Bond Case Briefs

Municipal Finance Law Since 1971

Waller: Municipal Debtors: "Cram Down" of Special Revenue Debt.

Municipal financing differs in a number of significant ways from traditional commercial financing. Therefore, while chapter 9 of title 11 of the United States Code (the "Bankruptcy Code") incorporates many provisions applicable in cases under chapter 11 of the Bankruptcy Code, including section 1129(b), a/k/a the "cram down" section, it also contains its own provisions with respect to the confirmation of a plan of adjustment – i.e., sections 943 and 944 of the Bankruptcy Code. See 11 U.S.C. § 901(a) (incorporating sections of the Bankruptcy Code). When considering the differences between cram down scenarios in cases under chapter 11 of the Bankruptcy Code and cases under chapter 9 of the Bankruptcy Code, one must consider the prevalence of special revenue financing by municipal debtors and the protections that are built into chapter 9 of the Bankruptcy Code.

I. CAN SPECIAL REVENUE DEBT BE IMPAIRED?

A. Special Revenue Financing

Our system of federalism grants state governments the independence and the freedom (with the consent of their citizens) to authorize local governmental bodies to finance various governmental functions and necessary improvements through the issuance of municipal bonds. Municipalities issue their own debt obligations either based on their full faith and credit (general obligation bonds) or based upon the revenues to be collected by the municipality from the financed improvement (revenue bonds). Local government borrowing differs in a fundamental way from either individual or corporate borrowing. The municipal borrower is an entity having special characteristics that differ from those of private actors. See Joel A. Mintz et al., Fundamentals of Municipal Finance 45 (2010). The local government exists solely to provide governmental services; it does not exist for profit-making purposes. Id. Due to the public benefit of financed projects, like water and sewer systems, municipalities are limited in the actions they can take with these assets, including certain restrictions on the right to mortgage or transfer the property, or to allow foreclosure or possession of the property by a secured creditor in the event of default.1 Further, limitations exist due to the state's interest in protecting the credit of the state and insuring that municipalities do not harm the state's credit by undertaking obligations which cannot be repaid.

As municipalities have grown, so has their need for financing. Protecting the integrity of municipal financing is essential to the continued confidence of the municipal bond markets. Thus, municipalities have traditionally made every effort to honor their public debt obligations.

i. Protections for Special Revenue Creditors

Unlike general obligation bonds, which are backed by the full faith and credit of the issuer and, therefore, rely on the assessment and collection of taxes for repayment, revenue bonds do not increase the tax burden of the citizens. They are non-recourse obligations repaid solely from the revenues (and other specified pledged funds) generated by the project that is being financed, such

as a sewer or water system, toll road, toll bridge, tunnel, or the like. Consequently, in many jurisdictions, revenue bonds may be issued without voter approval or other procedures often required for the issuance of general obligation bonds. See Fundamentals of Municipal Finance, at 3-4.

To entice the public to purchase revenue bonds in particular, states have enacted statutory provisions designed to promote this type of financing. Since repayment of the revenue bonds are limited to the stream of income from the financed public projects, states authorize the issuing municipality to irrevocably pledge (or set aside) the revenue stream (or net revenue stream) for the benefit of the revenue bondholders. Typically, the pledge includes the creation of a first lien on the revenue stream. Some states even provide that the pledged revenue streams are held in trust for the benefit of the special revenue creditors. For example, Alabama recognizes that pledged revenues "shall constitute a trust fund or funds which shall be impressed with a lien in favor of holders of the warrants to the payment of which such pledged funds are pledged" and that the pledged revenues are "irrevocably pledged for the payment of the principal and interest on such warrants as provided in Section 11-28-3." Ala. Code §§ 11-28-2, 11-28-3.

