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MEMORANDUM

TO: Houston Inns of Court Presentation

FROM: Zack A. Clement
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DATE: March 19, 2013

RE: Important Issues in a Chapter 9 Case

Chapter 9 of the Bankruptcy Code (11 U.S.C. § 901 *et seq*.) permits a state "municipality" to use the powers of federal bankruptcy law to reorganize its financial affairs. An insolvent municipality facing an unmanageable debt burden, including (a) burdensome contract obligations and (b) bond debt that it is unable to service according to its current terms, might pursue a Chapter 9 case to reject those contracts and generally reduce debt to move forward on a more financially sound basis. Lenders, employees and other creditors might raise a number of complex fact issues arguing against the fairness of such a restructuring, which will need to be resolved either by agreement or by trial in a bankruptcy court.

A. <u>Municipality as a Chapter 9 Debtor</u>.

The Bankruptcy Code defines a "municipality" as a "political subdivision or public agency or instrumentality of a state." (11 U.S.C. §101(40)).[1] This definition is quite broad and

[1] References to "Section" or "§," unless otherwise noted, refer to Title II of the United States Code, the Bankruptcy Code.

applies to counties, cities, towns, school districts, municipal utility districts, and many state entities.

A municipality is qualified to be a debtor in a Chapter 9 case if (a) it has been authorized by applicable state law to be a Chapter 9 debtor, (b) is "insolvent" and (c) has either (i) obtained majority approval of creditors in each class for the proposed plan of debt adjustment, or (ii) negotiated in "good faith" with creditors and failed to obtain such a majority, or (iii) such negotiations are "impracticable" (§109(c)).

Authorization to become a Chapter 9 debtor is often a very complex issue, grounded in state law and heavily imbued with political influences. [2]

In the Chapter 9 context, "insolvent" means "generally not paying its debts as they come due" or "unable to pay its debts as they come due," not asset versus liability "balance sheet" insolvency that is used in many other parts of the Bankruptcy Code. *In re Hamilton Creek Metropolitan District*, 143 F.3d 1381 (10th Cir. 1998); *In Re City of Bridgeport*, 129 B.R. 332 (Bankr. D. Conn, 1991). Because it relates to qualification to be a debtor, solvency is the first of many complex financial fact issues that come up in a Chapter 9 case.

B. Bankruptcy Court Control Over a Chapter 9 Case.

The Bankruptcy Court does not have as many powers to influence a debtor's conduct in a Chapter 9 case as it has in a Chapter 11 case. The powers to appoint a trustee (§1104) or to terminate the debtor's exclusive period to file a plan of reorganization (§1121) are not applicable in a Chapter 9 case. Only the debtor can file a plan in a Chapter 9 case (§ 941). Moreover, the Bankruptcy Court is not permitted to "interfere with . . . any of the political powers of the debtor;

[2] Some of the most populous states have given broad authorization to their municipalities to file a Chapter 9 case. Texas has given its municipalities authority to file a Chapter 9 case, if they choose to do so. Texas Local Government Code §140.001. California gives its municipalities the authority to file a Chapter 9 case, subject to an obligation to first go through a mediation process. California Government Code §53760. In New York, the Governor has been held to have the power to authorize a filing. *In re New York Off-track Betting Corp.*, 427 B.R. 256 (Bankr. S.D.N.Y. 2010).

. . . any of the property or revenues of the debtor; or . . . the debtor's use or enjoyment of any income-producing property" (§904(1)-(3)). These provisions reflect a concern for the separation of powers and show a deference to the political power of the state concerning its municipalities and the municipality's executive and legislative power.

The Bankruptcy Court does, however, have the power: (a) to dismiss a Chapter 9 case if it was not filed in good faith (§921(c)); (b) to deny confirmation of a plan if it finds that the plan is not in good faith or is otherwise not confirmable (§§943(b)(1), 901(a), 1129(a)(3)); and (c) to dismiss a case if a plan is not filed or confirmed within a time set by the Court (§§930(a)(3),(4),(5), 941)).

These provisions give the Bankruptcy Court substantial power to encourage a Chapter 9 debtor to use good faith efforts to file and confirm a plan on a schedule set by the Court. Otherwise, its case could be dismissed ending the benefits the municipal debtor could have received from a federal bankruptcy reorganization.

