THE OBLIGEE MAY BE BROKE, BUT YOU CAN'T SELL CITY HALL

PEARLMAN ASSOCIATION PRESENTATION

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I. INTRODUCTION

A brief history of Chapter 9 of the Bankruptcy Code provides some helpful background into its purposes and landscape. Chapter IX was included in the Bankruptcy Act of 1934 in response to widespread municipal defaults in that era. Earlier versions, which allowed creditors to file involuntary petitions, were declared unconstitutional because they materially interfered with states' control of governmental and fiscal affairs of local governments. A later version, without involuntary provisions, withstood constitutional scrutiny. Chapter IX provisions were amended in the 1940's and again in 1976 to address the then-deteriorating financial conditions of New York and other cities, which amendments were, in large part, incorporated into the current Chapter 9 of the Bankruptcy Code.[1]

A Chapter 9 municipal bankruptcy is not really a "bankruptcy" at all, in the traditional sense. It lacks much of the flexibility afforded debtors under other chapters of the Code. While other chapters allow debtors to liquidate assets or reorganize as a means to address and offer at least some payment to creditors and to receive a discharge from unsatisfied debt, Chapter 9 does not. Municipal debtors cannot liquidate their assets. Such a feat would require the state legislature to revoke the municipal charter and have the state government take over the city's assets.[2] Likewise, Chapter 9 does not contemplate the creation of an "estate" or appointment of a trustee, examiner, or other operating oversight.[3] The municipality continues to operate, largely free from creditor control. Indeed, this is first among the differences from bankruptcies filed under other chapter of the Bankruptcy Code. Because of the public nature of the entity experiencing financial difficulties, there is no provision in the law for liquidation of its assets and distribution of the proceeds to creditors. The City will continue to exist and cannot just dissolve.

Rather, Chapter 9 of the Bankruptcy Code is directed toward a reorganization of a municipality's financial affairs or, as the statutory title states "adjustment of its debts." The City is given the protection of the automatic stay against all collections actions or other actions against its property. The purpose of Chapter 9 legislation is to permit a financially distressed public entity to seek protection from its creditors while it formulates and negotiates a plan for adjustment of its debts, either extending maturities, reducing interest or principal, or refinancing its debt by obtaining a new loan elsewhere to pay off existing debt, in whole or in part, and to provide the mechanism by which the plan that is acceptable to the majority of creditors can be made binding on a recalcitrant and dissenting minority. This is also important and worth re-emphasizing—Chapter 9 operates via a "cram down" method so that a dissenting minority will not be able to alter the course of the bankruptcy. In other words, similar to Chapter 11 in some ways, a plan can be confirmed even if it creates significant hardship or works an inequity to a single or few parties, as long as the majority of the creditors accept the plan and the bankruptcy court confirms it.

Unique constitutional considerations also govern Chapter 9, unlike any other Chapter of the Bankruptcy Code. For example, involuntary petitions are not permitted because they would constitute an impermissible interference with the governmental affairs of the political subdivision.[4] Thus, a Chapter 9 filing may be made only by the municipality; not its creditors. Further, Sections 903 and 904 limit the power of a *federal* bankruptcy court to interfere or

regulate the function of a *state* entity or municipality. Section 904 provides as follows:

> Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—
>
> (1) any of the political or governmental powers of the debtor;
> (2) any of the property or revenues of the debtor; or
> (3) the Debtor's use or enjoyment of any income producing property.[5]

Thus, the court may not appoint a trustee or examiner to control the operation of the debtor or utilize the property or revenue of the municipality without its consent. These provisions alleviate the constitutional concerns of having a federal court exercise control over a municipality.[6] Importantly, too, if the case is not successful, or if the plan cannot be implemented as confirmed, some commentators have opined that in theory, the bankruptcy court's primary remedy could be limited to dismissal of the case pursuant to 11 U.S.C. § 930. Because of the Constitution, the bankruptcy court's jurisdiction is at least limited in terms of its ability to control the outcome otherwise in matters contrary to the agreement of the municipality, providing the municipality with greater flexibility than other debtors enjoy. Further, there is no oversight by the U.S. Trustee in a Chapter 9, unlike all of the other chapters of the Bankruptcy Code where the U.S. Trustee is vested with curbing various abuses of the Bankruptcy Code and oversight of the creditors' meeting. As for the latter, also note that there is no meeting of creditors in a Chapter 9 case.

As it concerns how the bankruptcy deals with municipal debt adjustment, Chapter 9 is somewhat similar to corporate reorganization under Chapter 11 of the Bankruptcy Code. However, unlike Chapter 11, Chapter 9 does not attempt to balance the rights of the municipality and its creditors. To assist the municipal debtor in its reorganization effort, the Chapter 9 debtor, like the Chapter 11 debtor, is permitted to adjust non-debt contractual relationships under the power to reject executory contracts and unexpired leases, subject to court approval. This power is similar to that granted in commercial reorganization cases. It allows the municipality relief from unwise or burdensome contracts, subject to court approval. Thus, the court has the additional power and responsibility to examine the issues presented in connection with a request to reject an executory contract, whether or not the request is made in the plan.

II. ELIGIBILITY FOR RELIEF UNDER CHAPTER 9.

In order to qualify for relief under Chapter 9, an entity must meet the five requirements set forth in Section 109(c) of the Bankruptcy Code.[7]

A. The Debtor Must Be A Municipality

First, the debtor must be a "municipality." The Code defines a municipality as "a political subdivision or public agency or instrumentality of a state." Except to the extent that Section 109(c)(1) defines a "public agency or instrumentality" as an entity "subject to control by

public authority, state or municipal,"[8] there is no further explanation of the precise scope of the "municipality" definition. States, counties, cities, and towns are obvious fits. Less clear is whether other "municipal-type" entities are eligible. If a hospital is subject to control by public authority, it may qualify as a municipality under Chapter 9.[9] Likewise, water conservation districts, irrigation districts, school districts, county natural gas authorities, and other similar entities that are "controlled by public authority" may also qualify.[10] As such, sureties should be aware that bonds for projects for such entities may possibly be impacted by a Chapter 9 filing.