Other protections that are authorized by state law and that are often contained in revenue bond documents are covenants in which the issuer pledges: (a) to issue all bonds necessary to finance the project; (b) to complete project construction expeditiously; (c) to maintain specified amounts of reserve funds; (d) to fix, establish, and collect appropriate fees, rates, tolls, or user charges; and (e) to restrict the investment of bond proceeds. Fundamentals of Municipal Finance, at 3-4. In addition, where revenue bonds are issued to finance a series of projects undertaken by the same issuer, the municipality that issued them will usually pledge not to issue any additional bonds that are secured by the same revenue stream, unless current revenues are sufficient to cover a specified percentage of both current and future debt service on both outstanding bonds and the new bonds. Id. Once entered into, the revenue bond covenants may not be modified or abandoned by the municipality. Id.2

Since bondholders are unable to take ownership of certain public assets, municipalities will often transfer certain control rights to bondholders to provide the holders with a meaningful remedy in the event of nonpayment. One such remedy is the right to the appointment of a receiver to oversee the particular project in question, and, if appropriate, raise rates sufficient to pay the special revenue debt issued to finance the project.

The states and their municipalities have designed these financing structures to guaranty that the revenue stream relied upon by special revenue bondholders will be protected and not impaired. These statutory provisions protect not only bondholders but also protect the overall credit of the state and all of its municipalities. See Fundamentals of Municipal Finance, at 4. As will be discussed in more detail below, given the prevalence of this type of financing, and with it being particular to municipal debtors, Congress, in amending chapter 9 of the Bankruptcy Code in 1988, intended to protect and preserve the bargain made between the municipal debtors, as issuers, and the holders of special revenue debt.

B. Chapter 9 And A Brief History Of Municipal Bankruptcy Legislation3

Chapter 9 of the Bankruptcy Code is the sole chapter under which a municipality may seek bankruptcy relief. Chapter 9 has evolved since it was first enacted in 1934. Prior to 1988, chapter 9 lumped all of a municipality's debt into one pot and did not distinguish between general obligation bonds and special revenue bonds. In 1988, Congress approved a series of amendments (the "1988 Amendments") aimed at distinguishing between the two types of bonds. The intent of Congress in enacting the 1988 Amendments was to ensure that state laws protecting special revenue financing

were honored in a chapter 9 proceeding and the rights of special revenue creditors would receive additional protections not granted prior to the 1988 Amendments. See S. Rep. No. 100-506, at 13 (1988) (the "Senate Report"). Specifically, the 1988 Amendments sought to ensure that special revenue bondholders would have unimpaired rights to the project revenues pledged to them.

The ultimate intent of Congress in enacting the 1988 Amendments was to provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing. The Senate Report for the 1988 Amendments noted that "[r]easonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal financing." Id. at 21. The Senate Report further noted that:

To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to receive the revenues pledged to them in payment of debt obligations of a municipality, a new section is provided in the amendment to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them. . . .

Id. at 12 (emphasis added). For example, prior to the 1988 Amendments, special revenue bondholders were at risk that section 552(a) of the Bankruptcy Code would strip them of their liens on post-petition revenues. The Senate Report addressed that issue:

In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenue granted pursuant to state statutory or constitutional provisions to bondholders can be terminated by the filing of a chapter 9 case. Likewise, under the contract clause of the constitution (article I, section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a chapter 9 proceeding.

Id. at 6 (emphasis added). The risk posed by section 552(a) was eliminated by the 1988 Amendments. See In re Cnty. of Orange, 179 B.R. 185, 191-92 (Bankr. C.D. Cal. 1995).

While protecting the integrity of special revenue bonds in chapter 9, Congress was also determined to protect the integrity of the state laws that authorize special revenue municipal financing. With revenue bonds, "the general taxpayers are usually not committed to repaying the bonds or funding operational deficits through general tax revenues . . . [and] it would be quite problematic and contrary to state law if a bankruptcy filing resulted in revenue bonds being converted into general obligation bonds." Senate Report, at 5. With regard to the 1988 Amendments, one court has noted:

The 1988 Amendments to the Bankruptcy Code added the definition of "special revenues" in § 902(2). The 1988 Amendments were intended to preserve a dichotomy between general obligation and special revenue bonds for the collective benefit of bondholders (to secure the benefit of their bargain), municipalities (to maintain the effectiveness of the revenue financing vehicle) and taxpayers (to ensure that revenue obligations were not transformed into general obligations).

