

# **Bond Case Briefs**

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## **Chapter 9 - Five Proposals for Meaningful Reform.**

When the next recession occurs there probably will be other municipalities in severe fiscal distress that opt to file under chapter 9. Now is a good time for capital market participants to focus on changes to chapter 9 that address the lessons from the most recent round of municipal bankruptcies.

The most significant lesson is that chapter 9 is unclear in many respects such that judges, with little or no municipal experience, have the leverage to achieve settlements often unsatisfactory to the capital markets. Settlements are often agreed to as a means of avoiding the risk of creating bad legal precedent. To address the lack of clarity of chapter 9 and to root it in municipal realities, we suggest the following as the top five critical changes that should be made to protect the capital markets.

### **1. Restricted Funds Should Be Treated in the Same Manner as Special Revenue**

In the municipal world, bonds may be payable from a specified revenue stream that may not be used for any other purpose or that must be used to pay the bonds before being used for any other purpose. The restricted revenue stream is typically deposited into a special fund on behalf of bondholders. Substantively the restricted use serves a similar function as a lien.

An undecided issue in chapter 9 is whether the owners of bonds payable from restricted funds have a property interest in these funds that will be protected in the event of a bankruptcy filing.

This issue was raised but not decided by the court in the Detroit bankruptcy. Chapter 9 should be amended to provide that bonds backed by restricted funds are protected in the same way as special revenue bonds. The same principles apply – the bondholders are taking the risk of a specified revenue stream and this risk should not be impacted by a bankruptcy filing.

### **2. Intercept Structures Should Be Immune from a Chapter 9 Filing**

In municipal finance, bonds are often paid from monies due from a State to a municipality. These monies are intercepted and paid directly to the trustee on behalf of bondholders. A lien is typically not granted on these State payments, but the intent is to provide special protection to bondholders so that these credits are evaluated based on the likelihood of the State payments being made.

An open issue in chapter 9 is whether these State payments are property of the municipality. If they are property of the municipality, the automatic stay applies. This issue was litigated but not decided by the court in the Vallejo bankruptcy. Chapter 9 should be amended to provide that

State aid intercepts are not property of the municipality. This would allow bonds backed by these

State payments to continue to be paid during the bankruptcy case, thereby preserving the basic credit risk intended when these bonds were issued.

### **3. Special Revenue Bonds Should Not Be Subject to Cram Down**

Another unresolved issue in chapter 9 is whether special revenue bonds may be crammed down.

This issue was litigated but not decided in the Detroit bankruptcy.

The cram down provisions allow a secured creditor class to be bound by a plan even if this class does not vote in favor of the plan so long as at least one impaired class votes for the plan and the secured creditor receives treatment based on the court-determined value of the property securing the debt and/or an adequate rate of interest. A cram down could, therefore, result in the lowering of the principal amount of the bonds or a lowering of the interest rate.

Chapter 9 incorporates the chapter 11 cram down provisions. However, the structure and intent of special revenue bonds is that they not be impacted by a bankruptcy filing. This creates an ambiguity in the Code that should be rectified. Chapter 9 should be amended to provide explicitly that special revenue bonds and bonds payable from restricted funds cannot be crammed down.

#### **4. The 'Best Interests of Creditors' Test Should Be Defined and Rooted in Municipal Realities**

In chapter 11, a plan must satisfy the best interests of creditors test by providing each group of creditors, as well as creditors as a whole, with at least as great a recovery as would have occurred in the event of a hypothetical liquidation. The test sets a minimum bar for class and aggregate creditor recoveries.

Because municipalities cannot liquidate, the chapter 11 liquidation test does not work in a chapter 9. Consequently, courts have compared plan recoveries with recoveries that would have occurred in the event the case were hypothetically dismissed. But in doing so, several courts have held that a dismissal would lead to a death spiral, and therefore invariably conclude that the best interests of creditors test has been satisfied no matter what the level of class and aggregate recoveries. This interpretation of the test renders it ineffective to protect creditors.

To address this inadequacy, chapter 9 should be amended to provide that the best interests of creditors test means:

**A.** Since in any dismissal certain claims would have stronger legal rights under State law, a plan must provide that any unsecured class that benefits from a state constitutional or statutory provision requiring superior payment of such obligations will be treated materially better than other unsecured claims. Superior claims would include (i) general obligation bonds backed by full faith and credit with no statutory limit on the ability to raise taxes to provide payment, (ii) pension payments with constitutional protections requiring payment under all circumstances, and (iii) obligations provided with an explicit constitutional or statutory first priority of payment.

**B.** In order to maximize aggregate creditor recoveries in a manner reasonable under the circumstances, a plan must provide that (i) the number of municipal employees, as well as their salaries and benefits, are comparable to those in municipalities of similar size, wealth and geographic area, (ii) taxes are raised as high as possible without causing a counterproductive economic impact, and (iii) the municipality maximizes the value of assets used for a proprietary rather than a public purpose, including monetizing such assets.

#### **5. The Unfair Discrimination Test Should be Objective and Straightforward**

Similarly situated classes of creditors may be treated materially differently only if there is no unfair discrimination. Courts have varied in their views of the meaning of unfair discrimination.

The court in Detroit held that discrimination is not unfair so long as the disparity does not violate the moral conscience of the court. This standard is totally subjective.

Chapter 9 should be amended to provide for an objective definition of unfair discrimination.

Materially different treatment between similarly situated classes should be considered fair only if either:

- A.** The class provided the better treatment has contributed equivalent new value to the municipality.
- B.** State law provides for materially better treatment for the class receiving the superior treatment.

This definition would be objective and similar to that used by many courts in chapter 11. The definition would provide a continuity of expectation based on State constitutional and statutory provisions designed to protect designated creditors.

These five proposed changes to chapter 9 would clarify the treatment of creditors and provide clearer guidance for the expectations of market participants. All of the changes are consistent with basic principles of municipal finance and should be integrated into chapter 9.

THE BOND BUYER

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