B. The Municipality Must Be Authorized By State Law To File

Second, state law must specifically authorize a municipality to file a Chapter 9.[11] This is important—not all States permit municipalities to file for bankruptcy in the first place. Attached hereto is a multi-State survey of the States which do and do not allow municipalities to file for Chapter 9. In addition, of interest to those sureties with California bonding programs is that California enacted new legislation in 2011 which is now in effect and embodied in California Government Code section 53760.3, that requires municipalities to engage in a neutral evaluation process during a 60-day period before filing for Chapter 9 bankruptcy, except in cases of "fiscal emergency" that jeopardizes the "health, safety, or well-being" of its residents. Therefore, in California, creditors typically have at least a window of advance notice before the Chapter 9 petition is filed.

C. The Municipality Must Be Insolvent

Third, the entity must be insolvent.[12] The Code defines insolvency for a municipality as the inability to pay its debts when they come due, except for debts that are the subject of a bona fide dispute.[13] This provision is a radical departure from other provisions of the Bankruptcy Code that do not require proof of insolvency.[14] Additionally, it should be noted that for purposes of Chapter 9, insolvency is determined by using a cash flow analysis.[15] It is not enough to show that the municipality has a budget gap--that is, for the coming fiscal year its total revenues will be outstripped by expenditures.[16] Instead, the municipality must demonstrate that, taking into account cash on hand and cash to be received, it will be unable to pay debts as they become due. This analysis is prospective. Indeed, the municipality is not required to wait until it runs out of money and defaults on its debts before it is deemed to be insolvent.[17]

D. The Municipality Must Desire To Adjust Its Debts

Fourth, the municipality must "desire" to file a plan to adjust its debts.[18] In the City of Vallejo's Chapter 9 bankruptcy case, the bankruptcy court held that the otherwise undefined term of "desire" meant as follows: "[w]hile the statutory requirement does not require a formal plan as such, some sort of comprehensive plan is required as one of the 'screening factors' to avoid a too early and rapid resort to the bankruptcy courts by municipalities."[19] Therefore, at least according to a few courts, this element requires some demonstrated evidence as of the petition date of the municipality's intent to implement a plan to adjust its debts.

E. The Municipality Must Adhere To "Good Faith" Filing Requirements

Finally, the municipality must obtain the agreement of creditors holding a majority (in dollar amount) of debts within each class (or category) of creditors that the entity intends to impair under its plan, or it must establish that it has negotiated in good faith but has failed to obtain an agreement among its creditors. This requirement is satisfied if the municipality is unable to negotiate with the creditors because negotiation is impracticable or the municipality believes that the creditor is attempting to bring a lawsuit to obtain a transfer that would be avoidable under Section 547 of the Bankruptcy Code.[20]

III. IMPACT ON CREDITORS

The following paragraphs highlight some of the specific aspects and provisions of Chapter 9 that distinguish it from more common Chapter 11 cases and are of particular import to contractors or sureties as actual or potential creditors of the municipality.

Notice by Publication. There are no schedules or statement of financial affairs filed in a Chapter 9 case. Instead, the municipality must provide the court with the list of its 20 largest unsecured creditors and a creditor mailing matrix. Because of the large number of creditors, however, and the difficulty in identifying all of them (particularly holders of bearer bonds) Chapter 9 allows notice of the bankruptcy to be given by publication in a newspaper in the district where the case is commenced.[21]

Automatic Stay. In a Chapter 9, the city has the benefit of not only the automatic stay under Section 362 of the Code, but also the more expansive provisions under Section 922, [22] which stay precludes actions against municipal officers (preventing mandamus actions against officers based upon prepetition debts) and provides an administrative claim to those who have been provided adequate protection by the debtor but who suffered losses because the protection is inadequate.[23] Also, claims based upon pledged "special revenues" discussed in greater depth below, are not stayed nor are they even part of the bankruptcy estate.[24]

Even though the stay prevents actions against city officials, it is not clear whether it would prevent a claim directly against Public Officials' fiduciary policies and bonds, a similar fidelity-type bond or comparable insurance coverage if, for example, that official has engaged in suspicious accounting practices or has pursued unusual or risky financing mechanisms.

Significantly for contractors (and those standing in their shoes or standing with or behind them), the automatic stay precludes contractors or subcontractors from pursuing the municipality for payment for work on public projects. The lack of any specific exception clearly extends this bar to any claim for unpaid progress payments on contracts in play. Section 362 provides that a creditor may seek for relief from the automatic stay if that creditor can demonstrate "cause," including lack of adequate protection.[25] While the Bankruptcy Code fails to define "cause," a contractor (or surety) may be able to argue that the debtor's failure to pay contract amounts is tantamount to a lack of adequate protection.

Executory Contracts. As mentioned above, the bankruptcy court retains the power and authority to examine issues presented in connection with requests to assume or reject executory contracts. Therefore, executory contracts remain an issue where a creditor may have limited power to affect the outcome, or, if nothing else, to force the municipality to make a decision sooner rather than later about the subject contract. Executory contracts are discussed below.

Avoidance Powers. A Chapter 9 debtor has the ability to set aside preferential transfers, fraudulent conveyances, and certain post-petition transfers, with some limitations.[26] If a contractor accepts a payment from the municipality within 90 days before its bankruptcy filing, that payment may be at risk for avoidance as a preferential transfer. Such a reversal of payment could have obvious impact on contractors, especially those who have passed payments through to subcontractors and suppliers.[27] Further, Section 926 provides that if the debtor refuses to pursue any such avoidance actions or other claims it may have under the Bankruptcy Code's "strong-arm" provisions, a creditor can request that the court appoint a trustee to pursue such causes of action.[28]

Use, Sale, Lease Of Personal Property And Cash Collateral. Unlike other Chapters of the Code, a municipal Chapter 9 debtor is not required to obtain approval of the Bankruptcy Court to use, sale or lease personal property or cash collateral pursuant to 11 U.S.C. § 363.