In re Heffernan Mem'l Hosp., 202 B.R. 147, 148 (Bankr. S.D. Cal. 1996).

C. Sections 927, 928(a) And 1111(b) Protect Special Revenue Debt From Impairment During the Case and From a Cram Down.

The confluence of sections 927, 928(a) and 1111(b) of the Bankruptcy Code demonstrate Congress' intent to protect the benefit of the bargain made by a municipal debtor, as issuer, and the holders of special revenue debt obligations under chapter 9 of the Bankruptcy Code both during the case and

at confirmation.

i. Congress preserved the extent, validity and priority of liens on special revenues post-petition.

Through section 928(a) of the Bankruptcy Code, Congress preserved the extent of the creditors' liens on special revenues of a municipal debtor. Section 902 defines special revenues as:

(A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than taxincrement financing) levied to finance the general purposes of the debtor[.]

11 U.S.C. § 902(2). In turn, section 928(a) of the Bankruptcy Code preserves the extent of a creditor's lien on special revenues by granting such creditor a continuing post-petition lien on special revenues to the same extent as existed prepetition. Specifically, section 928(a) of the Bankruptcy Code provides:

Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, 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.

11 U.S.C. § 928(a). Whereas, in a chapter 11 case a secured creditor with a consensual lien will not maintain its liens on collateral of the same type generated post-petition, in a chapter 9 case a consensual lien secured by special revenues continues to attach to post petition revenues to the same extent it existed prepetition.

ii. Congress similarly preserved the value of liens on special revenues.

Through the combination of sections 1111(b) and 927 of the Bankruptcy Code, Congress also preserved the value of liens against special revenues. Section 1111(b) of the Bankruptcy Code provides:

(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless – (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

11 U.S.C. § 1111(b). Congress enacted Section 1111(b) in an attempt to prevent the harsh results faced by non-recourse lenders in a cram-down scenario. See, e.g., Great Nat'l Life Ins. Co. v. Pine Gate Assocs., Ltd., 2 B.C.D. 1478 (Bankr. N.D. Ga. 1976). In Pine Gate, the court exercised its cram-down powers under Chapter XII to cash out a nonrecourse undersecured mortgagee at the appraised value of the property, rather than the amount of debt, at a time of depressed prices. In opposition to

the debtor's proposed plan, the lenders argued that their negotiated "benefit of the bargain" under the non-recourse financing arrangement was either (i) full payment or (ii) the right to foreclose on the property, and that their interests would not be adequately protected unless they were paid in full or allowed to foreclose. The Pine Gate court disagreed, holding that the proposed treatment of the secured claim through a cash payment equal to the appraised value of the collateral was sufficient. In reaching its decision, the court relied upon authority for the proposition that a secured creditor was entitled to receive no more than the appraised value of secured property as just compensation for the loss of the property and satisfaction of its security interest." Pine Gate, 2 B.C.D. at 1478. Accordingly, while the debtor retained ownership of the property, the mortgagee was not paid in full, did not retain its lien, and was deprived of its right to sue for a deficiency. See In re S. Vill., Inc., 25 B.R. 987 (Bankr. D. Utah 1982) (discussing the Pine Gate decision).

As a result of Pine Gate, it became clear that a debtor could seek relief through bankruptcy during a period when property values were depressed, propose to repay secured indebtedness only to the extent of the then-appraised value, cram-down a non-recourse secured lender, and preserve all potential future appreciation for the debtor alone." See In re DRW Prop. Co., 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986). In addition, "[t]he undersecured nonrecourse lender would not be entitled to vote in the unsecured class, thereby making confirmation of the plan much easier." Id. (citing In re S. Vill., 25 B.R. 987 (Bankr. D. Utah 1982); Jeffrey A. Stein, Section 1111(b): Providing the Undersecured Creditors with Post-Confirmation Appreciation in the Value of the Collateral, 56 Am. Bankr. L.J. 195 (1982)). Secured creditors were shocked by this result and sought relief from Congress when the Bankruptcy Code was proposed and debated. See Richard F. Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Prerogative, 39 Bus. Lawyer 441 (1984).

