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Chester, PA Chapter 9 Court Confirms Certain Municipal Financing Techniques, Raises Concerns About Others: Cadwalader

On November 3, 2023, the Court in the Chapter 9 bankruptcy case of the City of Chester, Pennsylvania issued its ruling in an adversary proceeding challenging the perfection of the liens securing certain revenue bonds issued by the City.1 Confirming the municipal bond market's longstanding understanding, the Court concluded that the liens on revenues were properly perfected by the filing of UCC financing statements.

However, the Court also held that the liens had ceased to attach to postpetition revenues by virtue of Section 552(a) of the Bankruptcy Code, which generally provides that prepetition liens cease to attach to property acquired after the commencement of a bankruptcy case. The Chester Court concluded that no relevant exception to Section 552(a) applied, in the process analyzing issues related to statutory liens, the nature of postpetition "proceeds," and the nature of "special revenues."

BACKGROUND

Chester, Pennsylvania is a city of around 30,000 residents located near Philadelphia. In 2017, the City issued two series of revenue bonds pursuant to (i) an ordinance authorizing the issuance of the bonds and (ii) a Trust Indenture. The bonds were secured primarily by liens on three major revenue streams:

> "Harrah's Revenues," which consist of an annual slot machine license operation fee that the State of Pennsylvania collects pursuant to the Pennsylvania Race Horse and Development Gaming Act (the "Gaming Act") from a Harrah's casino located in Chester, and a portion of which the State then pays to the City;
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> "Harrah's Table Game Revenues," which consist of a "local share assessment" that the Harrah's casino is required to pay to the State, equivalent to 2% of daily gross revenue from the casino's table games, and a portion of which the State distributes to the City; and
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> "Host Community Revenues," which consist of fees paid to the City by a waste incinerator operator ("Covanta") pursuant to an agreement that authorized Covanta to operate a waste incinerator in the City.

In November 2022, following decades of financial difficulties, the City filed for Chapter 9 bankruptcy protection. In the bankruptcy case, the City commenced an adversary proceeding against the bondholders and their trustee, alleging, among other things, (i) that the bondholders' liens on the revenues were unperfected and could therefore be avoided, and (ii) that the bondholders' liens did

not extend to postpetition revenues because of Section 552(a) of the Bankruptcy Code.

The Court ultimately ruled for the bondholders on the perfection and avoidance issues, holding that the bondholders' liens were properly perfected by the filing of UCC financing statements and therefore unavoidable. The Court ruled for the City on the Section 552(a) issue, however, holding that Section 552(a) had terminated the bondholders' liens as to postpetition revenues because none of the relevant exceptions applied.

ANALYSIS

UCC Financing Statements Can Perfect Liens on Municipal Revenues

Under the Uniform Commercial Code ("UCC"), the method of perfecting a lien depends on the nature of the collateral and how it is characterized under the UCC. In Chester's case, the City argued that the pledged revenues constituted "money," a security interest in which can be perfected only by "possession." Because the City alleged that the bondholders did not have "possession" of postpetition revenues as of the petition date, the City argued that their liens could be avoided under Section 544 of the Bankruptcy Code.

The bondholders countered by arguing that the pledged revenues were properly characterized as either an "account" or a "payment intangible" for UCC perfection purposes. The UCC defines an "account" as "a right to payment of a monetary obligation," and defines a "payment intangible" as a "general intangible under which the account debtor's principal obligation is a monetary obligation." *See* 13 Pa.C.S.A. § 9102. Unlike a security interest in "money," a security interest in an "account" or a "general intangible" (including a "payment intangible") can be perfected through the filing of a UCC financing statement, and the trustee for the bonds had in fact filed such UCC financing statements.

The Court agreed with the bondholders that the pledged revenues were "more akin to an 'account' or 'payment intangible' than 'money' for purposes of perfection." This holding was consistent with prior cases addressing security interests in "revenues" under other types of agreements, such as where hotel revenues serve as collateral under a private loan agreement.2 The Chester Court's ruling appears to be one of the first to expressly hold revenues to constitute "accounts" or "payment intangibles" in the case of a municipal revenue bond. Financing statements are routinely filed to perfect liens on revenues in the municipal finance context, so the Chester Court's perfection holding was consistent with the practices and expectations of the municipal bond market.

