Special Issues Under Chapter 9
Of the Bankruptcy Code, Part II

The first installment of this two-part series on municipal bankruptcy published on March 4, 2010, provided a basic overview of Chapter 9. Among the concepts raised in that column were the operation of an automatic stay to permit a municipality to obtain a “breathing spell” from its creditors, the right to reject collective bargaining agreements, and the ability for a municipality to reduce debt through a plan of adjustment. Part I also noted the overarching constitutional limitation that the Tenth Amendment imposes on federal courts under Chapter 9. Because states retain the exclusive right to control the affairs of their municipalities pursuant to the Tenth Amendment, bankruptcy courts have far less supervisory authority and power over a municipality than it does with respect to corporate and individual debtors.

Notwithstanding the Tenth Amendment, in a Chapter 9 case a bankruptcy court serves as a gatekeeper, scrutinizing the bankruptcy petition of a municipality at the outset of a case to ensure that the municipality is eligible to file under Chapter 9 and did so in good faith. To be eligible, a Chapter 9 debtor must (1) qualify as a municipality, (2) have specific state authorization to file bankruptcy, (3) be insolvent, (4) desire to effect a plan to adjust its debts, and (5) have actually negotiated or attempted to negotiate in good faith with its creditors.

Since the publication of part I in this series, the U.S. Bankruptcy Court for the Southern District of New York rendered an opinion in the Chapter 9 case of the New York City Off-Track Betting Corporation (OTB) on whether it was eligible to file under Chapter 9. The New York Racing Association (NYRA) objected to OTB’s petition because the New York Legislature had not passed a statute explicitly granting OTB the power to file for Chapter 9 protection. The court overruled NYRA’s objection and held that OTB had the necessary specific state authorization because the Governor of New York had issued an executive order authorizing it to file for bankruptcy protection.

In this final installment on municipal bankruptcy, this column will review the treatment of special revenue bonds, the “best interests” test, and “cramdown” plans.

Special Revenue Bonds

An understanding of Chapter 9 is especially critical for investors who frequently invest in municipal bonds. Chapter 9 draws a distinction between two types of bonds issued by municipalities to raise money. Special revenue bonds are those that raise special revenue, which is defined under Bankruptcy Code §902(2) as revenues derived from (1) the operation or ownership of transportation and utility projects, (2) special excise taxes (such as taxes on hotel rooms), (3) incremental taxes attributable to a specific project (such as infrastructure improvement), (4) particular municipal functions (such as stamp taxes), and (5) taxes levied to finance a specific project.

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In contrast to special revenues, general revenues are derived from other taxes and sources and are levied to fund a municipality’s general obligations and projects other than those listed in §902(2).

Special revenue bondholders receive favorable treatment in municipal bankruptcy cases because their claims continue to be secured by liens arising postpetition and they can seek remedies from a Chapter 9 debtor without violating the automatic stay. In contrast, the prepetition claims of holders of general obligation bonds are treated as general unsecured claims and such bondholders cannot enforce remedies against the municipality postpetition.

Section 928 affords a key advantage to special revenue bondholders because it permits such holders’ prepetition security interests in the special revenues to continue to attach to special revenues that accrue postpetition. This is a significant exception to Bankruptcy Code §552(a), which provides that property acquired by a debtor postpetition is not subject to a creditor’s prepetition security interest in such after-acquired property, notwithstanding the existence of an after-acquired property clause in a prepetition security agreement in favor of the secured creditor.

Section 928 explicitly states that §552(a) does not apply and provides that bondholders secured by a lien on special revenues retain their liens on special revenues that arise during the postpetition period. This security interest carveout is subject to the operating expenses of the project involved. This means that the postpetition security interest applies only to the revenues after taking into account the operating expenses of the underlying project.

In addition to enjoying the benefit of postpetition liens, special revenue bondholders are permitted under Bankruptcy Code §922(d) to continue to receive payments under their bonds notwithstanding the automatic stay. Thus, a municipality could continue paying an indenture trustee who could then pay special revenue to bondholders without violating the automatic stay. The municipality is not required to make these payments, but is permitted to do so without obtaining the court’s permission or notifying other creditors. However, as with postpetition security interests, the operating expenses of the project from which the special revenues are derived must be paid before payments to the bondholders.

In addition to the above protections, both general obligation and special revenue bondholders benefit from §926(b), which exempts payments by the municipality on such bonds from being recovered as preferences. Bankruptcy Code §547 provides that a prepetition transfer to a creditor may be avoided as a preference if the debtor made the transfer 90 days before the commencement of
its bankruptcy case on account of an antecedent debt, while the debtor was insolvent, and if the transfer permitted the recipient to recover more than it would have in a liquidation. In Chapter 9, such prepetition payments made by a municipality to or for the benefit of bondholders are protected from being attacked as preferences.

