. He has experience in all aspects of bankruptcy and restructuring, representing secured lenders, debtors, and official and ad hoc creditors' committees. Mr. Mintz served as the lead associate in Cadwalader's representation of United States Treasury in the restructuring of Chrysler, a deal named* M&A Advisor*'s Magnus Deal of the Year for 2009.*

Mr. Mintz has played a key role in some of the largest DIP financings in recent years including: Representing the United States Treasury (the DIP Lender) in the $33.3 billion DIP financing in the General Motors Corp. bankruptcy; Representing the Debtors in the $8 billion LyondellBasell Industries DIP financing; Representing the United States Treasury (the DIP Lender) in the $4.9 billion Chrysler DIP financing; and Representing the Agent to the DIP Lenders in the $1.5 billion LandSource DIP financing.

Mr. Mintz has advised multiple elected officials on municipal finance and Chapter 9 issues. Mr. Mintz also has advised a number of hedge funds regarding Chapter 9.

Mr. Mintz has extensive experience representing debtors in Lyondell Chemical Company, Mirant Corp. and Pacific Gas & Electric Co. Chapter 11 cases. He has represented prepetition secured lenders in many cases, with a focus on real estate cases such as Station Casinos, LandSource, and North Las Vegas. His creditors' committee representations include Galey & Lord, Desa Holdings, and MCSi. He also has represented bondholders and bond holders committees in cases including Adelphia Communications. Mr. Mintz also has experience with issues related to safe harbored contracts, structuring bankruptcy remote entities, FDIA receiverships/conservatorships, Chapter 9, and other issues.

Mr. Mintz has frequently lectured on topics including Fraudulent Transfers in Leveraged Buyouts and Assets Sales in Bankruptcy. For his recent work on cases like GM, Chrysler, and Lyondell, The M&A Advisor *named Mr. Mintz a Runner-Up for its "40 Under 40" M&A Advisor Recognition Awards. A frequent author and managing editor of Cadwalader's* Restructuring Review, *Mr. Mintz received his BA, magna cum laude, from the University of Maryland, and his JD from the University of Virginia School of Law. He is admitted to practice in the state of New York and the District of Columbia and before the Southern District of New York and the District Court for the District of Columbia.*

***Terence L. Workman**, special counsel at Cadwalader, Wickersham & Taft LLP, represents dealers, banks, and other financial institutions in the development, structuring, negotiation, and documentation of various financial products in both primary and secondary capital markets, with an emphasis on derivatives, liquidity and credit support, and investment products relating to the municipal capital markets. His work with financial products includes fixed income derivatives, credit derivatives, structured products, and various forms of credit enhancement and credit intermediation structures. Mr. Workman's practice involves a wide array of state, municipal, and not-for-profit financing structures throughout the United States, including general obligation, revenue bond, appropriation risk, tax-backed, higher education, and obligated group health care financings. His practice also focuses on transactions involving various forms of public-private partnerships and infrastructure finance. He has more than twenty-four years of experience in the capital markets.*

Prior to joining Cadwalader, Mr. Workman was a partner with Hawkins, Delafield & Wood LLP, with a practice focusing on representation of issuers, borrowers, underwriters and lenders in a wide array of both taxable and tax-exempt public finance transactions involving various credit, security, and investment structures. His practice included representation of some of the largest public transportation entities in the United States, as well as participation in various higher education, health care, general obligation, special tax-backed, distressed municipality, water supply and wastewater, public power, and utility financings.

Mr. Workman is the co-author of "Lehman Brothers Bankruptcy Filings: Issues for Replacement Swap Counterparties and their Municipal Clients," Pratt's Journal of Bankruptcy Law*, March 2009.*

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