C. **Plan Confirmation Standards**.

Section 901(a) adopts many of the plan confirmation standards applicable in Chapter 11. However, three important Chapter 11 provisions do not apply in Chapter 9 cases.

1. **Important Chapter 11 Provisions Essentially Not Applicable in Chapter 9**.

a. **Absolute Priority Rule**.

The absolute priority rule of §1129(b)(2)(B), which provides that holders of equity interests cannot receive or retain anything under a plan unless unsecured creditors have been paid in full, is largely irrelevant in a Chapter 9 case because a municipality has no equity holders. This means that a plan might provide for only partial payment of unsecured claims with the remainder being discharged even though the municipal debtor retains its assets. As described

below, however, some courts have placed a subjective gloss on this objective absolute priority rule, making the standard more difficult to meet.

b. Chapter 7 Liquidation Test.

Section 1129(a)(7), which requires that, to confirm a Chapter 11 plan, all creditors in a rejecting class must be paid at least as much as they would have received in a Chapter 7 liquidation (the "best interest of creditors" test), does not apply in a Chapter 9 case. The Bankruptcy Code does not authorize a municipality to file a Chapter 7 case and a Chapter 9 case cannot be converted to Chapter 7. However, as described below, a different "best interests of creditors" test applies in Chapter 9 that probably establishes a floor for what must be paid to unsecured creditors that is lower than the inapplicable §1129(a)(7) Chapter 7 liquidation test.

c. Rejection of Labor Contracts.

Because §§1113 and 1114 are not applicable in Chapter 9, a municipality has more flexibility in dealing with collective bargaining agreements than would a Chapter 11 debtor. Absent §§ 1113 and 1114, Bankruptcy Code section 365 governs a debtor's right to reject a labor contract, and the opinion in *N.L.R.B. v. Bildisco v. Bildisco*, 465 U.S. 513 (1984) sets the standard for that rejection. *See e.g., In re County of Orange*, 179 B.R. 177 (Bankr. C.D. Cal 1995); *In re City of Vallejo*, 403 B.R. 72 (Bankr. E.D. Cal 2009); *In re City of Vallejo,* 432 B.R. 262, 270 (E.D. Cal 2010):

> *In Bildisco*, the Supreme Court held that the language "executory contract" in section 365(a) of the Code included collective bargaining agreements. The *Bildisco* Court held that the Bankruptcy Court should permit rejection of such an agreement under section 365(a) if the debtor can show that the agreement burdens the estate and that the equities balance in favor of rejecting the labor contract. Id. at 526. Furthermore, the Court held that before acting on a petition to modify or reject a collective bargaining agreement, the Bankruptcy Court should be persuaded that reasonable efforts to negotiate a voluntary modification have been made and are not likely to produce a prompt and satisfactory solution.

Vallejo, 432 B.R. at 270.

Congress has chosen more than once when it was amending the Bankruptcy Code not to make the more difficult requirements of sections 1113 and 1114 applicable in a Chapter 9 case. Therefore, the *Bildisco* standard still applies to the rejection of labor contracts in Chapter 9.

Moreover, otherwise applicable state labor laws cannot alter the *Bildisco* standard because Bankruptcy Code Section 365 preempts state law. *Vallejo*, 432 B.R. at 268-69; *Kroske v. U.S. Bank Corp.*, 432 F. 3d 976 (9th Cir. 2005). When a state authorizes a municipality to use the federal Bankruptcy Code to reorganize its financial affairs pursuant to Section 109(c)(2), it agrees to this preemption:

> Section 903, together with 11 U.S.C. § 109(c)(2), allows states to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code. When a state authorizes its municipalities to file a chapter 9 petition it declares that the benefits of chapter 9 are more important than state control over its municipalities.
>
> Consequently, if a municipality is authorized by the state to file a chapter 9 petition, it is entitled to fully utilize 11 U.S.C. § 365 to accept or reject is executory contracts.
>
> Since the state must consent to a bankruptcy filing under § 109(c)(2), the state consents to the displacement of its own law in order to obtain the benefits uniquely available under the Bankruptcy Code.

Vallejo, 403 B.R. at 76.

If a Chapter 9 debtor rejects a labor contract, this acts as a permanent anticipatory breach of that contract (§365(g)). The present value of damages from future breach of that contract are calculated to determine the allowed amount of an unsecured rejection damage claim

(§365(g)(1)).[3] That unsecured claim can be dealt with in a plan along with unsecured bond debt as described below.