Unsecured Creditors' Committee. Like other Chapters of the Code, Chapter 9 provides for the formation of an unsecured creditors committee by the U.S. Trustee. Such a committee has access to financial records of the municipality and will be able to form an independent opinion of the municipality's finances. This may be useful if there are questions of insolvency, if the municipality's accounting practices are suspicious, or if there has been foul play by city administrators.[29]

Operation of the Municipality Post-Petition. Because Section 904 prohibits the court from interfering with the operations of the municipality, a Chapter 9 debtor will continue with the same management and elected officials and carry forward with operations post-petition and post-confirmation.[30]

IV. THE CHAPTER 9 DEBT ADJUSTMENT PLAN: CONTENTS AND CONFIRMATION

One of the requirements under Section 109(c) for an entity to be eligible as a debtor under Chapter 9 is that it must desire to effectuate a plan to adjust its debts. As explained above, the debtor cannot liquidate assets or reorganize. It can only propose a scheme of adjustments of its debts, attempt to obtain the acceptance of those proposed adjustments from its creditors, and seek the confirmation of the plan from the Bankruptcy Court. Many of the provisions governing the contents, disclosure, voting, and confirmation of a Chapter 9 plan are borrowed largely from Chapter 11.[31] In fact, Section 901(a) sets forth a list of the specific provisions of Chapter 11 (as well as other sections of the Bankruptcy Code) that are expressly incorporated into Chapter 9, including major parts of Sections 1123 (Contents of the Plan) and Section 1129

(Confirmation).[32]

The debtor has wide latitude to reduce the principal and/or interest of its obligations, thereby "impairing" those claims or classes of claims (subject, of course, to its ability to obtain the acceptance of that class, as discussed below).[33] It also has the option of leaving some classes of creditors unimpaired. A class is impaired unless it meets one of three criteria: (1) the plan does not alter the legal, equitable, or contractual rights of the claim holder; (2) the plan provides for curing the default, reinstating the original terms of the claim, and compensating the holder for the damages incurred as a result of the claim holder's reliance on certain contractual provisions; or (3) the plan provides for payment in cash equal to the allowed amount of the claim.[34] The distinction between impaired and unimpaired classes is significant because only impaired classes are entitled to vote on the plan.

A. Contents of the Chapter 9 Plan.

The provisions relating to the Chapter 9 Plan are contained in Sections 941 through 943, as supplemented by Section 1123. The first task in a Chapter 9 Plan is classification of claims of creditors. Claims are fixed as of the date of filing, and the debtor will classify claims that are substantially similar in nature in the same "class." After classification, the debtor must specify which classes are impaired and which are unimpaired. The debtor must then specify how it intends to treat unimpaired classes.[35]

B. Approval of the Disclosure Statement.

Before the debtor can solicit acceptances of its plan, it must have its disclosure statement approved after notice and a hearing. The adequacy of the disclosure statement is judged on whether it contains enough information to enable a "hypothetical reasonable investor" to make an informed judgment about the debtor's plan.[36] As Professor Norton's treatise explains: "The kind of information expected to be found in a Chapter 9 disclosure statement might include general information about the municipality, such as its form of government, population, per capita income, and industrial base. Other important information could be extracted from the official statements for the most recent bonds issued by the municipality;" including financial statements, operating budgets, and sources of taxes and tax revenue, past and present.[37]

C. Voting.

The debtor's plan cannot be confirmed unless at least one class of claims accepts the plan.[38] Only the impaired classes are entitled to vote. A class accepts the plan if two-thirds of the dollar amount of claims in that class or more than 50% in number of claim holders comprising the class vote to accept the plan.[39]

D. Cram Down.

Notwithstanding the dissenting votes of some classes, the debtor may confirm a plan over objections if it has secured the acceptance of the plan from at least one class of creditors.[40] The

debtor can therefore "cram down" the plan to confirmation if the plan "does not discriminate unfairly and is fair and equitable" with respect to the dissenting impaired classes.[41] The plan does not unfairly discriminate if classes of equal rank receive equal treatment under the plan.[42] In order to satisfy the "fair and equitable test, the criteria is whether the plan provides creditors with all that the creditors reasonably expect under the circumstances."[43]

E. Confirmation.

Section 943 sets forth the seven standards for confirmation of a Chapter 9 plan. Those standards are also supplemented by the specific provisions of Section 1129 that are expressly incorporated into Chapter 9 by Section 901. The following paragraphs discuss each of those standards.

First, the plan must comply with those specific provisions of the Code that are incorporated into Chapter 9. For example, pursuant to Section 1129(a)(3), the plan must be proposed in good faith and not by any means prohibited by law.[44] Because of the scarcity of Chapter 9 cases, the meaning of good faith in the context of a Chapter 9 plan has not been explored like its Chapter 11 counterpart. Thus, courts generally rely upon case law analyzing good faith in the context of Chapters 11 and 13 to determine good faith in Chapter 9.[45] Some Chapter 9 cases have addressed the issue in the context of abuse of bankruptcy procedure and unfair treatment of certain parties. In one case, the District Court reversed the confirmation of a Chapter 9 plan for lack of good faith because the property owner whose future tax obligations were unfairly impacted was denied due process.[46] In another, the court found good faith even though the Chapter 9 was filed in response to a dispute over an elected official's authority to reverse annexation because at the time of filing, the town had funds frozen, multiple lawsuits, and substantial loss of tax income.[47] The good faith inquiry will likely be a fact-intensive one, requiring a review of the totality of the circumstances.

Second, the plan must comply with the provisions of Chapter 9.[48]

Third, the plan must disclose all amounts to be paid for services incident to the plan—including attorneys' fees--and the amounts must be reasonable.[49]

Fourth, the debtor must not be prohibited by law from taking any action necessary to carry out the plan.[50]

Fifth, the plan must provide that all administrative claims are paid, in cash, on the effective date of the plan, unless the claim holder agrees to different treatment.[51]

Sixth, the debtor has obtained any regulatory or electoral approval necessary under non-bankruptcy law in order to carry out the provisions of the plan, or that particular provision is expressly conditioned on obtaining such approval.[52]

Seven, the plan is "in the best interest of creditors and is feasible." These last two

amorphous standards are neither defined by the Code nor well-explained in case law.[53] The following paragraphs briefly discuss each standard.

