



AMERICAN
INNS *of* COURT

Chapter 9
Bankruptcies

Modification or Discharge of Debt In a Chapter 9 Case

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Chapter 9 of the Bankruptcy Code, consistent with the Tenth Amendment of the U.S. Constitution, severely restricts federal interference with municipal government reorganization.

Bankruptcy Code

Does not provide for liquidation if reorganization of the municipality is not successful;
only municipality can propose a plan

Court role limited

No authority to appoint trustee or examiner

No authority to approve professionals or order payment, only review fees for disclosure and reasonableness

If no objection to the petition, required to enter an Order of Relief

Must dismiss the case if the proposed plan cannot be confirmed

UST role limited

No supervisory authority; no 341 examination

No oversight authority (MORs, compliance, etc.)

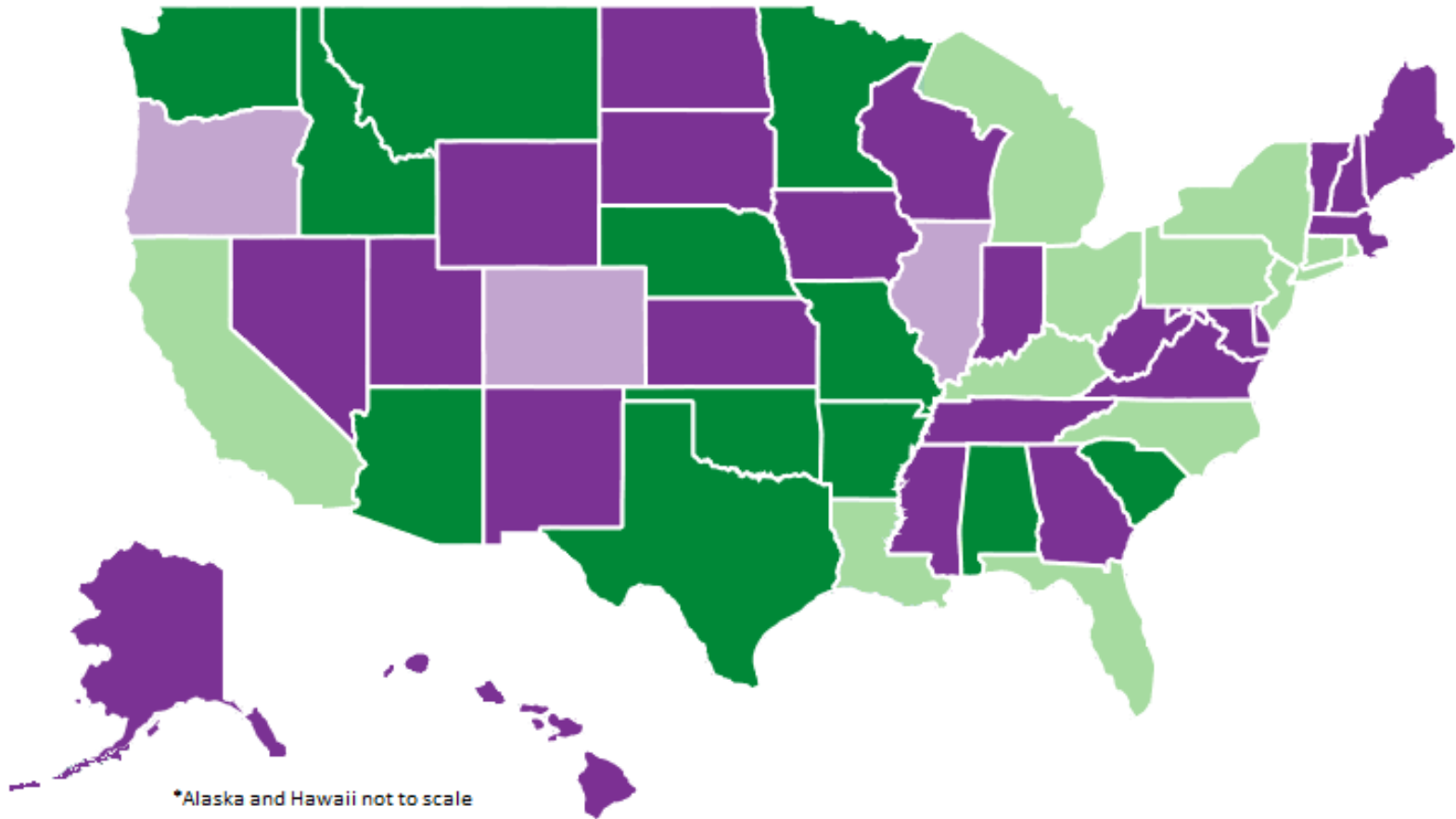
May appoint committees consistent with 11 U.S.C. § § 1102, 1103

