Bond Case Briefs

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Butler Snow: Should Bond Lawyers Care About Chapter 9 of the Bankruptcy Code?

I have been practicing public finance law for almost thirteen years, and during the first half of that period, I never gave Chapter 9 of the Bankruptcy Code much thought, as prior to the financial crisis, municipal bankruptcies were extremely rare. And while the bankruptcy courts are not overflowing with Chapter 9 cases today, there have been a sufficient number to force bond attorneys to pay closer attention.

The municipal bond market demands secure investments, and as bond attorneys we strive to document bond transactions in order to insulate bondholders from any challenges to the expected return on their investment, whether there are challenges to the validity of the bonds or challenges to the priority of the pledges of revenues securing the bonds. Out of necessity, municipal issuers facing dire economic circumstances, and their bankruptcy attorneys, are forced to comb through bond documents in an attempt to find language that allows them to use pledged revenues for other purposes (e.g., ongoing operating and capital costs) or pay other creditors (e.g., municipal employees and pensioners). The terms of the settlements resulting from the Chapter 9 cases that have been filed are forcing the public finance industry to reexamine long-standing views regarding various types of municipal bonds and the security pledged in support of their payment. Unfortunately, recent Chapter 9 proceedings have focused more on encouraging negotiation and settlement than adjudicating provisions of bond documents and therefore have offered little clear precedent to help us with such reexamination of the long-standing views.

A quick look at the settlement resulting from the City of Detroit's Chapter 9 case offers us a glimpse of what we do (and do not) know about Chapter 9. Until recently, general obligation bonds issued by a municipal issuer and supported by the full faith and credit and taxing power of the issuer were the "gold standard" of municipal credit. That notion took a bit of a beating in Detroit. Detroit's initial Chapter 9 plan treated general obligation bondholders as unsecured creditors and sought to divert funds pledged to the payment of the bonds to the City's general fund. As expected, bondholders objected and, as with most else everything in Detroit's case, there was a settlement. In exchange for their consent to divert some of the pledged revenues to the City's general fund, bondholders received relatively favorable repayment terms under the plan ($0.74 on the $1.00 – pensioners received approximately $0.60 on the $1.00), a covenant that ensures that no unsecured creditor can recover more than any general obligation bondholder, and a lien on specific tax revenues that the bankruptcy court held to be special revenues. Notwithstanding this relatively favorable treatment, however, the public finance industry is somewhat troubled by the Court's statement that the City's chance of success on the merits of the question of whether the general obligation bonds were unsecured was a "coin toss."

While revenue bonds, such as bonds secured by revenues from a utility system of a municipality, have not traditionally been thought of as being as strong of a credit as general obligation bonds, they are generally accompanied by a covenant of the issuer to set rates and charges at levels sufficient to pay debt service and therefore they are still viewed as a relatively strong credit in the municipal market. In addition, revenue bonds benefit from a unique provision in Chapter 9 that affords special protection for “special revenues,” which are defined to include, among other things, receipts derived from the ownership and/or operation of projects or systems that are primarily used to provide transportation, utility, or other services. Chapter 9 provides that obligations secured by a lien on special revenues retain such lien post-petition. Consequently, special revenue bonds should have continued access to the revenue stream that secures the debt service payments.

As with the general obligation bonds, Detroit’s initial plan sought to impair the lien of water and sewer bondholders and divert water and sewer revenues to the City’s general fund. Bondholders objected, and Detroit agreed to pay “special revenue” bond debt in full, but only after bondholders, facing prospects of a lower rate and a stripping of their call protections, accepted an “invitation” to “voluntarily” tender their bonds. Thus, even with bonds secured by special revenues, the threat of impairment spurred a settlement. While a few years ago, the general consensus was that general obligation bonds were the better municipal credit, there is now a more open question as to whether it is better to be a general obligation bondholder or a special revenue bondholder in a Chapter 9 proceeding.

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