In the Chapter 11 context, a debtor can establish that the plan is in the best interests of creditors if it is better than liquidation. But that standard is inappropriate for Chapter 9 because liquidation is not even permitted. The Colorado District Court in *In re Mount Carbon Metropolitan District*[54] defines the best interest requirement as follows:

> The "best interest" requirement of Section 943(b)(7) is generally regarded as requiring that a proposed plan provide a better alternative for creditors than what they already have. This is often easy to establish. Since creditors cannot propose a plan; cannot convert to Chapter 7; cannot have a trustee appointed; and cannot force sale of municipal assets under state law, their only alternative to a debtor's plan is dismissal. Outside of bankruptcy, general unsecured creditors often have little possibility of being repaid, especially where the municipality's debt burden is too high to be retired by taxes. Therefore any possibility of payment under a Chapter 9 plan is often perceived by creditors as a better alternative. With few options and little negotiation leverage, either inside or outside of bankruptcy, creditors may accept even a hopelessly infeasible Chapter 9 plan in preference to the non-bankruptcy status quo.[55]

Thus, the "best interest of creditor's" test can be satisfied if the plan proposes that the creditors receive something rather than nothing, which would be the alternative. On the other hand, the city should not be required to propose a plan that requires it to raise taxes to the point that citizens move to other cities, which would make the plan self-defeating.[56]

The plan must also be feasible. Again, that term is not defined by the Code. Further, because of the fundamental differences between Chapter 11 and Chapter 9, resort to Chapter 11 cases analyzing feasibility is not particularly helpful. The *Mount Carbon* court provides the following guidance:

> As with a case in Chapter 11, a Chapter 9 feasibility finding should 'prevent confirmation of visionary schemes which promise creditors . . . more under a proposed plan than the debtors can possibly attain after confirmation.'… A plan should offer a reasonable prospect of success and be workable. In Chapter 9, this requires a practical analysis of whether the debtor can accomplish what the plan proposes and provide governmental services. Although success need not be certain or guaranteed, more is required than mere hopes, desires and speculation.... The probability of future success will depend upon reasonable income and expense projections. As with plans under Chapter 11, if performance of a Chapter 9 plan is based upon deferred payments, projections of future income and expenses must be based upon reasonable assumptions and must not be speculative or conjectural.[57]

Summarizing, the court states: "The court must, in the course of determining feasibility, evaluate whether it is probable that the debtor can both pay pre-petition debt and provide future public services at the level necessary to its viability as a municipality.[58]

F. Confirmation vs. Dismissal.

If the Chapter 9 plan is confirmed, it is then binding upon the debtor and any creditor, regardless of whether the creditor's proof of claim was filed, allowed, or whether the creditor even accepted the plan.[59] Likewise, the municipality is discharged of all its debts, except those it did not provide for in the plan and those of creditors that had no notice or actual knowledge of the case.[60]

If confirmation is denied, the court is required to dismiss the case.[61] The dismissal is not discretionary, which should provide motivation to municipalities to initially propose a good faith plan that can be accepted and confirmed.[62]

V. TOP 10 DIFFERENCES BETWEEN CHAPTER 11 AND CHAPTER 9

As a summary of the above, the following are the top ten differences between Chapter 11 and Chapter 9:

10. Municipalities cannot be put into bankruptcy through an involuntary petition. Section 303 of the Bankruptcy Code, which governs involuntary cases, is not applicable in Chapter 9.

9. The 10th Amendment to the U.S. Constitution protects a municipality from interference by a Federal Court and thus limits the ways the Bankruptcy Court can modify the way a municipality conducts its business. As a result, absent consent by the Debtor, the Court cannot interfere with political or governmental powers, any property or revenues of the Debtor or the Debtor's use and enjoyment of any property or revenue streams.

8. A Chapter 9 Debtor does not need court approval to use cash collateral or any other property of the estate.

7. A Chapter 9 Debtor must be authorized under state law to be a debtor in a Chapter 9 bankruptcy proceeding. About ½ of states have legislation authorizing Chapter 9 filings, and many have limitations or prohibitions.

6. A Chapter 9 Debtor must be insolvent – this is not required in Chapter 11. The Debtor bears the burden of proving it is insolvent. Courts will use cash flow analysis rather than balance sheet test.

5. The court may dismiss the petition if it was not filed in good faith. There is no other explicit good faith filing requirement in any other chapter. Good faith requirements are as follows:

- Debtor has agreement of at least ½ of creditors in a class that is impaired;
- Debtor has negotiated in good faith with creditors but was not able to reach an agreement;
- Debtor is unable to negotiate with creditors because negotiation is impractical;
- Debtor reasonably believes that a creditor may attempt to receive an avoidable preference.

4. A trustee cannot be appointed in Chapter 9 except for specific purpose such as pursuing avoidance actions.

3. The holder of a claim payable from special revenues does not have a claim against the debtor. This prevents special revenue bonds from becoming general revenue bonds. The automatic stay does not prevent special revenues from being used to pay obligations from pledged special revenues.

2. A municipal debtor is allowed greater latitude in modifying or rejecting collective bargaining agreements. Section 1113 does not apply in chapter 9 which requires extensive negotiation prior to rejecting collective bargaining agreement.

1. End game in chapter 9 is the confirmation of Plan of Adjustment (not reorganization). Only a debtor may propose a plan in chapter 9. Discharge in chapter 9 only after confirmation of plan, deposit of securities to fund plan and determination by the court that the securities deposited constitute a valid obligation of the debtor and that any provision made to pay or secure payment of obligations is valid.

VI. ISSUES IMPORTANT TO THE SURETY

For obvious reasons, the impact on the surety of a municipal bankruptcy filing is the effect upon the surety's obligee. The issues important to the surety fall into (1) reactive measures when the Chapter 9 petition has already been filed; and (2) proactive strategies and underwriting considerations to plan in advance for the potential risk, if any. This article starts with an examination of the issues involved when the Chapter 9 has already been filed.

A. EXAMINATION OF THE REASONS THAT THE MUNICIPALITY WENT INTO BANKRUPTCY

When confronted with a Chapter 9 petition, the surety's inquiry should usually start with an examination of the reasons why the bankruptcy petition was filed. The reasons why the case were filed will often better inform the surety as to what the municipal debtor intends to do—i.e., "whose ox is being gored."