Section 552(a) of the Bankruptcy Code

Section 552(a) of the Bankruptcy Code generally cuts off most security interests in property acquired by a debtor after the date of the bankruptcy petition.3 There are three main exceptions to Section 552(a), which permit a prepetition lien to continue to attach to property acquired after the commencement of the bankruptcy case if:

- the prepetition lien is a "statutory lien";
- postpetition collateral constitutes "proceeds" of prepetition collateral; or
- the postpetition collateral qualifies as "special revenues" as defined in the Bankruptcy Code.

The Chester bondholders argued that each of these exceptions to Section 552(a) applied, but the Court rejected the bondholders' arguments, ultimately holding that no relevant exception to Section 552(a) applied and that the bondholders' liens therefore did not attach to the City's postpetition revenues. Certain of the Court's rulings with respect to Section 552(a) undermine fundamental

principles of the municipal financing of revenue-generating projects.

Statutory Lien Analysis

Because Section 552(a) by its terms applies only to a "lien resulting from a security *agreement*," Section 552(a) does not apply to a *statutory* lien that results from a statute rather than an "agreement." The Bankruptcy Code defines a "statutory lien" as one "arising solely by force of a statute on specified circumstances or conditions." 11 U.S.C. § 101(53). The Chester bondholders argued that they had such a statutory lien arising from the below provision of the ordinance authorizing the issuance of their bonds:

> Pledge of, and Security Interest in, Pledged Revenues. The City hereby irrevocably pledges the Pledged Revenues for the payment of the principal of, premium, if any, and interest on the Bonds and grants a security interest in and to all such Pledged Revenues which shall be perfected as provided in the [Debt] Act and the Pennsylvania Uniform Commercial Code (the 'UCC'), as applicable, for the benefit and security of the Trustee . . . on behalf of the owners of the Bonds. The Trustee is hereby authorized to file a financing statement under the UCC reflecting the foregoing pledge and security interest. Such pledge and security interest shall be subject, as appropriate, to those existing pledges and security interests securing existing obligations of the City described in the recitals hereto.

The Court rejected the bondholders' statutory lien argument, holding that because the bondholders had a consensual security interest arising from the applicable Trust Indenture, they did not have a statutory lien. In reaching this conclusion, the Court relied on language from the legislative history of the Bankruptcy Code indicating that statutory liens and consensual security interests are "mutually exclusive." *See* S. Rep. No. 95-989, 95th Cong, 2d Sess. 26 (1978); H.R. Rep. 95-595, 95th Cong., 1st Sess. 313-14 (1977). The Court seemed to take this legislative history to mean that a statutory lien and a consensual security interest can never coexist, but that is by no means a consensus reading of the legislative history. A significant number of courts have instead read the "mutually exclusive" language in the legislative history simply to mean that a *single* lien cannot be both a statutory lien and a consensual security interest.4 This does not necessarily mean that a statutory lien and a consensual lien cannot exist simultaneously if they arise from two different sources (i.e., one is created by a statute and the other is *separately* created by a security agreement). Indeed, the Court's approach leads to the illogical conclusion that a cautious creditor trying to create a lien regardless of which of the two sources applies, instead runs the risk that *no* lien will be created.

The Chester bondholders argued that the applicable ordinance does create a statutory lien, because the ordinance itself "hereby irrevocably pledges" the "Pledged Revenues," and the term "Pledged Revenues" is defined within the ordinance itself without reference to the Trust Indenture. Furthermore, the bondholders argued that an ordinance qualifies as a "statute" under Pennsylvania law, and the City did not meaningfully dispute that argument.

Section 552(b) "Proceeds" Analysis

The bondholders also argued that the Section 552(b) "proceeds" exception to Section 552(a) applies. Section 552(b) permits prepetition liens to continue to attach to property acquired by the debtor after the commencement of the bankruptcy case if the postpetition collateral constitutes "proceeds" of prepetition collateral.5

The bondholders argued that Section 552(b) applied because their prepetition collateral package included a security interest in the City's "right to receive" the pledged revenues, such that postpetition revenues were the "proceeds" of the City's "right to receive" those revenues. The Court rejected the bondholders' argument based on its reading of the applicable Trust Indenture, holding that the Indenture just defined the applicable collateral as the "Pledged Revenues" themselves, without expressly granting a security interest in the City's "right to receive" the revenues.