As a result of the concern communicated to Congress, the final version of the Bankruptcy Code included section 1111(b) for purposes of alleviating the problem recognized under Pine Gate and restoring the "benefit of the bargain" expected by nonrecourse lenders. Kenneth N. Klee, All you Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L.J. 133 (1979); Michael J. Kaplan, Nonrecourse Undersecured Creditors Under New Chapter 11 – The Section 1111(b) Election: Already a Need for Change, 53 Am. Bankr. L.J. 269 (1979). Accordingly, as codified in the Bankruptcy Code, section 1111(b) now represents Congress' attempt "to create a balance between the debtor's need for protection and a creditor's right to receive equitable treatment." See In re Trenton Ridge Investors, LLC, 461 B.R. 440, 505 (Bankr. S.D. Ohio 2011) (quoting In re Union Meeting Partners, 160 B.R. 757, 769 (Bankr. E.D. Pa. 1993)).

Section 1111(b) balances those interests in two ways. First, if a nonrecourse mortgagee is substantially undersecured, the mortgagee may retain the recourse status conferred by section 1111(b)(1)(A) and cause that class of claims to vote to reject the plan. Id. In such a circumstance, the undersecured creditor can make it impossible to confirm a plan absent a cramdown in accordance with section 1129(b)(2)(B), which would require that the unsecured claims be paid in full or that junior interests receive nothing under the plan. Id. In this way, the undersecured creditor can force the debtor into a situation where the debtor must propose a plan satisfying the unsecured debt or eliminate the debtor's interest in the property. Id. (citations omitted).

Second, a secured creditor is permitted to make an election pursuant to section 1111(b)(2). Upon making such an election, the secured creditor forfeits its right to recourse against the debtor (i.e., the right to pursue an unsecured claim), but is instead granted an allowed secured claim in the amount of the debt rather than in a judicially determined amount. Id. Hence, the creditor may benefit from any future increase in the value of the property. Id.; see also Tuma v. Firstmark Leasing Corp., 916 F.2d 488 (9th Cir. 1990) (with section 1111(b), Congress sought to give creditors the opportunity to capture future appreciation in the value of their collateral); In re Bloomingdale

Partners, 155 B.R. 961, 974 n.7 (Bankr. N.D. Ill. 1993) ("Congress [arguably] enacted section 1111(b) to prohibit debtors from cashing-out creditors at judicially determined values."); In re Weinstein, 227 B.R. 284, 295 n.12 (B.A.P. 9th Cir. 1998) ("The real benefit of the [section 1111(b)] election is that it protects the creditor against a quick sale of its collateral. . . . By making the election, the creditor guards against an opportunistic sale . . . .").

In 1988, Congress amended chapter 9 of the Bankruptcy Code, proposing "to clarify the provisions of the Bankruptcy Code applicable to municipalities and to correct unintended conflicts that currently may exist between municipal law and bankruptcy law." Senate Report, at 1. Congress approved the 1988 Amendments to chapter 9 because it wanted to ensure that the market for municipal debts remained stable. Id. at 21 (Senate Judiciary Committee recognizing that "[r]easonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal financing."). In approving the 1988 Amendments, Congress recognized that the pledges common to municipal finance must not be adversely affected, even where a bankruptcy filing has occurred, in order to ensure stability in the special revenue financing market. Id. at 3. Congress also recognized that there were restraints on the treatment of special revenue financing imposed by state constitutions. Accordingly, Congress included limitations on both the: (i) conversion of non-recourse obligations into recourse obligations; and (ii) the ability to impair the holders of special revenue debt obligations.