Typically, Chapter 9 cases will be filed either to deal with a single large debt or deal with systemic funding problems. For instance, the Chapter 9 bankruptcy of Orange County, California was motivated by a one-time financial hit in the form of massive $1.6+ billion in losses on risky investments.[63] Contrast that with more recent cases of Vallejo, Stockton,

Mammoth Lakes and San Bernardino, all in California, which have been plagued with sustained operating losses due to, among other things, reduced real property tax revenues due to collapsing real property market and soaring pension costs. Contrast that yet with Compton, California, which has been threatening to file for Chapter 9 for awhile but has yet to do so (and as of the date of this article states it will not do so now), where the issues have been a combination of sustained operating losses combined with rumblings of financial fraud.

To generalize for purposes of explanation, in the case of a one-time financial hit, it is fairly clear to see what the purposes of the bankruptcy will be, and it seems likely that creditors other than the target may be relatively unaffected. Said another way, the sureties' bonded contracts may flow through the Chapter 9 without interruption. In the case of systemic losses and financial drain, many of those cases—of which Vallejo is good example—demonstrate that the labor union contracts are the target and many other creditors may be unaffected. However, in the case of financial fraud, it may be that all bets are off in terms of who is affected, as there is the possibility at least in theory that there may be no assurances of sufficient funds to cover any of the municipality's operating expenses in full and that all creditors are forced to accept losses—to date, this latter scenario has yet to be experienced in the recent filings in the last five years. All in all, however, there is no way to generalize from one case to the next. Each must be evaluated according to its own facts and circumstances, and in connection with early dialogue that should occur with debtor's counsel as to the specific effects upon the surety's bonded contract and contract balances, as further discussed below.

B. EFFECTS ON CONTRACT BALANCES: GENERAL FUNDS V. SPECIAL FUNDS

In a Chapter 9, key among the surety's concerns will always be the effect upon contract balances and the surety's subrogation rights. After determining the reasons for the Chapter 9 filing, as discussed above, the surety will want to specifically examine how the municipal debtor is holding the contract funds, if the surety has not done so already. This typically involves an examination of whether the surety's claim is ultimately one against the municipality's "general fund" or the contract funds are safely tucked away into "special funds."

The municipality's "general fund" is its general operating fund from which it pays typical operating expenses. By contrast, the municipality's "special funds" are those which are restricted, either by grant or by law, such that those funds can be used for no other purpose than that to which they are already dedicated.[64] In the world of Chapter 9, the difference is somewhat akin to the difference between a general unsecured creditor (general fund) and a secured creditor (special fund). If the surety has a claim against the general fund, it may have only a pro rata claim, at best, to some amount. By contrast, if the surety's subrogation rights are in a fund which is a special fund, then that special fund should be outside the reach of other creditors of the municipal debtor. Therefore, special funds, when truly restricted, are better than a security interest—they are not even part of the bankruptcy!

There is no clear dividing line in terms of what causes a fund to be a "special fund." Indeed, whether a fund is a restricted fund or not can be determined with regard to bankruptcy

law, federal law, State law, constitutional law or municipal law, or even by the contact terms upon which the municipal debtor's access was granted to the fund.

Typically, where this issue first arises in a Chapter 9 is in the initial pleadings where creditors (primarily the creditor whose "ox is being gored") challenges the eligibility of the municipal debtor to file for Chapter 9, particularly on the insolvency prong. For instance, in the Vallejo, California Chapter 9 bankruptcy, the labor unions claimed that Vallejo was not insolvent because its balance sheet should be viewed with reference to all of its special funds (which the labor unions claimed were not "special") instead of solely the general fund. The bankruptcy court disagreed and found that the debtor had adequately proven that the special funds were restricted and therefore could not be factored into the insolvency analysis—such special funds being outside of the reach of the labor unions and other creditors.[65] Indeed, the bankruptcy court issued findings of fact and conclusions of law as to each specific special fund placed into dispute, finding that indeed those funds were restricted.[66] That is, this is a fund-by-fund analysis with no clear legal dividing line. When the matter went up on appeal to the Ninth Circuit Bankruptcy Appellate Panel ("B.A.P."), the B.A.P. upheld the decision of the bankruptcy court's findings of fact and conclusions of law were not clearly erroneous.[67]

Indeed, in the *Vallejo* case, the B.A.P. also made a number of findings related to the issue of general funds and special funds, including the following observation describing the "complexity of municipal accounting practice":

> This practice includes a mix of laws authorizing the creation of funds; laws restricting the use of funds; facts as to the current amounts available in particular funds; laws de-authorizing the funds; laws loosening the restrictions; laws tightening the restrictions; laws and facts regarding the source of financing for the funds; and facts as to Vallejo's discretionary allocation of amounts in the funds. Further, some of the legal enactments were municipal, some state and some federal. In total, the enactments covered a time spectrum of approximately 30 years.[68]

In other words, there is no clear dividing line between special funds and general funds. Research of municipal or State accounting laws or guidelines provides little more in the way of clarity.[69]

1. Special Funds: Federal Funding

Probably some of the more clear-cut restricted funds derive their nature from their funding sources, including federal funding on public works construction projects. Such federal funding typically has as a matter of course, by both law and grant, use restrictions, with additional requirements of the public entity specially allocate sufficient other funds. Therefore, if the surety's bonded contract is funded in part with federal funds, chances are that a restricted special fund holds the contract balance, or at least a percentage of it. Federal funding is often mixed and matched with municipal funding. The good news is, however, that federal funding sources often require the municipality to specially allocate its share of matched funding. Of

course, the surety needs to verify that that funding restrictions are indeed in place, which must necessarily include third party verification with the funding source.

2. Special Funds: Allocated Special Revenue Bond Funds

Besides federal funding, another common source for use restrictions is specially allocated funds from municipal bonds—revenue bonds. That is, the municipal debtor specially allocated money from a municipal bond offering (e.g., tax revenue bonds or lease revenue bonds) to the construction of the public works project. Ideally, this required the municipality to have earmarked those funds with the municipal bond indenture trustee (a bank) such that funds are released from the bank/indenture trustee almost like a construction loan. That is, the funds may be held by the indenture trustee and released only when the indenture trustee is satisfied that the conditions for release have been met. Various duties apply to the indenture trustee in the release of those funds in accordance with the indenture trust documents. If the surety is going into the Chapter 9 bankruptcy with specially allocated funds held by an indenture trustee, depending on the use restrictions in the indenture trust documents, the surety may find that the Chapter 9 bankruptcy has no impact. Again, this must be specifically confirmed with the indenture trustee.