I. What is a municipality that may file a Chapter 9 case?

- A. Under Section 109(c), an entity may be a debtor under Chapter 9 only if it is a “municipality.”
- B. Section 101(40) defines a “municipality” as a “political subdivision or public agency or instrumentality of a State.”
 - 1. The definition of municipality moves from relative precision: “political subdivision” – county, city, school district, etc.
 - 2. To relative generality: “public agency or instrumentality of a State” – special purpose district, public facility corporation, etc.
 - 3. See, for example, Consent Order as to Chapter 9 Petition, in Connector 2000 Association, Inc., Case 10-04467, Bankruptcy Court, District of South Carolina

II. Section 109(c) also requires that a Chapter 9 debtor must:

- A. Be “specifically authorized” to file a Chapter 9 case
 - 1. by state law, or
 - 2. by a state governmental officer/organization empowered to authorize a Chapter 9 filing.
 - 3. California AB 506, signed by Governor Brown Oct. 9, 2011:
 - a. A local public entity . . . may file a petition . . . pursuant to applicable federal bankruptcy law if either of the following apply:
 - i. (a) The local public entity has participated in a neutral evaluation process pursuant to Section 53760.3.
 - ii. (b) The local public entity declares a fiscal emergency and adopts a resolution by a majority vote of the governing board pursuant to Section 53760.5.
 - b. "Local public entity" means any county, city, district, public authority, public agency, or other entity, without limitation, that is a municipality as defined in Section 101(40) of Title 11 of the United States Code . . . [but not] a school district.
 - 4. Compare with Texas, § 140.001, Local Government Code:
 - a. A municipality [defined by Texas law], taxing district, or other political subdivision . . . may proceed under all federal bankruptcy law intended to relieve municipal indebtedness. . . if it has the power . . . to incur indebtedness.
 - b. Special statute and regulations apply to Texas Municipal Utility Districts.



- State specifically authorizes Chapter 9 filings
- Chapter 9 filing is authorized upon conditions met and further action of state, officials or other entity
- Municipalities have limited authorization
- No Chapter 9 authorization outlined, laws are unclear or filing otherwise prohibited

Original image courtesy of GOVERNING Data, *Municipal Bankruptcy State Laws*, available at <http://www.governing.com/gov-data/state-municipal-bankruptcy-laws-policies-map.html> (last visited Mar. 8, 2013).

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- B. Be “insolvent” – is generally not paying its debts (unless in bona fide dispute) or is unable to pay its debts as they become due.
 - C. Desire to effect a plan of adjustment.
 - D. Have:
 1. Obtained requisite agreement, or
 2. Negotiated in good faith and failed to reach agreement, or
 3. A belief that creditor negotiations are impracticable, or
 4. A belief that a creditor is about to receive a preferential transfer.

E. Threshold Issues – Insolvency and Cash Flow

1. “generally not paying its debts as they come due.”
 - a. Layoffs versus paying 90¢ to all current employees
2. “Unable to pay its debts when they come due.”
 - a. Large looming pension liabilities.
 - b. How many cuts can feasibly be made
 - c. How much can taxes feasibly be raised

III. What general standards must be met to confirm a Chapter 9 Plan?

- A. A plan must be proposed in good faith (§ 1129(a)(3)).
- B. A plan must be in the “best interests of creditors” – each class of creditors will receive not less than they would receive if the Chapter 9 case were dismissed and creditors were left to pursue uncoordinated state law remedies (§ 943(b)(7)).
- C. A plan must be feasible § 1129(a)(11).
 - 1. Financially sound;
 - 2. Likely to be able to be performed.
- D. Unless accepted by a class, the plan must provide fair and equitable treatment to that class in order to be confirmed (§ 1129(b)). We will discuss separately below what is fair and equitable treatment for secured claims and unsecured claims.