As part of the amendments in 1988, Congress addressed the non-recourse nature of special revenue financing. One of the main concerns that the 1988 Amendments sought to address was that "[s]ection 1111(b) provides that in some circumstances non-recourse debt may be treated as recourse debt." Senate Report, at 22. The problem presented was that "[m]any municipal obligations are, by reason of constitutional, statutory, or charter provisions, payable solely from special revenues and not the full faith and credit of the municipality." Id. Thus, to resolve this problem, the 1988 Amendments adopted section 927, prohibiting conversion of revenue bonds into general obligation bonds in a chapter 9 case. "[The 1988 Amendments] [therefore] avoid[] the potential conversion of revenue bonds into General Obligation bonds under Section 1111(b)." Senate Report, at 2; see also H.R. Rep. No. 100-1011 (1988), at 7 (new section 927 to be added to ensure that non-recourse revenue bonds cannot be converted under section 1111(b) into recourse, or general obligation, debt because allowing such may violate some state constitutions and statutes). The reasoning behind Section 927 has been summarized as follows:

The amendments protect the future effectiveness of revenue bond financing against the possibility of an adverse judicial determination in connection with a municipal bankruptcy. Specifically, the amendments insure that in the event of a municipal bankruptcy, taxpayers will not be required to pay bondholders for bankrupt municipal projects that were intended to be funded exclusively through project revenues. The amendments insure that state constitutional and statutory debt limits will not be preempted by the application of bankruptcy laws. Finally, the amendments insure that revenue bondholders receive the benefit of their bargain with the municipal issuer, namely, they will have unimpaired rights to the project revenues pledged to them.

Senate Report, at 12-13 (emphasis added).

Section 927 of the Bankruptcy Code reads as follows:

The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b) of this title.

11 U.S.C. § 927. While adding section 927 to chapter 9, Congress could also have elected to remove

the incorporation of section 1111(b) into chapter 9. However, pursuant to section 901, Congress incorporated section 1111(b), but chose merely to limit it. Section 1111(b), subject to the limitations imposed by section 927, still stands. Thus, in the context of special revenue bonds, the section 1111(b) election is automatic, not requiring any affirmative act by the secured creditor. The ability to elect full recourse treatment for non-recourse debt has been statutorily removed by section 927.

Although Congress recognized that the existing chapter 11 choice for full recourse treatment of non-recourse debt would be unavailable to chapter 9 creditors due to state constitutional limitations on recourse financing, it did not intend for the result to be the continued impairment of special revenue financing by results such as that reached in Pine Gate. Indeed, the existing structure of the Bankruptcy Code prevents such an impairment. By incorporating section 1111(b) into chapter 9, but also limiting the conversion of nonrecourse debt to recourse debt, Congress made the section 1111(b)(2) election automatic, providing that the debtor must pay the full value of the claim. Any other reading would render the incorporation of section 1111(b) and the limitation set forth in section 927 superfluous. Further, it makes no sense to read chapter 9 as taking both the recourse protection as well as the section 1111(b)(2) protection away from secured lenders when Congress could have achieved such a result by simply not including section 1111(b) in section 901. Accordingly, in a case under chapter 9, a special revenue finance creditor must be treated as having an allowed secured claim in the full amount of the outstanding debt.

D. In Addition To The Foregoing Provisions Of The Bankruptcy Code, Municipal Debtors Face Additional Constitutional Limitations.

In addition to Congress's intent to protect the bargains made with respect to special revenue financing, municipal debtors, as governmental units, are also subject to certain limitations imposed by the United States Constitution (the "Constitution") and the municipality's applicable state constitution.

Limitations set forth in the Fifth Amendment to the Constitution may impose obstacles or otherwise prohibit a cramdown with respect to a creditor whose claim is secured by special revenues. The Fifth Amendment provides:

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

U.S. Const. amend. V. (emphasis added). The limitations of the Fifth Amendment also apply, through the Due Process Clause of the Fourteenth Amendment, to takings by state governments and their subdivisions. See, e.g., Lucas v. S.C. Coastal Council, 505 U.S. 1003 (1992). As a result, the Fifth Amendment is applicable to municipal debtors, and a municipal debtor may not take property without just compensation.

