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Insolvent “On Behalf Of” Municipal Bond Issuers: Chapter 9, Chapter 11, or Ineligible?

Last week, President Trump unveiled his proposal to fix our nation’s aging infrastructure. While the proposal lauded \$1.5 trillion in new spending, it only included \$200 billion in federal funding. To bridge this sizable gap, the plan largely relies on public private partnerships (often referred to as P3s) that can use tax-exempt bond financing. In evaluating bankruptcy and default risk with P3s and similar quasi-governmental entities it is important to understand whether such entities are eligible debtors under the Bankruptcy Code, and, if so, whether they are Chapter 11 or Chapter 9 eligible.

P3s often involve the issuance of bonds by quasi-governmental hybrids, including so-called “63-20 corporations” (named after an IRS Revenue Ruling) that meet IRS criteria for the issuance of bonds by a non-profit corporation “on behalf of” a state or municipality. Such hybrids are used because they have a sufficient nexus to a state or municipal government to satisfy federal tax criteria for the issuance of tax-exempt municipal debt, while being sufficiently distinct from the state or municipal government to escape otherwise applicable state law restrictions on the incurrence of debt. Given such hybrid nature, questions can arise about whether the issuing entity is eligible for Chapter 9 of the Bankruptcy Code (in those states that have authorized filings under that Chapter) or Chapter 11 of the Bankruptcy Code. That distinction is significant.

Not only are the rules in Chapter 9 and Chapter 11 different (particularly as they relate to bond debt), but there are more eligibility restrictions in Chapter 9 than in Chapter 11. Chief among these is the requirement of specific state authorization for Chapter 9 eligibility. Where such authorization currently does not exist, bondholders can be lulled into a false sense of security thinking their issuer cannot file bankruptcy under Chapter 9, only to find out that the issuer is Chapter 11 eligible.

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February 26, 2018

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