IV. Creditor Expectations

A. General Obligation Bonds

1. No Rights in Specific Collateral
2. Backed by full faith and credit of issuer, supported by taxing power
3. Tax Pledge
4. Generally the least risky, lowest rates

B. Revenue Bonds

1. Again No Specific Physical Collateral
2. Pledge of Specific Stream of Future Income
3. Deficiency Claim??

C. Remedies

1. G.O. Bondholder Must Compel/Convince the Municipality to Raise Taxes for Debt Service
 - a. Low Default Rates Indicate Enforceability of Tax Pledge
2. Bondholder Suit for Order Directing Municipal Official to Take Specified Action
 - a. Pay Judgment
 - b. Fulfill Statutory Duty to Raise Taxes
 - c. Deliver Income Securing Revenue Bond
3. Money Judgment is Not Helpful
 - a. Public Policy (if not specific state law) precludes foreclosure

V. What is fair and equitable treatment for a secured claim?

A. Types of Secured Claims in Chapter 9

1. Special Revenue Bonds - secured by a pledge of the stream of revenue generated by a special project or tax levy (§ 902(2))
2. Statutory Liens Bonds - secured by a statutory pledge
3. Contractual Liens of Bonds - secured by a pledge in the bond resolution/contract

B. Generally how are they treated?

1. Special Revenue Bonds
 - a. Post-Petition Lien. “notwithstanding Section 552(a)...., 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.”

- b. No Recourse. A claim “payable solely from a special revenues of the debtor” cannot be transformed into a claim with recourse against the debtor by Section 1111(b). (§ 927).
 - c. Automatic Stay. Application to “special revenues”? (§ 922(d)).
2. Statutory Liens
- a. Bankruptcy Court should respect statutory pledge.
3. Contractual Liens
- a. Post-petition revenues are not subject to the pledge (§ 552(a))
 - i. What about the principle that the Bankruptcy Court cannot interfere with the property of the Chapter 9 debtor ? (§ 904)
 - b. May be treated like General Obligation of bonds.

C. Specific secured claim cram down standards

1. Retain lien and receive cash payment over time (§ 1129(b)(2)(A)(i));
2. Sale with right to credit bid (§ 1129(b)(2)(A)(ii))
3. Indubitable equivalence (§ 1129(b)(2)(A)(iii))

VI. Labor Issues:

- A. Section 1113 and 1114 do not apply in Chapter 9.
- B. Rather, section 365 governs rejection of labor contracts in chapter 9.
 - 1. Collective bargaining agreements are executory contracts subject to the *Blidsco* standard for rejection. See *N.L.R.B. v. Blidsco*, 465 U.S. 513 (1984).
 - 2. The *Blidsco* standard generally requires a showing that:
 - a. The agreement burdens the debtor more than it benefits the debtor.
 - b. Reasonable efforts to negotiate a voluntary modification have been made.
 - c. Rejection of a labor contract constitutes an anticipatory breach entitling the counterparty to unsecured rejection damages claim.

Rejection of Collective Bargaining Agreements (CBAs)

NLRB v. Bildisco & Bildisco, 465 S. Ct. 513 (1984)

- Often cited for proposition that Section 365 displaces existing state labor law governing CBAs in Chapter 9. See *In re City of Vallejo*, 403 B.R. 72, 78 (Bankr. E.D. Cal. 2009); *In re County of Orange*, 179 B.R. 177, 182 (Bankr. S.D. Cal. 1995); *In re County of Orange*, 403 B.R. 72, 77 (Bankr. E.D. Cal. 2009).
 - But *Bildisco* holding limited to: Section 365 in a Chapter 11 permits violation of the National Labor Relations Act's limitations on unilateral changes to CBAs governed by federal law. By 5 to 4 decision the Supreme Court held that Section 365 permits pre-rejection unilateral modification of CBA's governed by the NLRA which would otherwise violate the NLRA.
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Rejection of Collective Bargaining Agreements (CBAs)

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- Note: the majority, the dissent and all the parties to the decision accepted the premise that Section 365 permits a rejection of private employer/employee CBAs in violation of the NLRA.
- Often ignored by commentaries: NLRA does not apply to municipal unions and their CBAs. They are governed by state law.

29 U.S.C . § 152(2)

Rejection of Collective Bargaining Agreements (CBAs)

State Law Governance of Public Sector Employers/Employees and their CBAs

- Automatic stay prohibits enforcement of state/local public sector CBAs in state court. *In re City of Vallejo*, 403 B.R. 72, 78 (E.D. Cal. 2009).
 - Sections 903 and 904 prohibit enforcement of state/local CBAs in bankruptcy court. *In re City of Stockton*, 478 B.R. 8 (Bankr. E.D. Cal. 2012); *In re City of Vallejo*, 403 B.R. 72, 75-76 (E.D. Cal. 2009); *contra Orange Cty. Employees Ass'n v. County of Orange (In re County of Orange)*, 179 B.R. 177, 183 (Bankr. C.D. Cal. 1995).
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Rejection of Collective Bargaining Agreements (CBAs)