The protections afforded by the Fifth Amendment are not abrogated by the Bankruptcy Code. The legislative history of the Bankruptcy Code indicates that the drafters of the Bankruptcy Code considered the Fifth Amendment to be a limitation upon the impairment of property rights in bankruptcy, and current bankruptcy law gives great deference to property rights. Julia Patterson Forrester, Bankruptcy Takings, 51 Fla. L. Rev. 851, 863 (Dec. 1999). The Supreme Court of the United States has addressed the takings issue in the context of bankruptcy on several occasions, holding each time that the bankruptcy power is limited by the Fifth Amendment. See United States

v. Security Indus. Bank, 459 U.S. 70, 75, 78 (1982); Wright v. Vinton Branch of Mtn. Trust Bank, 300 U.S. 440, 456-58 (1937); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935); see also Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island, & Pac. Ry., 294 U.S. 648, 669 (1935) (stating that the bankruptcy power is not unlimited); Holt v. Henley, 232 U.S. 637, 639 (1914) (holding that an amendment to bankruptcy law must be applied prospectively to avoid affecting existing property rights). In the context of a chapter 9 case, it is important to determine the scope of the property rights held by a creditor where the debt at issue is secured by special revenues, and the impact that may have on the debtor's ability to effect a cramdown.

While most people think of property as a thing that is owned by someone, bankruptcy specialists understand property as a collection of rights with respect to things. Stephen J. Ware, Security Interests, Repossessed Collateral, and Turnover of Property to the Bankruptcy Estate, 2002 Utah L. Rev. 775, 776 (2002). A sophisticated understanding of property dissolves the unitary conception of ownership into a metaphorical "bundle" of rights reflecting the fact that more than one person can have rights with respect to a particular thing. Id. Consistent with this understanding, courts have held that contractual rights are cognizable property interests protected under the Takings Clause of the Fifth Amendment. Century Exploration New Orleans, Inc. v. United States, 103 Fed. Cl. 70, 76 (Fed. Cl. 2012) (citing Lynch v. United States, 292 U.S. 571, 579 (1934) (stating that valid contracts are property protected by the Fifth Amendment); Lion Raisins, Inc. v. United States, 416 F.3d 1356, 1370 (Fed. Cir. 2005)). Even further, courts have generally classified as property, or rights to property, transferable interests generating pecuniary value. 21 West Lancaster Corp. v. Main Line Restaurant, Inc., 790 F.2d 354, 357 (3d Cir. 1986) (citing United States v. Bess, 357 U.S. 51, 55 (1958) (for tax lien purposes, life insurance policies are property to the extent of their cash surrender value, since policy holder could compel payment of that amount); Note, Property Subject to the Federal Tax Lien, 77 Harv. L. Rev. 1485, 1486–87 (1964) (federal classifications have focused on transferability and leviability of interest)). In the words of one court, the question to be asked is, "[is] the interest . . . bargainable, [is] it transferable, [does] it have value?" Randall v. Nakashima & Co., Ltd., 542 F.2d 270, 278 (5th Cir. 1976). Based upon the foregoing, the question then becomes, "Which parts of the contract – of the bargain – constitute property subject to the protections afforded by the Fifth Amendment?"

While it is clear that the Fifth Amendment provides certain protection, there is no set formula for determining when justice and fairness require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons. Penn Central Transp. Co. v. City of N.Y., 438 U.S. 104, 124 (1978). Rather, a takings analysis depends on the facts of each case, as the Supreme Court of the United States has explained:

[T]he Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant, and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. . . . So, too, is the character of the governmental action. A "taking" may more readily be found when the interference with property can be characterized as a physical invasion by government . . . than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the public good.