Not only is the Court's reading of the Trust Indenture inconsistent with creditors' expectations, it also runs counter to the Court's own holding that the relevant collateral qualified as an "account" for UCC purposes, because the UCC *defines* an "account" as "**a right to payment** of a monetary obligation." See 13 Pa.C.S.A. § 9102 (emphasis added). A more internally consistent analysis therefore might have concluded that the collateral included the City's "right to payment" both for purposes of the UCC's perfection requirements and for purposes of the Section 552(b) "proceeds" exception.

Special Revenues Analysis

Section 928(a) of the Bankruptcy Code overrides Section 552(a) with respect to security interests in "special revenues."6 Section 902(2) of the Bankruptcy Code in turn defines "special revenues" to include "special ***excise taxes*** imposed on particular activities or transactions," among other categories of "special revenues." See 11 U.S.C. § 902(2)(B) (emphasis added).

The Chester bondholders argued that the "fees" and "assessments" that the State of Pennsylvania imposed on Harrah's slot machine and table game operations under the Gaming Act qualified as "special excise taxes" and therefore "special revenues," but the Chester Court rejected this argument by drawing a distinction between "taxes" and "fees." Specifically, the Court relied on a Sixth Circuit case stating that "a tax is an exaction for public purposes while a fee relates to an **individual privilege or benefit** to the payer,"7 as well as a Third Circuit case similarly stating that "a situation in which a payment is exchanged for a **government benefit** not shared by others indicates that the debt is not for a tax."8 Based on these definitions, the Court concluded that the "fees" and "assessments" imposed on the casino under the Gaming Act were more like "fees" than "taxes," because those fees and assessments were imposed only on specific entities operating gaming enterprises, and were imposed as a precondition to the "privilege" or "benefit" of operating such gaming enterprises.

To date, there has been limited authority interpreting the phrase "special excise taxes" specifically in the context of the Bankruptcy Code's "special revenues" definition. Although the Chester decision surely will not be the last word on this issue, participants in the municipal bond market should be aware of the Court's distinction between "fees" and "taxes" as potentially relevant to their assessment of how likely particular revenue streams are to qualify as "special revenues."

CONCLUSION

The Chester Court's holding that a revenue pledge can be perfected through the filing of a UCC financing statement is consistent with the municipal bond market's longstanding practice and expectations, and therefore serves to strengthen the foundations of the municipal bond market. However, other aspects of the Court's decision demonstrate that bankruptcy courts continue to struggle with some of the unique features of municipal revenue bonds and issue rulings that contradict market expectations. In part, bankruptcy courts' lack of familiarity with some of the nuances of municipal finance may result from the fact that Chapter 9 municipal bankruptcy cases have been relatively rare historically as compared to other types of bankruptcy cases. One might hope that, as the Chapter 9 case law continues to develop, bankruptcy courts may gradually become

more equipped to interpret municipal revenue bonds in a manner more consistent with the expectations of market participants.

In the interim, certain aspects of the Chester Court's Section 552(a) rulings may provide fertile ground for a bondholder appeal.

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1 See *In re City of Chester*, Adv. Proc. No. 22-00084-AMC, 2023 WL 7274750 (Bankr. E.D. Pa. Nov. 3, 2023).

2 See, e.g., *In re Northview Corp.*, 130 B.R. 543, 547 (9th Cir. BAP 1991) (characterizing hotel revenues as "accounts"); *In re Ocean Place Dev. LLC*, 447 B.R. 726, 732 (Bankr. D.N.J. 2011) (characterizing hotel revenues as "accounts" or "payment intangibles").

3 Section 552(a) provides: "Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a).

4 *See, e.g., In re Holmes*, 603 B.R. 757, 775 (D.N.J. 2019) ("Assume, then, that under the Code, any single lien must be either a security interest or a statutory lien. Even so, there is no text or even legislative history suggesting that a single claim cannot be supported by more than one category of lien. Two liens—one statutory, and the other a security interest—can coexist and support the same claim without violating the principle that any particular lien must be one thing or the other. To say that a single claim may be supported by both a statutory lien and a separate consensual security interest is not to say that the two merge, or are the same thing.")

5 Section 552(b) provides that "[I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, **then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case** to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise." 11 U.S.C. § 552(b).

6 Section 928(a) 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).

7 *See United States v. River Coal Co.*, 748 F.2d 1103, 1106 (6th Cir. 1984) (emphasis added).

8 *United Healthcare Sys., Inc. v. New Jersey Dept. of Labor (In re United Healthcare System, Inc.)*, 396 F.3d 247, 260 (3d Cir. 2005) (emphasis added).

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