2. **General Plan Confirmation Standards**.

Section 901(a) makes certain general Chapter 11 plan confirmation standards applicable in a Chapter 9 case, including: (a) §1129(a)(2) requiring compliance with applicable Chapter 11 procedures concerning a disclosure statement and solicitation; (b) §1129(a)(3) requiring that the plan must be proposed "in good faith;" (c) §1129(a)(6) requiring that applicable regulatory approvals must be obtained and (d) §§1129(a)(8) and (10) requiring that the plan must be accepted by one impaired class that is not controlled by insiders.

a. **Cram Down Power**.

Section 901(a) explicitly makes §1129(b)(1)'s "cram down" power applicable in Chapter 9 cases. Thus, if at least one impaired class of creditors has voted to accept a plan, which is in the best interests of creditors and is feasible, that plan can be confirmed over the objection of a rejecting class of creditors, "**if the plan does not discriminate unfairly and is fair and equitable**" to that class. (§§901(a), 1129(b)(1)). Chapter 9 explicitly (i) adopts the three alternatives for fair and equitable treatment of secured claims contained in §1129(b)(2)(A) and (ii) adopts the absolute priority rule standard for fair and equitable treatment for unsecured claims set out in §1129(b)(2)(B).

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[3]In many cases pension rights are expressed in a state statute or code rather than a separate contract. Sometimes these statutory rights are categorized by State constitutional provisions as "constitutionally protected contract rights," leading to questions about whether they could be rejected under Section 365. However, assuming that a city is a party to a pension contract, if that contract were rejected in a Chapter 9 case, expert actuarial testimony would be required to calculate the present value of the rejected pension rights.

This same kind of expert testimony would be relevant if the contract for retirement benefits is considered as simply one part of an employee's contract of employment with a city, a contract which could be rejected. See, for example, *Dallas v. Trammel*, 129 Tex 150 (Texas S. Ct. 1937) which describes two lines of cases, one holding that an individual employee's contract of employment includes additional contract rights to a pension that might be described in a state statute and another holding that the contract of employment contemplates a mere gratuity in the form of a pension that might be described in a state statute. If individual employment contract rejection claims were to be calculated as a class, such actuarial evidence would be relevant for the class.

Section 1129(b)(2)(A) provides that secured claims may be treated fairly and equitably if the plan, (a) allows the secured creditor to retain its lien and to receive cash payments over time which have a present value equal to the value of its collateral as of the effective date of the plan; (b) provides for a sale of the secured creditor's collateral at which it can credit bid or (c) provides the secured creditor with the "indubitable equivalent of its claim," including, among other things, returning the creditor's collateral to it.

Section 1129(b)(2)(B) provides that unsecured creditors who are not paid in full are still treated fairly and equitably under a plan as long as "**any claim or interest that is junior . . . will not receive or retain under the plan or on account of such junior claim or interest any property**." §1129 (b)(2)(B)(ii)). This is generally referred to as the **absolute priority rule.** In Chapter 11 cases for corporations, this means that common shareholders, the most junior class of claims or interests, cannot retain their ownership interests unless unsecured creditors are paid in full. *Case v Los Angeles Lumber Products,* 308 U.S. 106 (1939).

In a Chapter 9 case, however, a municipality has no "equity owners." Thus, it would be a straightforward matter to show that the literal terms of the absolute priority rule have been met. Even if unsecured claims were not paid in full, a municipality could continue to own and operate its assets post-reorganization and no one junior to unsecured creditors would receive any value. *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 458-59 (Bankr. E.D. Cal. 1999). However, as described in greater detail below, some courts have placed a subjective gloss on this otherwise simple, objective absolute priority rule by inquiring whether unsecured creditors are being paid "all that they can reasonably expect under the circumstances."

b. Best Interests and Feasibility.

Finally, §943(b)(7) states that a plan shall be confirmed if it "is in the best interests of creditors and is feasible."

Feasibility has the meaning commonly used in Chapter 11 - - that the plan is financially sound and likely to be able to be performed. *In re Mount Carbon Metropolitan District*, 242 B.R. 18 (C.D. Colo. 1999).