The ‘Best Interests’ Test

The Tenth Amendment’s limits on a federal bankruptcy court’s ability to impose itself on a municipality significantly affects the manner in which a Chapter 9 plan is confirmed and a court’s role in the plan process. One key area of distinction is the “best interests” test. This test comes into play in Chapter 11 by requiring that a plan provide that impaired creditors receive a distribution at least equal to what they would receive in a Chapter 7 liquidation. Similarly, in Chapter 9, Bankruptcy Code §943(b)(7) demands that a municipality’s plan be in the creditors’ best interests. In Chapter 9, however, liquidation value is not a benchmark against which a creditor’s recovery is measured because, creditors’ best interests. In Chapter 9, however, liquidation value is not a benchmark against which a creditor’s recovery is measured because, unlike an ordinary business, a municipality cannot liquidate. In applying a different best interests test in Chapter 9, courts have concluded that they must determine whether “the plan as proposed is better than the alternatives.” In Chapter 9, the only alternative is dismissal of the case, which would permit the undesirable outcome of creditors racing to the courthouse to sue a municipality or to foreclose on its assets. Although this test may seem foreclosing on its assets. Although this test may seem

In a Chapter 9 case, however, the “fair and equitable” test is the focus of Chapter 9 offers. Further, creditors of all classes should be cognizant of Chapter 9’s flexible “best interests” test to ensure they receive a fair share of available assets. Similarly, if a class of creditors votes against a plan of adjustment, municipal debtors may seek to utilize Chapter 9’s subjective “fair and equitable” test to achieve plan confirmation in the face of creditor dissent.

Conclusion

Holders of special revenue bonds should take close heed of the significant benefits of continued debt service and liens on post-petition revenue streams that Chapter 9 offers. Further, creditors of all classes should be cognizant of Chapter 9’s flexible “best interests” test to ensure they receive a fair share of available assets. Similarly, if a class of creditors votes against a plan of adjustment, municipal debtors may seek to utilize Chapter 9’s subjective “fair and equitable” test to achieve plan confirmation in the face of creditor dissent.

Cramdown Plans

Another aspect of the plan process in which Chapter 9 markedly differs from the other chapters of the Bankruptcy Code is with respect to “cramdown” plans. Generally, the Bankruptcy Code provides that a plan may be confirmed even if certain impaired classes of claims have voted to reject the plan. Section 1129(b) allows for a plan proponent to “cram down” a plan on dissenting creditors if (1) all of the other requirements under §1129(a) are satisfied except the requirement under §1129(a)(8) that each impaired class of claims accept the plan; (2) the plan proponent requests the court to confirm its plan; (3) at least one impaired class accepts the plan; (4) the plan does not discriminate unfairly against dissenting impaired classes; and (5) the plan is “fair and equitable” to dissenting impaired classes. With respect to whether a plan discriminates unfairly, the plan must treat a dissenting class in a manner similar to other classes.

Bankruptcy Code §1129(b)(2)(A) and (B) define what is “fair and equitable” for classes of secured and unsecured claims, respectively. In short, a plan is fair and equitable 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 in the event their collateral is sold free and clear of their liens and have their liens attach to the proceeds of such sale; or (3) receive the indubitable equivalent of its claims, which traditionally means that such creditors receive replacement collateral.

Section 1129(b)(2)(B) provides that a plan is fair and equitable to a class of unsecured claims if the plan provides that such creditors receive or retain 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 claims.

In Chapter 11 cases, the definition of “fair and equitable” under §1129(b) is at the heart of disputes over collateral value, the appropriate interest rate for the post-confirmation debt secured by liens retained by the secured creditor, and whether plan consideration constitutes an “indubitable equivalent” of a secured creditor’s claims. In the context of a corporate debtor, these issues can be resolved 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 value is not readily ascertainable, and state law may restrict a municipality from granting replacement liens on municipality property. As a result, courts have responded to the differences in the Chapter 9 setting 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.” This generally means that the plan is fair and equitable if “the amount to be received by the bondholders is all that they can reasonably expect in the circumstances.” Such a subjective standard appears to provide potential arguments for and against plan confirmation. For instance, dissenting classes of bondholders may argue that the plan proponent must pay such bondholders the present value of the revenue stream securing the value of their liens. The municipal debtor may counter that its revenues do not permit the bondholders to reasonably expect payments in that amount or that the payments should not be at contract rate of interest. This seldom-tested debtor-creditor tension, 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.

2. Id. at *7.
3. 11 USC §928(b).
4. Id.
5. Id. §547.
6. Id. §1129(a)(7).
7. See 7 Collier on Bankruptcy ¶900.01[1].
10. Fano v. Newport Heights Irrigation Dist., 114 F.2d 563, 566 (9th Cir. 1940).
12. See 7 Collier on Bankruptcy ¶943.03[7][a].
13. 11 USC ¶1129(b).
15. Lorber v. Vista Irrigation Dist., 127 F.2d 628, 639 (9th Cir. 1942) (citation omitted).