Id. (citations omitted). Consistent with the Penn Central opinion, the Supreme Court of the United States has further explained that, when considering whether an impermissible taking has occurred, courts should consider: (i) the economic impact of the action; (ii) its interference with reasonable investment-backed expectations, and (iii) the character of the governmental action. Kaiser Aetna v. United States, 444 U.S. 164, 175 (1979).

Based upon the foregoing, many questions arise in the context of a chapter 9 debtor seeking to

cramdown the holders of debt, particularly special revenue debt. Can a municipal debtor impair covenants, such as the covenant to control the value of the stream of special revenues – i.e., covenants with respect to controlling the proverbial spigot – without violating the Fifth Amendment? Is a municipal debtor entitled to divert special revenues to pay additional obligations for the good of the municipality? To the extent certain provisions of the contractual relationship between a municipal debtor and a creditor secured by special revenues are deemed property, the Fifth Amendment arguably prohibits such actions or, at least, imposes obstacles to the debtor's ability to do so.

E. State Trust Law May Remove Special Revenues From A Municipal Debtor's Control and Its Ability to Impair in a Case Under Chapter 9.

As mentioned above, some state laws provide that special revenues pledged to the repayment of special revenue obligations are pledged and held in trust. For example, the Supreme Court of Alabama has stressed, a pledge "means set apart, appropriated, or charged with the payment of a specific obligation authorized by law. . . . That the pledge may, by appropriate remedy, require such revenues conserved and applied to the secured demand . . . needs no citation of authority." Heustess v. Hearin, 104 So. 273, 274 (Ala. 1925). See also Sylvan G. Feldstein, et al., The Handbook of Municipal Bonds 1295 (John Wiley & Sons, Inc. eds., 2008) (defining "pledged revenues" as "revenues legally pledged to the repayment" of the warrants).

It is fundamental that a debtor can only restructure "claims" against it in accordance with the requirements of the Bankruptcy Code. "[A] debtor owes a 'debt' to [a] creditor, who has a 'claim' against the debtor." In re Threatt, No. 04-82082C-13D, 2004 WL 2905344, at *2 (Bankr. M.D.N.C. Dec. 13, 2004) (quoting 8 Collier on Bankruptcy ¶ 1300.12[5] (15th ed. 2d. rev. 2004)). "Claims against a debtor" are defined as including "claims against the property of the debtor." 11 U.S.C. § 102(2) (emphasis added).4 These fundamental principles of bankruptcy law were incorporated into chapter 9. When special revenues are by state law transferred to be held in trust for the benefit of the holders of the debt secured by the special revenues, the municipal debtor may not be able to impair the creditors' property interests in the revenues.

A bankruptcy court must look to state law to determine the debtor's interest in a particular piece of property. Under settled principles of state trust law, property held in trust by one for the benefit of another is deemed to be property belonging to the beneficiary, not the trustee. Because, under state law, trust assets belong to the beneficiaries, the trust assets are not debtor's property or property of the debtor's estate, and shall not be distributed to any other creditors or sold unless all trust beneficiaries have been paid. See, e.g., In re Monterey House, Inc., 71 B.R. 244 (Bankr. S.D. Tex. 1986) ("That the corpus of a trust is not property of the estate is so widely accepted as to be beyond dispute."); Matter of Vacuum Corp., 215 B.R. 277, 280 (Bankr. N.D. Ga. 1997) ("Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not 'property of the estate' and is also not 'property of the debtor' for purposes of § 547(b)."); Matter of Quality Holstein Leasing, 752 F.2d 1009 (5th Cir. 1985) ("Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own."); United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n. 10 (1983) ("Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition."); Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36 (1962) ("[Bankruptcy law] simply does not authorize a trustee to distribute other people's property among a bankrupt's creditors.").5

