

Bond Case Briefs

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What 'Adult Entertainment,' Puerto Rico And Chapter 9 Bankruptcy Have In Common.

To keep a sense of perspective during the ongoing contentious priority-of-liens fight in the Puerto Rico bankruptcy proceedings, consider the case of [Eric Joelner, Fish, Inc. d/b/a XXXtreme Entertainment v. Village of Washington Park, Illinois](#). In the annals of municipal bankruptcy, this is a very small footnote, for sure, but still relevant.

Back in 2003, Washington Park was having a hard time paying its bills. The usual economic suspects were making it tough on this 2.5 square mile town of 5,300 residents with a 42% poverty rate—manufacturing jobs were gone, there were cuts to state aid, and people were leaving. By its own admission, it was “in the red” on its \$3.8 million budget.

To make ends-meet, the town raised licensing fees on its highest revenue generating businesses: “adult entertainment” establishments. Those businesses within the city limits saw their licensing fees jump ten-fold, from \$3,000 to \$30,000.

Mr. Joelner, a long-time proprietor of such a “public service” business (the court’s words, not mine) took exception on First Amendment grounds, sued and prevailed. Washington Park didn’t get the revenues. The Village ultimately filed for bankruptcy protection, in part due to, among other things, yes, monies owed to the owner of a certain [topless bar](#)—Mr. Joelner, to be exact.

Priorities

That put the judge in the case in the rather thankless role of determining the priority of unsecured liens that, in addition to the bar’s claim, included fees to lawyers, the police pension and one Johnny “Chico” Matt, the town’s former public safety director. While the jokes write themselves about how to weigh the priority of lawyers against adult entertainment owners in the Washington Park case, the judge handling Puerto Rico’s case faces the same issue of prioritization, just without any of the humor.

For example, look at the recent intricate proposal by the bondholders of Puerto Rico’s sales-tax backed COFINA (Puerto Rico Urgent Interest Fund Corporation) debt seeking court approval in an upcoming hearing. It includes, in addition to a bond swap, a provision to pay themselves the \$1.2 billion in Trustee-held funds. In justifying the plan, COFINA bondholders point to [Act 91-2006](#) as the statutory security for their senior priority of lien claim.

The [general obligation](#) bondholders disagree vehemently. In their view, the plan gives COFINA investors, senior and subordinate, priority over what they see as their constitutionally protected priority lien. They point to [Article VI, Section 8 of the Puerto Rico’s Constitution](#).

Let the legal fisticuffs ensue.

Practitioner’s Perspective

This problem of prioritizing and resolving conflicting claims falls to the job of the U.S. District Court magistrate. When it comes to municipal bankruptcies, one former judge on that court has given this a great deal of thought. Drawing from his considerable experience on the bench, most notably overseeing the \$3 billion bankruptcy filing by [Jefferson County, Alabama](#), the [Honorable Thomas B. Bennett \(Ret.\)](#) (now of Counsel with Bailey & Glasser) reflected on the problem of unsecured or conflicting liens when a municipality files under Chapter 9.

A Quick History Of The General Obligation Pledge

Since the general obligation (GO) security pledge backs the vast majority of debt issued by municipalities, the Counselor offered some key legal history as to how it came to pass. A democratic government is by and of the people; government entities cannot offer a lien on those things owned by the people. Hence the “general obligation” pledge: a promise to pay but not a lien on any specific public assets.

That left governments seeking to borrow with a problem. They lacked traditional hard assets to offer as a lien to secure payment. A promise to pay is not a lien. To make up for that, some states established a statutory mandate to back the GO pledge. Often local governments added unlimited taxes to the pledge as further, tangible security.

An Unsecured Security

But as the Detroit bankruptcy demonstrated, even the “unlimited tax” pledge has limitations. Bondholders found themselves fighting not only other unsecured creditors but also pensioners who claimed, well, a superior claim. Bondholders discovered, to their chagrin, that court can only rule on the GO pledge’s priority in the pantheon of liens and claims; it cannot impose nor raise “unlimited taxes” by judicial decree. The “unlimited tax” bondholders took a cut that left them with 74 cents on the dollar.

James E Spiotto, retired partner of Chapman and Cutler LLP and now Managing Director Chapman Strategic Advisors LLC framed the problem succinctly: a paper right might not exist in reality. He too comes from a practitioner’s perspective. A published author in the field of Chapter 9 bankruptcies, Spiotto not only practiced bankruptcy law but also provided testimony and written statements to the U.S. House of Representatives and Senate on the 1988 Amendments to Chapter 9 legislation.

A More Secured Security

Unsecured creditors are but one lien issue the court has to vet through. As government and its services expanded, politicians got “cutesy”—Bennett’s words exactly. To avoid taking on more municipal debt on their balance sheet and having to go to the voters to raise taxes to support it, they created new financing authorities and agencies to fill the need. This begat types of security other than the GO pledge to back those bonds. Correspondingly, a cascade of varying liens and carve-outs developed as revenues from fees, sales taxes, taxes on incremental property values, tolls, fuel taxes and structured settlements—to list a few—were codified in bond documents as secured liens to repay debt holders.

