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FEDERAL JUDICIAL CENTER Q&A Re: Municipal Finance and BANKRUPTCY

Lawrence A. Larose
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Q1: What is the most important difference between municipal finance and corporate finance from a bankruptcy perspective?

A1. In the corporate world, the distinction between “secured” obligations and “unsecured” obligations of a debtor, and the relative priorities of those obligations, is fairly well developed and understood.

- The municipal finance world is much murkier.
- For decades the “gold standard” of municipal bonds (i.e., considered the safest investment) has been the “general obligation” (GO) bond.
- A municipality “pledges” its full faith and credit and taxing power to the payment of a GO bond. Thus, it is argued that these bonds have “first call” on municipal taxes and should be senior to other obligations of a municipality in bankruptcy.
- Chapter 9 incorporates the priority and security provisions applicable in Chapter 11.
- The question is whether a GO “pledge” creates a “lien” under the Code.

A.1 (Cont'd.)

- Code Section 101(37) defines “lien” as a “charge against or interest in property to secure repayment of a debt or performance of an obligation”.
- Black’s Law Dictionary (9th Ed.) defines “pledge” as “the act of providing something as security for a debt or obligation”.
- Arguably the GO pledge is intended to provide security for payment of the bond and therefore constitutes a “lien” under 101(37).
- However, because the GO pledge relates to the “full faith and credit” and the “taxing power” of the municipality it arguably does not relate to “property” and therefore does not satisfy the 101(37) definition.
- These issues were fully briefed and argued in the Detroit case but the parties settled before a ruling was entered.
- So a fundamental aspect of municipal finance – the priority of GO bonds in bankruptcy – is not definitively answered.

Q.2: Are there different types of GO bonds and does the structure of individual bond issuances affect the bankruptcy analysis?

A.2:

- Yes, there are many different “flavors” of GO bonds and the structure does have an affect on the bankruptcy analysis.
- For example, certain issues are supported by a pledge of the municipalities’ unlimited taxing power without regard to rate or amount.
- Other issues may be supported by taxing power that is limited in rate and/or amount. These limited GO pledges are generally considered subordinate to an unlimited GO pledge.
- GO bonds (either unlimited or limited) may also be supported by a pledge of a specific revenue source, restricted funds or statutory liens (these are sometimes called “double barrel bonds”).
- The specific terms of each bond issue are defined in the bond resolution, indenture and/or applicable state and local law, all of which must be carefully reviewed in each case.

Q3: What is the difference between GO bonds and revenue bonds?

A3:

- In contrast to GO bonds, revenue bonds are generally supported by revenues generated from a specific project, tax or other revenue source without recourse to the municipalities' general fund.
- Typical examples are bonds supported by public utility revenues, transit systems, sales taxes or state aid.
- Because these are ongoing revenue streams that are pledged for payment of the bonds, Section 552(a) of the Code, which is incorporated into Chapter 9, presents a serious problem:
- Section 552(a) says "...property acquired 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..."

A.3 (Cont'd.)

- Since pledged public utility revenues, sales taxes and the like are collected and distributed on an ongoing basis, Section 552(a) would limit the security for revenue bonds to amounts collected before the commencement of the case, generally an amount less than the next coupon payment.
- This was a vexing problem for municipal finance that required a statutory amendment to the Code enacted in 1988.
- Code Section 928 was added:

“(a) Notwithstanding section 552(a) of this title...special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.”

Q4: How does the Code define “special revenues” and why is it important?

A4:

- The term “special revenues” is defined in Code sections 902(2) (A) through (E).
- The definition encompasses revenues from “projects or systems” of the debtor that are “used primarily” for public services, specific taxes of various types and other revenues “derived from specific functions of the debtor.”
- It is important because:
 - under 928(a) liens on special revenues are not cut off at the commencement of the case under 522(a); and
 - under Code section 922(d) the automatic stay under Code section 362 “does not operate as a stay of application of pledged special revenues in a manner consistent with section [928] of this title to payment of indebtedness secured by such revenues”;
 - finally, under Code section 927, special revenue claims do not have recourse against the general account of the debtor – i.e., the 1111(b) election does not apply.