State Law Governance of Public Sector Employers/Employees and their CBAs

- Omission of Section 1113 from Chapter 9: two different inferences:
 - Congress left labor law governing municipal employees and CBAs to the states, except where Section 365 expressly governs. *In re County of Orange*, 179 B.R. 177, 182 (Bankr. S.D. Cal. 1995)
 - Congress left labor law governing municipal employees and CBAs to the implied applicability of *Bildisco* to state labor law. *In re City of Vallejo*, 403 B.R. 72, 78 (E.D. Cal. 2009); *In re City of Vallejo*, 432 BR 262, 273 (Bankr. E.D. Cal. 2010).
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Rejection of Collective Bargaining Agreements (CBAs)

Competing rationales for preservation or abrogation of state law labor laws governing CBAs

- Preservation:
 - *Bildisco* is a Bankruptcy Code v. National Labor Relations Act decision
 - Tenth Amendment means what it says: state sovereignty should not be easily swept aside
 - No appellate authority expressly exploring the tensions between the 10th Amendment, Sections 903/904, and Section 365
 - No appellate authority applying *Bildisco*'s GET OUT OF JAIL FREE card to violations of state labor law in Chapter 9
 - preemption opinions ignore cautionary case law regarding liberal preemption of state law and *Bildisco*'s concern for bankruptcy court involvement in labor relations

Rejection of Collective Bargaining Agreements (CBAs)

Competing rationales for preservation or abrogation of state law labor laws governing CBAs

- **Abrogation:**
 - State consents to preemption of state labor law by Section 365 when authorizing Chapter 9
 - State cannot cherry pick Section 365
 - *Bildisco's* limited approach to violating federal labor law applies to all violations of state labor laws in Chapter 9
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Rejection of Collective Bargaining Agreements (CBAs)

Other Issues

- Rejection of CBAs does not deprive employees of the reasonable value of their services.
 - Often the payments called for by the rejected contract are presumed to be the reasonable value.
 - Unpaid post-petition reasonable value claims should be admin. claims.
 - Continued employment/vested rights may create federal and/or state constitutionally protected rights. What protection for individual due process rights in the procedures employed under Section 365.
 - Enforcement of state labor law prior to formal rejection. How?
 - The issuance and enforcement of state labor law is inherently the intrusive use of state governmental power. Outside the rejection of the financial terms of public sector employee CBAs, where is the 10th Amendment limit of the federal court's power in the labor relations of the Chapter 9 debtor and its employees?
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VII. There seems to be both an objective and subjective standard for fair and equitable treatment of general unsecured claims.

- A. Section 1129(b)(2)(B) establishes an **objective “absolute priority rule”**:
1. the holder of any claim or interest that is junior to the claims of such class will not receive or retain any property under the plan on account of such junior claim or interest.
 2. Since a municipality has no equity holders, this objective absolute priority rule can be met by simple, straight forward proof.
- B. Cases under the previous Bankruptcy Act and certain cases under Chapter 9 have created a subjective gloss on this objective absolute priority rule – does the plan pay creditors in a class **“all they can reasonably expect under the circumstances”**?

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- C. In analyzing whether creditors are receiving “all they can reasonably expect under the circumstances,” the courts have looked at the following:
1. Has the municipality run its business as wisely as possible to carry out its politically mandated mission at the least cost?
 - a. Is the municipality doing unmandated things that are too costly to continue?
 - b. Is the municipality managing itself wisely?
 2. Has the municipality adequately exercised its taxing authority?
 - a. Measured by objective comparison to other similar entities,
 - i. Have past levels of taxation been adequate when compared to peer group?
 - ii. Are proposed future levels of taxation adequate when compared to peer group?
 - b. Is there adequate political support for the proposed future level of taxation?
 - c. Is any greater level of taxation fair or possible?
 3. Will the municipality have adequate funds to carry out operations for its politically mandated mission? It is not necessary that all taxes collected go to pay creditors?
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VIII. What floor is set by the “best interest of creditors test”?

1. The “best interest of creditors” test provides the floor for what must be paid to unsecured creditors under a plan.
2. In a Chapter 9, best interests of creditors has generally been held to mean what would a creditor receive if the Chapter 9 case were dismissed and creditors were all left to their state law remedies.
3. The absence of an organized bankruptcy process would often lead to less value being obtained in a liquidation than in an organized Chapter 7 liquidation.
4. Thus § 943(b)(7) probably sets a lower floor than in a Chapter 11 case where § 1129(a)(7) sets a floor based on an orderly liquidation in Chapter 7.