Indeed, in the case of special funds which tie into special revenues, there is an overlay of the Bankruptcy Code which can make such special funds "extra special"—such that they are not even part of the bankruptcy estate at all. For instance, Section 902(2) of the Bankruptcy Code defines "special revenues" as follows:

> (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 tax-increment financing) levied to finance the general purposes of the debtor

While the foregoing is a limited definition which covers only the "receipts" back to the municipal debtor, this definition has greater application because of Section 922(d), which provides that "a petition filed under this chapter does not operate as a stay of application of pledged special revenues…" Therefore, when the municipality has pledged its special revenues, it can continue to service the underlying debt with the indenture trustee. Further, Section 927 provides that "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…" Therefore, in theory, the relationship created by the municipal revenue bonds between municipality and indenture trustee would be exempted from the bankruptcy process altogether. Thus, money would ostensibly flow and the proceeds held by the indenture

trustee should continue to be slated and applied for their purposes. Again, if the indenture trust documents provide for use restrictions, then the surety and its principal may well be the direct albeit perhaps unintended beneficiary in that the money will continue to flow to the job.

The surety may be able to partially confirm special revenue bond funding allocations by review of the applicable municipality's meeting minutes (many of which are online) and a review of the Municipal Securities Rulemaking Board ("MSRB"), Electronic Municipal Market Access ("EMMA") system website: http://www.emma.msrb.org/

The EMMA website allows access to the official statement (like a prospectus) and municipal financial statements, since municipal bonds are publicly and privately offered. However, the EMMA system does not contain the indenture trust documents, but the official statement will provide the name of the indenture trust bank and therefore leads to avenues for issuance of subpoenas or other public records act requests.

3. Other Special Funds

The surety may have other special fund and restricted fund arguments available to it, depending upon the jurisdiction involved. These may derive from construction trust fund statutes, earmarking of funds (perhaps at the request of the surety), stop notice rights (including the foreclosure by the surety of existing stop notices), and retention escrow accounts (such as on public works projects in California for instance). The surety may also be able to negotiate for (such as in the underwriting phase) or litigate (pre-petition) for protection and ear-marking of its funds. The viability of each such argument or avenue of recovery requires a State-by-State and fact-specific analysis which is outside the scope of this article.

4. Disappearing Special Funds?

Once the surety confirms that the contract balance is indeed held and retained in "special funds," however, that may not be the end of the analysis. As noted earlier, any confirmation should be made with third party verification. The reason that third party verification is key is because it appears that there may be many ways in which "special funds" still may be lost in the shuffle. Some of the "parade of horribles," may include the following: (a) the municipality may have never actually allocated the special funds for the project despite their promise to do so; (b) the municipality may have allocated the special funds but never confirmed it administratively with the indenture trustee bank holding the money—i.e., city hall voted and approved special funds allocations, but no one put the project name on the bank's books and records; (c) the municipality over-allocated the special funds and/or did not reserve enough funds, overly-optimistically thinking that it did not need as much money; (d) the municipality has or had the ability to "change" or "swap out" which projects are covered by the indenture trust agreements so that it can recharacterize the special funds as applying to other projects—therefore, the flexibility of the municipality under the special fund restriction documents must be examined; (e) the municipality borrowed against the special funds for other projects during the time that the municipality's bond ratings were good;[70] or (f) outright fraud occurred in the city finance department. Any one of the foregoing or other factors could materially impact the surety's or

principal's recovery of the contract balance.

Further, at the very least, the surety or its principal may consider putting the indenture trustee bank on notice of its claim so as to impose an additional layer of scrutiny on the part of the indenture trustee bank in its release of any special fund to the municipality. At least in one reported decision in a Chapter 9 bankruptcy, the contractor was unsuccessful in subordinating the claim of the indenture trustee in the bankruptcy under Section 510 of the Bankruptcy Code (which subordinates liens based upon gross or egregious conduct of the lienholder) because the contractor had never put the indenture trustee bank on notice that the funds it was holding were insufficient to complete the job.[71] This case suggests that one of the first things that the surety will want to do is to locate the indenture trustee bank (through the EMMA System or other means) and put it on notice of its potential claim if the surety gets notice of a potential Chapter 9 bankruptcy by the obligee.

C. EXECUTORY CONTRACTS: ISSUES AND CHALLENGES FOR CONTRACTORS AND THEIR SURETIES.

When faced with a Chapter 9, the surety and principal should also consider immediate negotiation with the municipal debtor to assume (preferably) or reject the bonded contract.

Contractors contracting with municipalities for the construction of public works are generally unable to obtain security interests (such as mechanics' liens) in property improved by their work to secure payment of the contract amounts. Liens are generally prohibited by state law, and municipalities are generally precluded from granting security interests in their property or funds. Thus, if the municipality files Chapter 9, contractors technically are relegated to unsecured creditor status.

A contract that has not been completed is considered to be "executory."[72] The filing of a Chapter 9 bankruptcy case does not automatically terminate executory contracts, even though the contract may be in default. As in Chapter 11, the debtor entity is granted the opportunity to "assume" the obligation of the contract and keep such contract in force, or "reject" it and terminate it, pursuant to the general provisions of the Bankruptcy Code. Again, judicial guidance from Chapter 9-specific cases dealing with assumption and rejection is scarce, but general principles from Chapter 11 cases dealing with Section 365 are directly applicable.

1. Assumption of the Executory Contract.

If the municipal debtor is in default but wishes to affirm and assume the executory construction contract, it must comply with Section 365 of the Bankruptcy Code, which requires it to do the following:

a. Cure or provide adequate assurance that it will promptly cure the default;

b. Compensate or provide adequate assurance that the city will promptly compensate the other party to the contract for any actual pecuniary loss to such party resulting

from the default; and

c. Provide adequate assurance of future performance under the contract.[73]

A municipal debtor may therefore assume the contract only if it can promptly cure the default and otherwise satisfy the requirements of Section 365, including providing adequate assurance of future performance. Thus, even though the bankruptcy court is precluded from interfering with the function of the municipality, the court can, in fact, order the debtor to pay "adequate protection" in the context of assuming an executory contract. In fact, in the Orange County bankruptcy, the court indicated that by coming into the bankruptcy court for protection, the municipality "consented to [the court's] jurisdiction to order, if necessary, adequate protection [for creditors] in connection with [the] proceeding."[74]

2. **Rejection of the Executory Contract.**

If debtor elects to reject the construction contract, Section 365(g) indicates that such rejection is a breach of the contract as of the date of filing, giving rise to a claim by the non-debtor party for "rejection" damages.[75] Further, the debtor, in rejecting a contract, may have a number of options that negatively impact the contractor. Such impact generally transfers, in one way or another, to the sureties that have posted bonds securing the performance and payment on those public projects.