Q.5: Are there any other limitations on the application of Code section 552(a) that are important in a municipal bankruptcy?

A.5:

- Yes. Because Code section 552(a) by its terms only applies to liens “created by a security agreement”, it does not apply to liens created solely by a statute, and such liens continue to attach to pledged revenues post-petition.
- It is important to note that “statutory liens” are liens that arise automatically by force of law and are not based on or derived from a pre-petition security agreement, contract or judicial action.
- The interplay between the relevant statutory language and any financing documents will be relevant in determining whether a lien is a “statutory lien” for this purpose. This dynamic was litigated in both the bankruptcy court and the District Court in the Orange County Chapter 9 case.
- Suffice it to say that the more explicit and automatic the lien is in the statute the more likely it is to be considered a “statutory lien.”

Q.6: So bonds that are supported by a statutory lien or a lien on pledged special revenues will continue to be paid according to their terms during the pendency of the case to the extent of pledged revenues?

A.6:

- Not necessarily.
- The Code section 922(d) exception to the automatic stay only applies to “pledged special revenues” and does not apply to statutory liens on property that does not qualify as “special revenues”.
- Even with respect to special revenues, Code section 928(b) creates a “carve out”:

“(b) Any such lien on special revenues...derived from a project or system shall be subject to the necessary operating expenses of such project or system, as the case may be.”
- Although the legislative history of the 1988 Amendments suggests that Section 928(b) was added to protect projects that are subject to a lien on gross revenues from being starved of operating cash flow during the case – rather than a net lien that permits defined operating expenses to be paid before the bonds – the extent of the ‘928 carve out’ is controversial and was extensively litigated in the Jefferson County Chapter 9 case.

A.6 (Cont'd.)

- Holders of statutory liens on non-special revenue property must file a motion to lift the automatic stay under Code sections 362 and 922 for “cause”.
- There is no case law specifically addressing adequate protection for statutory liens and decisions under analogous provisions of Chapter 11 can be distinguished.
- More recent litigation in the Puerto Rico cases under PROMESA suggest that bondholders have the burden of proof to show the need for adequate protection. It is unclear whether these cases should be applied in Chapter 9.

Q.7: Are creditor constituencies different in municipal cases than in a typical Chapter 11 case?

A.7:

- The first obvious difference is that a Chapter 9 does not generally include the formation of creditor committees (although they are permitted under Code sections 1102 and 1103) simply because a municipal debtor cannot be compelled to pay the fees of committee professionals.
- The major exception to the above is retiree committees, which have been formed in certain important cases (e.g., Stockton and Detroit) with the consent of the debtor to pay reasonable fees and expenses.
- In addition, Code section 1104 is not applicable in Chapter 9, so the Court generally lacks the authority to appoint a trustee or examiner. The Court may also not appoint a receiver in a Chapter 9 case under Sections 105(b) and 103(f).
- Traditionally, the rights of bondholders have been left to be protected by indenture trustees, although many types of municipal bonds (particularly GOs) do not have trustees and are administered solely by fiscal agents (which can be the municipality itself).

A.7: (Cont'd.)

- More recently, in large cases such as Detroit and Jefferson County, distressed investors have taken large positions and appeared in the case to defend their bond rights at their own expense.

Q.8: Does the presence of bond insurance have an impact on the case?

A.8:

- The existence of private insurance companies that insure the payment of principal and interest, as and when due, is unique to municipal finance.
- Financial guaranty policies generally obligate the insurer to pay any missed payments directly to bondholders, but do not require payments upon acceleration.
- Insurers generally have control over the exercise of remedies under the bond documents, sometimes including voting rights in a Chapter 9 case.
- Because the insurer cannot cancel the policy or “trade out” of an insured position, it may be the real party in interest in the Chapter 9 case and could take a major role.