Because a municipality cannot file or be forced involuntarily into a Chapter 7 case, courts have construed "best interests of creditors" in §943(b)(7) to mean that a proposed Chapter 9 plan must pay no less than the alternative available to creditors if the Chapter 9 case were to be dismissed and creditors were left to uncoordinated non-bankruptcy law remedies, including foreclosure and mandamus. *Faitoute Iron & Steel Co. v City of Asbury Park*, 316 U.S. 502 (1942); *U.S. v Bekins*, 304 U.S. 27 (1938); *Ashton v. Cameron County Water Improvements District No. 1*, 298 U.S. 513 (1936); *In re Sanitary Improvement Dist. No. 7,* 98 B.R. 970 (Bankr. D. Neb. 1989).

Proof of what recovery would be in such non-bankruptcy actions will set the floor for what must be paid to unsecured creditors in a plan that is found to be otherwise fair and equitable. As a practical matter, this is likely to be a lower floor than what would be set in a more organized chapter 7 liquidation.

3. Relation between Fair and Equitable, Unfair Discrimination, Good Faith and Feasibility.

Opinions under Chapter IX of the old Bankruptcy Act, which are often followed as precedent for Chapter 9 cases, and even some opinions under Chapter 9, have blurred the lines between (1) fair and equitable; (2) feasibility; (3) unfair discrimination; and (4) good faith. The following discusses generally how these broad concepts have been construed.

a. Fair and equitable.

While "fair and equitable" has been given a number of additional meanings in the facts of particular municipal cases,[4] a central issue has been whether the amount to be received by unsecured creditors, including labor contract rejection claims and bondholders, is "**all that they 'can reasonably expect in the circumstances**.'" *Collier on Bankruptcy* §943.03 [1][f][i][B]. *Lorber v. Vista Irrigation Dist.*, 127 F.2d 628, 639 (9th Cir. 1942). Cases applying this rule focus on whether a municipal debtor has spent its money wisely and used its taxing power adequately. *Fano v. Newport Heights Irr. Dist.,* 114 F.2d 563, 565-66 (9th Cir. 1990) (Confirmation denied where the debtor had spent twice what was needed on capital expenditures to improve facilities that had been in bad repair and, even with that, would only have had to raise taxes a small amount to meet existing bond obligations).

Other courts have held that, in determining what can be reasonably expected under the circumstances, it is not necessary that all taxes collected go to the payment of creditors. *Lorber v. Vista Irrigation Dist.,* 143 F.2d 282 (9th Cir); *cert denied*, 323 U.S. 784 (1994) ("Heavy delinquencies in meeting assessments . . . an increase of taxes and assessments would make this matter worse . . . the need for large expenditures in the restoration to good working conditions of the District irrigation pipelines . . . the District bonds were listed on exchange at 18 cents; while RFC offered to refinance at 55¢ . . . substantial evidence that the District had been unsuccessful in obtaining a loan from sources other than RFC. We hold that the findings are a sufficient basis for the concluding paragraph IX to the effect that 55¢ on the dollar was the maximum that the District could reasonably pay on outstanding bonds.").

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[4] For example, under old Chapter IX, the fair and equitable standard was held also to include a feasibility standard. *Kelley v. Everglades Drainage District*, 319 U.S. 419 (1943). Fair and equitable has been held to mean that the plan must embody a fair and equitable bargain openly arrived at and devoid of overreaching. *Town of Belleair, Fla v Groves*, 132 F. 2d 542 (5th Cir. 1942); *cert denied*, 318 U.S. 769 (1943). Fair and equitable has also been interpreted as requiring that there is no unfair discrimination in favor of any creditor or class of creditors. *American United Mutual Life Ins. Co. v. City of Avon Park,* 311 U.S. 138 (1940).

Nor is it necessary that taxes be increased where there is evidence that this would not be feasible. *In re Corcoran Hosp. Dist.*, 233 B.R. 449, 459-60 (Bankr. E.D. Cal. 1999) ("[I]n these cases under Chapter IX, the Ninth Circuit Court of Appeals looked at the insolvency of the debtor and whether the debtor could, in fact, raise taxes sufficient to pay the bondholders in full. Here the court has found that the debtor Hospital District could not raise taxes sufficient to pay more to class 5.").