First, if the city rejects the construction contract, the contractor's "rejection damages" constitute an unsecured claim for all unpaid amounts due under the contract. That may count for little, however, since the municipality may, in its Chapter 9 Plan, reduce or "adjust" that claim all the way down to zero if it chooses. In such circumstances, the contractor will receive nothing for the unpaid work performed on the project, and subcontractors will undoubtedly begin making claims against the payment bonds. Such a tactic by the debtor effectively results in a discharge of the obligation, with no right by the contractor or its surety to any recourse against the city or undisbursed contract funds.[76]

If the contract includes provisions allowing the municipality to terminate for convenience, the city can assume the contract under Section 365 (particularly if the unpaid amount is not too large), then promptly terminate it in order to reduce its ongoing liability, subject to the terms governing payments due to the contractor in light of such a termination. This whipsaw tactic potentially removes the contractor from the class of unsecured creditors and, since the contractor can no longer vote against the debtor's plan, improves the city's chances for confirming its plan.[77]

If the debtor rejects the contract, it can still make use of applicable procurement procedures to obtain a new contractor to finish the project, even for less money.[78] Under this scenario, again, original contractors go unpaid, creating exposure for sureties to those subcontractors and suppliers depending on the contractor for payment.

3. Timing of Assumption or Rejection and Prejudice to Non-Debtor Contractors

The most serious challenge relating to assumption or rejection of executory contracts lies in the timing of that election. Pursuant to Section 365(d)(2), a Chapter 9 debtor can wait until confirmation to decide whether to assume or reject an executory contract, risking leaving contracting parties literally in limbo for months until an election is made. But to prevent prejudice to the non-debtor party to the contract, the court may, on motion by that party, order the debtor to decide earlier whether it will assume or reject the contract.[79] In determining such a motion, the bankruptcy court must "balance the interests of the contracting party against the interests of the debtor and its estate" because "[i]t is vitally important to all interested parties that the debtor make a prudent assumption or rejection decision...."[80] Other courts have listed a number of factors the bankruptcy court should consider in determining whether to expedite the decision to assume or reject:

> What constitutes a reasonable time is left to the bankruptcy court's discretion, to be determined on a case-by-case basis in light of the broad purposes of the entire Bankruptcy Code. Relevant considerations include the damage that the non-debtor will suffer beyond the compensation available under the Bankruptcy Code, the importance of the contract to the debtor's business and reorganization, whether the debtor has had sufficient time to appraise its financial situation and the potential value of its assets in formulating a plan, and whether exclusivity has terminated. "Above all, the court should interpret reasonable time consistent with the broad purpose of Chapter 11, which is 'to permit successful rehabilitation of debtors.'"[81]

In *In re Physicians' Health Corp.*, the court reasoned that it must balance the competing interests of the debtor and the non-debtor parties to the contract. It then concluded the non-debtor contractor had presented no compelling evidence why it should accelerate the decision to assume or reject within 15 days, only five months into the bankruptcy. The contractor further failed to present evidence of prejudice from the delay or that the debtor had been dilatory.[82]

Because of the prejudice and exposure from delaying such a decision until confirmation, contractors and sureties would typically have compelling arguments to expedite the decision to assume or reject; they should not be required to either (a) work for free, or (b) hold off from seeking other paying work, while the debtor decides whether or not to finish the project or reduce its scope. At the same time, there is danger in assuming that a contractor will be paid for work it continues to perform, absent an election or attendant assurances of continuing payment for that work.

As a practical matter, contractors and sureties on public works projects may be protected from complete rejection or long-term delay of a public works construction contract prompted by a Chapter 9 filing. Funding for many of these projects may be earmarked, as a condition for

matching funds from county, state, and/or federal sources. Armed with adequate funds to complete such projects, municipalities have good reason to complete projects that are underway, and they may be motivated to assume executory construction contracts without much deliberation and in a relatively quick time frame. Nevertheless, there is nothing in Chapter 9 that differentiates public works contracts from other municipal obligations, and contractors and their sureties face the risk of efforts to "adjust" the scope or terms of a construction contract, either by limiting the scope of the work or renegotiating the amount to be paid.[83]

Municipal debtors also have Code-established rights to reject its executory contracts.[84] At the heart of the Vallejo bankruptcy litigation was the city's ongoing attempts to reject collective bargaining agreements with public employee unions, even as the threat of rejection is used to leverage the City's position in renegotiations.[85] Since filing its Chapter 9 Petition on May 23, 2008, Vallejo successfully renegotiated the collective bargaining agreements with its city police officers and administrative workers while motions to reject the respective collective bargaining agreements were before the court.[86] Negotiations with the two remaining unions, the firefighters and electrical workers, were ongoing while Vallejo's motion to reject the collective bargaining agreements remains before the court.[87] Indeed, the bankruptcy court refused to issue a ruling on the rejection motions pending further settlement discussions.[88] One can see how these same efforts could be used to force a renegotiation of a public works contract.

In addition to the right that a contractor (and those standing in its shoes) has to seek an expedited determination of assumption or rejection, some cases suggest that the debtor cannot compel the contractor to continue performing under the contract, pending the debtor's decision to assume or reject, without assurance of payment by the debtor.[89] In *Thomas Companies, Inc. v. United Fire & Casualty Co.*,[90] an HVAC contractor continued to perform work under a contract with a Chapter 11 debtor, post-petition. The debtor ultimately rejected the contract and sought recovery of payments for post-petition performance. The court ruled for the contractor, reasoning that "a Debtor should be responsible for any associated expense incurred while [the decision to assume or reject an executory contract] is being made."[91] Likewise, some courts have held that any work performed by the contractor post-petition (and pre-rejection) would be afforded the ultimate priority of administrative claim status.[92] Similar arguments might be forwarded that work done on a public works contract during the time a Chapter 9 debtor is deciding whether to assume or reject that contract, would be entitled to that same priority for payment.