Q.9: Special revenue bonds clearly have a unique status during a Chapter 9 case, but what about the confirmation process? How are they to be treated in a Plan of Adjustment?

A.9:

- Whether special revenue claims can be impaired without the consent of the claimants – i.e., a ‘cram down’ under Code section 1129(b) is a hotly debated topic without judicial resolution.
- While it is clear that Code section 1129(b) generally applies in a Chapter 9, its application to special revenue claims is difficult because of the inability to liquidate a municipality or its assets and valuation issues generally.
- The debtor in the Detroit case proposed a ‘cram down’ plan for the City’s special revenue bonds that would have imposed a principal and interest rate ‘haircut’ on the bonds (through a Till analysis) even though adequate special revenues from the project existed to service the existing bonds in full.

A.9: (Cont'd.)

- The parties briefed the issues in full, and such briefs are instructive. No judicial resolution was forthcoming since the City eventually amended its Plan of Adjustment to provide for a favorable refinancing of the bonds in full.
- My personal view is that in a case where sufficient special revenues are available to service claims in full, neither a “cram down” under 1129(b) nor a market interest rate adjustment under Till is permissible because the lien on special revenues survives the commencement of the case under Code section 928 and attaches to every dollar of special revenues produced until repayment of the bonds – and nothing in the Code case law (even the plurality Supreme Court decision in Till) permits or condones impairment of a ‘live’ lien under any circumstances.

Q.10: What other unique aspects of municipal finance might have an important impact on a Chapter 9 case?

A.10:

- State laws on “restricted funds”, “enterprise funds” or “limited use funds” remain applicable to the Chapter 9 debtor and can reduce assets available for distribution to creditors.
- State “intercept” laws sometimes permit a revenue stream that otherwise would be paid to the debtor to be re-directed to bondholders upon certain conditions and triggers. The enforceability of such mechanisms in Chapter 9 may vary. Suffice it to say that the more ‘automatic’ the trigger and the re-routing, the more likely it is to be enforceable and not caught by the automatic stay. This issue was examined in the Vallejo Chapter 9 case.
- It must be noted that a Chapter 9 debtor can utilize Code sections 364(c)-(f) to obtain post-petition “super-priority” lien financing but it is unclear whether such super-priority liens can prime special revenue or statutory liens.

Q.11: You have outlined for us many interesting issues that have not reached judicial conclusions at the bankruptcy court or district court levels, let alone at the Court of Appeals to establish some binding precedent. What impact do you think that the Puerto Rico bankruptcy cases under PROMESA will have on Chapter 9 and municipal restructuring generally?

A.11:

- It is true that the Commonwealth of Puerto Rico and its various public instrumentalities used virtually all the structures available in the bond market (and perhaps more) to finance their obligations and that many of those structures are being tested in the Puerto Rico “bankruptcy” cases.
- But the wider impact of any rulings in the Puerto Rico cases is unknown and we need to be cautious about making predictions.
- First, PROMESA is a unique federal statute implemented under the Territorial Clause of the U.S. Constitution, not the Bankruptcy Clause. The Title III “bankruptcy-like” cases under PROMESA are not bankruptcy cases under the Code.
- Second, while PROMESA incorporates many provisions of Chapters 9 and 11 (including many discussed above), it also has many other unique provisions that must be taken into account.

A.11: (Cont'd.)

- Third, it cannot be ignored that the entire Puerto Rico situation is highly politicized and gravely impacted by an unforeseen humanitarian crisis which may bear on outcomes.
- Finally, the District Court for Puerto Rico in one of the early PROMESA cases (pre-Title III) cautioned that even through that case involved sections and terms used in the Code, jurisprudence under the Code should not be applied blindly or by rote to PROMESA cases because of the uniqueness of the statute. The reverse may also be true. See, Peaje Investments.
- We should revisit this question in the next year or two.

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