Courts have treated numerous types of municipal debtors as "trustees" of funds held on behalf of municipal bondholders. See, e.g., State ex rel. Central Auxiliary Corp. v. Rorabeck, 108 P.2d 601, 603 (Mont. 1941) (officers of irrigation district responsible for levy and collection of tax sufficient to pay principal and interest on bonds of the district, as well as county treasurer who is custodian of

those funds, are trustees for district bondholders); Blackford v. City of Libby, 62 P.2d 216, 217-18 (Mont. 1936) (city becomes trustee on behalf of warrantholders of special improvement district); Fidelity Trust Co. v. Vill. of Stickney, 129 F.2d 506 (7th Cir. 1942) (holding the money which municipality collects in payment of special assessments is trust fund). In those cases, the courts held that the municipality merely served as a custodian of the funds held for the bondholders, and could not apply the funds toward other purposes. See, e.g., In re City of Columbia Falls, Mont., 143 B.R. 750, 762 (D. Mont. 1992) ("A fund that is derived from a special levy or one created for a specific purpose is in the hands of municipal officials in trust. The municipality is merely a custodian, and its duties relative to such funds are purely ministerial. . . ."; holding funds held in trust may not be applied to purchase of other property). In addition, courts have found a fiduciary relationship exists between the municipality and the bondholders. See, e.g., Vill. of Brookfield v. Prentis, 101 F.2d 516 (7th Cir. 1939) (municipality issuing special assessment bonds for local improvement is a trustee of the special assessment funds charged with all duties of such a fiduciary, including the obligation to spread the assessment, collect it, and make disbursement thereof in conformity with the statutory provisions to those holding bonds payable out of the assessments); Sampson v. Vill. of Stickney, 173 N.E.2d 557 (Ill. App. 1961) (holding special assessments bondholder entitled to accounting from municipality who acted as trustee; "[t]he rule is that when a municipality issues special assessment bonds it becomes a trustee of the funds resulting from the collection under the special assessments, and is charged with all attending fiduciary duties.").

Based upon the foregoing, a bankruptcy court could find that, because the holders of debt secured by special revenues hold an ownership interest solely in the special revenues, and because the special revenues are held in trust and are not property of the debtor, such holders do not have a claim against the debtor or the debtor's property. See, e.g., Ni-Fuel Co. v. Jackson, 257 B.R. 600, 619 (N.D. Okla. 2000) (remanding to state court those claims which are not "property of the estate," and involved "no claims" against the bankrupt debtors); In re Threatt, 2004 WL 2905344, at *2 (holding the movant has "no claim" against the debtor or against any property of the debtor; hence, there is no debt owed to movant and movant is not a creditor in the case). Without a claim against the debtor or the property of the debtor, the holder of debt secured by special revenues is arguably not subject to the cram-down provisions contained in the Bankruptcy Code.

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Footnotes

1 U.S. Secs. & Exch. Comm'n, Field Hearing on the State of the Municipal Securities Market, Distressed Communities, Remarks of James E. Spiotto, July 29, 2011, at 36 (generally, foreclosure is not permitted for essential governmental property as it would be against public policy). http://www.sec.gov/spotlight/municipalsecurities/statements072911/spiotto.pdf (the "Spiotto Statements").

2 See also Spiotto Statements.

3 For an excellent discussion of the history or chapter 9 and the 1988 Amendments, see Spiotto Statements.

4 11 U.S.C. § 101 also defines the term "claim" to mean—(A) right to payment, whether or not such right is reduced to judgment, liquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

5 Further, the Senate Report on the 1978 Bankruptcy Act and statements of the floor managers of the Act in both the House and Senate demonstrate that the Bankruptcy Act "will not affect various

statutory provisions . . . that create a trust fund for the benefit of a creditor of the debtor." See S. Rep. No. 989 at 82, 95th Cong., 2d Sess. (1978). U.S. Code Cong. & Admin. News 1978, pp. 5787 at 5868; 124 Cong. Rec. S17.413 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConconcini); 129 Cong. Rec. H11.096 (daily ed. Sept. 28, 1978) (remarks of Rep. Edwards).

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