Liening On The Law

As these liens developed, the law did not keep pace. This created a problem for the U.S. District Court judge adjudicating a Chapter 9 proceeding. Bennett observed that in a municipal bankruptcy, the law hasn’t been fully fleshed out and the issues haven’t been worked. Because municipal

bankruptcy is rare and the causes unique, the Bench has limited guidance from which to draw when looking to apply legal criterion to determine priority among unsecured creditors. To misapply the words from Tolstoy's *Anna Karenina*, happy bondholders are all alike; every unhappy bankruptcy participant is unhappy in their own way. Stockton, Vallejo, Harrisburg and Central Falls make for good headlines; they leave little in terms of precedent in the case law for the courts to cite. The plethora of other liens, as the Puerto Rico example highlights, only complicates matters.

Statutory Direction

Bennet offered that, in the courtroom, the judge can only rely on the facts presented and make a determination based on the law. Here is where turning to the actual statute should offer direction. The Chapter 9 legislation establishing the municipal bankruptcy framework was drafted to offer guidance but also to be flexible. Since experience and case law didn't offer much, legislators had limited experience from which to draw. Additionally, there was the tacit acknowledgement of the varying circumstances in each bankruptcy. No law can be so comprehensive as to cover every situation, nor should it be. The courts need some leeway to find direction in working the law. Additionally, the drafters had to consider the varied state statutes governing bankruptcy; there are [state by state](#) laws as to whether or not a municipality can file and under what terms they can file if so permitted. Consequently, to take all these factors into account, the statute was crafted to offer guideposts as to process and procedure, but not dictate outcomes.

Spiotto contends that there is one aspect of the law that is clear. The U.S. Bankruptcy Court is bound to adhere to the Tenth Amendment of the U.S. Constitution and co-sovereignty the states. State laws and mandates cannot be rewritten from the bench. Equally, his view was that a municipality not only must pay any revenues dedicated to creditors but also those dedicated revenues cannot be used for other purposes until creditors are paid. Moreover, the municipality cannot be compelled by the court to not pay that which the state, by statute or otherwise, has mandated to be paid—which was the rationale behind the 1988 amendments to the federal statute.

Ultimately, that is the legal root of the dispute that continues to this day in Puerto Rico.

Academic Thinking

Discerning and prioritizing claims in municipal bankruptcies is on the minds of legal scholars as well. David Schleicher, professor of law, Yale Law School and fellow authors Adam J. Levitin, professor of law Georgetown University Law Center and Yale Law School graduate Aurelia Chaudhury, in their upcoming article *Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities* (California Law Journal) take up the central question of conflicting security interests in Chapter 9 bankruptcy.

In this thoroughly researched and well-written piece, the authors contend that conflicts between bondholders as seen in Puerto Rico are just the tip of the iceberg and are likely to get more intractable. For example, one count had residents of Chicago paying taxes to 21 different districts, entities and authorities with separate levies on essentially the same underlying taxable boundary. It is not difficult to imagine the troubles one or more bankruptcy filings could create.

Seeing the emerging problem and noting that "Chapter 9 does not currently address the problems of overlapping local debt crises" and that the "statutory language is sufficiently capacious and indeterminate," Schleicher, et alia view that as an opportunity. They advocate that the vagueness leaves room for "both courts and state legislatures [to] develop tools to stop local governments from acting in ways that are collectively harmful, even if individually rational, during insolvency crises." Given the events in Puerto Rico, the authors may be both current and prescient.

What Guides The Final Plan

If plan approval were solely a matter of clean-cut law, the dispute would be over and done with in Puerto Rico, as some contend it should be.

But the fact that it *hasn't* been clean cut summons the issue that the law is conjoined by another factor the court must weigh—public policy. Municipal bonds fund essential public purposes. It is the core of their strength as an asset class. Businesses may come and go as public tastes change and technologies evolve. Municipal services—good schools, paved roads, clean water, green parks, lit streetlights and such—are necessary regardless. The law can say whatever it says but, if at the end of the day, a plan leaving a municipality bereft of resources to provide its citizens basic services yet still pays bondholders in full is dead before the ink dries on the brief.

This critical factor weighs on the mind of every justice overseeing a Chapter 9 proceeding and likely, in particular, the judge overseeing the case in cash-strapped and economically destitute Puerto Rico.

So what guides the court through the fog of litigation to address both the law and public policy so a plan can be approved? Spiotto presented three simple and to the point questions:

1. Is the plan feasible both economically and by implementation?
2. Is it in the best interest of the creditors?
3. Is it fair and just?

For a plan to be approved, the answer to each of these questions must be an unequivocal “yes.”

There is a lesson for the municipal bond investor. When sorting through the seemingly overwhelming number of debt issues, their jumble of security liens and unduly complex documents, keep in mind that good economics and an essential public purpose will do more than any carefully drafted legal protections. Otherwise, be ready to face the risk of joining the unhappy bankruptcy family.

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