Finally, a "[municipal] district must still have adequate revenues to continue operations because the debtor cannot be dismantled or liquidated as in ordinary bankruptcy." *Collier on Bankruptcy*, ¶ 943.03[1][f][i][B], p. 943-16, citing *Newhouse v. Corcoran Irrigation District,* 114 F. 2d 690 (9th Cir. 1940)*, cert denied,* 311 U.S. 717 (1941).

b. Feasibility.

For a plan to be feasible, the debtor must have adequate capital and cash flow to make the payments proposed under the plan and still maintain operations and service at a level it believes appropriate as a municipality. *In re Corcoran Hosp. Dist*., 233 B.R. 449, 453 (Bankr. E.D. Cal. 1999 (plan feasible); *In re Mount Carbon Metropolitan District*, 242 B.R. 18, 37-38 (D. Colo. 1999) (plan not feasible). This standard focuses on the debtor's ability to perform its proposed plan and does not appear to have been embellished with concepts about how much more the debtor ought to be expected to do to raise money to pay to creditors.

c. Not Discriminate Unfairly.

This is a separate standard, which, as described above, is sometimes treated as an element of fair and equitable and sometimes as an element of good faith. Taken as a separate requirement, it prohibits one creditor receiving some special favor or inducement not given to others. *American United Mutual Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940).

d. Good faith.

The good faith standard employs a case-by-case analysis based on the totality of circumstances. One case found lack of good faith because of disproportionate and discriminatorily better treatment for a landowner who proposed to fund the plan. *In re Mount Carbon Metropolitan District*, 242 B.R. 18 (D. Colo. 1999). *See also Kaufman County Levee Improvement District No. 4 v. Mitchell*, 116 F.2d 959 (5th Cir. 1942); *cert. denied,* 318 U.S. 769 (1943) (confirmation was denied when large bondholders would have received special benefits). Other cases have construed good faith to focus on more traditional concerns about disclosure of self-interest. *In re Wolf Creek Valley Metro District,* 138 B.R. 610 (D. Colo. 1992).[5]

Some litigants might argue that good faith requires a debtor to try harder to pay creditors more by raising more taxes or making more cuts to spending. However, the proof offered by the debtor to meet the "all they can reasonably expect under the circumstances" test would also support its position against such an argument.

D. Summary.

These Chapter 9 standards appear to permit reorganization of a municipality based on reasonable cuts to expenditures and a reasonable level of taxation, with adequate funds to continue the operations of the municipality, even though secured creditors receive only the Court-determined value of their collateral over time, and unsecured claims may not be paid in full and are partially discharged. As such, Chapter 9 may permit a municipality to minimize the damage from past bad business decisions and move forward on a more financially sound basis

The class of general unsecured claims is potentially quite broad. It includes claims for goods provided, rejection damage claims concerning contracts for provision of goods, real estate

[5] One old Fifth Circuit case decided under Chapter IX seems at odds with the statutory scheme set up in Chapter 9 that plainly contemplates, if necessary, forcing a plan on recalcitrant holdouts. In *Wright v. City of Coral Gables*, 137 F. 2d 192 (5th Cir. 1943), the Fifth Circuit found a lack of good faith in the debtor's efforts to "bludgeon" 6% of the bondholders who had held out into accepting the refinancing proposal that it had negotiated with the majority of bondholders.

and labor services, and unsecured bondholders claims for capital provided, including claims for the unsecured portion of undersecured claims where the collateral is worth less than the amount of the claim leaving a residual unsecured claim. This large class of unsecured claims is subject to substantial debt discharge if a municipality is able to show that creditors will receive "all they can reasonably expect under the circumstances" and not less than they would receive if the Chapter 9 case were dismissed.

Negotiations between financially troubled municipalities and their secured and unsecured creditors, including providers of labor and bond financing, will take place against the backdrop of a possible Chapter 9 case. A municipality that has made preparation for a Chapter 9 case can seek to maintain leadership in ongoing negotiations if it is prepared to prosecute plan confirmation litigation promptly. Creditors can seek greater influence through preparation to litigate (i) the municipality's eligibility to be a debtor and (ii) what is actually fair and equitable in the facts of the case. Both sides will be well served if they have employed financial professionals early in the process and are prepared to try these issues, if necessary.

If the system works as intended, it can lead to prompt and efficient resolution of a municipality's financial problems, whether through negotiation or prompt trial.