These potential options for treatment of executory contracts raise an interesting issue for sureties seeking to control their exposures. If the debtor rejects the contract pursuant to Section 365, preventing the contractor from completing the project, it should act to exonerate the performance bond, as if the municipality had breached the contract. The difference is that there is no recourse against the debtor for contract rejection. But, since payment bond liability is usually statutory and not often conditioned on owner payment, a payment bond may remain exposed to claims of those suppliers and subcontractors whom a contractor may be unable to pay, for lack of payment from the municipal debtor. If the debtor rejects the contract and ultimately reduces the claims under its plan (at all, let alone to zero), the contractor and its surety

will certainly face liability to unpaid suppliers and subcontractors without full recourse against the project owner.

VII. PROACTIVE EFFORTS & UNDERWRITING CONSIDERATIONS

Predictions for the future vary considerably. Some believe we will continue to see more Chapter 9 bankruptcies, while others predict a trickling but not a deluge. The surety may be able to undertake proactive efforts to protect itself from municipal obligee insolvency, including through the following steps, some of which may be incorporated into underwriting of the subject municipal bonds. The following provides a checklist of certain (non-exhaustive) recommendations for the surety, depending upon the circumstances:

1. **Examine the Obligee**

   a. Is the Obligee even eligible to file Chapter 9 as a matter of State law? (See Exhibit A list of States)

   b. Is the Obligee even part of or controlled by a municipality that is in Chapter 9 or eligible to file? I.e., Just because "San Bernardino" is in the title obligee's name does not mean that the obligee is San Bernardino.

   c. How financially healthy is the obligee?

      (1) How far have real property prices fallen since 2007? Municipal insolvency goes hand in hand with reduced real property taxes.

      (2) Check the EMMA System for updated financial information if available. (Note that EMMA shows that the municipality has not furnished updated financial information for over a year or more, that is probably a bad sign too.)

      (3) Some commentators have noted that charter cities, which lack budget restrictions imposed by the State, have fallen to Chapter 9 in higher numbers.[93]

      (4) Moody's and Standard & Poor's ratings may be used to gauge possible insolvency.[94] Word of caution: The ratings systems have been criticized for moving slowly in downgrading municipal bond ratings for insolvent municipalities. It appears that this criticism may have prompted the ratings systems to reexamine at least California municipalities.[95]

      (5) Google the obligee for dirt and gossip about the obligee: In

the aftermath of several recent filings, some commentators have endeavored to predict which municipalities will be next, publishing their research into the solvency of several California public entities.[96]

2. **Examine The Principal**: In the face of potentially insecure contract funds, the surety may need to reevaluate how much credit it takes for a principal to get bonding for a public works project. Alternatively, for weaker credit accounts, confirming sources of funding (next) may become the most important.

3. **Examine Or Safeguard The Source Of Project Funding**

   a. How does the obligee intend to fund the project? Municipal bond funding, federal funding, other funding?

   b. What "special fund" restrictions can the surety and/or principal negotiate for either in the bonded contract or bond?:

      (1) Contractual requirements that the obligee agree to specially allocate project funding from sources that are not general funds?

         (a) What is penalty for non-performance?:

            (i) Right to demand financial assurances

            (ii) Right to terminate or suspend performance

         (b) Right to continued reporting or to access reports from the indenture trustee on municipal bonds?

      (2) Fund restriction mechanisms such as escrow accounts?

      (3) Assurance letters / "set aside" letters?

      (4) Agreements that all funds specially allocated are construction trust funds?

      (5) Subrogation rights contractually given to the sureties in pledged revenues on municipal bonds? (Would require surety involvement in underlying transactional documents as part of municipal bond offering.)

4. **What Is The Bond?** Commercial Bonds vs. Contract Bonds: Is the bond cancellable in the event of material breach? On what intervals will the

> principal be paid by the obligee? If the principal is paid month to month for services such that the accounts receivable it carries will not put it out of business and the bond is cancellable, the credit risk during each payment interval may simply not warrant further concern. Further, for certain commercial surety bonds relating to services which are necessary to the municipality, such as water, power and garbage pickup, these would presumably be the last to be outright cancelled or defaulted upon under penalty of rioting residents—the last thing that the Chapter 9 debtor wants and probably reasonably anticipated only in the event of complete economic meltdown.

The foregoing is a non-exhaustive list of recommendations and considerations that may or may not be applicable to the given circumstances. Importantly, any one or combination of the foregoing may be ineffective to safeguard the surety's interests in a given fund, depending on the circumstances. Moreover, whether past cases will be a good predictor of future cases remains to be seen.

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[1] *See In re Mount Carbon Metropolitan Dist.*, 242 B.R. 18, 32 (Bankr. D. Colo. 1999) (citations omitted).

[2] Hon. William L. Norton, Jr. and William L. Norton III, *Bankruptcy Law and Practice*, 90:1 (3rd ed. 2008). This paper relies heavily upon Professor Norton's excellent treatise on Chapter 9 and commends it to the reader for further discussion of these issues.

[3] *See In re Mount Carbon*¸ 242 B.R. at 32.

[4] 11 U.S.C. §§ 903, 904, 901(a); Norton, *supra* note 12, at 90:5.

[5] 11 U.S.C. § 904.

[6] *See In re County of Orange*, 179 B.R. 195 (Bankr. C.D. Cal. 1995).

[7] All references to the "Bankruptcy Code" or "Code" in this paper refer to the United States Bankruptcy Code, codified at 11 U.S.C. § 101, *et seq.* References to "Section" refer to specific sections of the Code.

Section 109(c) provides as follows:

> An entity may be a debtor under Chapter 9 of this Title if and only if such entity—
> (1) is a municipality;
> (2) is specifically authorized in its capacity as a municipality or by name to be a debtor under such chapter by state law or by a governmental officer or organization empowered by state law to authorize such entity to be a debtor under such chapter;
> (3) is insolvent;
> (4) desires to effect a plan to adjust such debts; and
> (5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan and a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding of at least a majority in an amount of the claims of each class that such entity intends to impair under a plan and a case under such chapter;
(C) is unable to negotiate with creditors because such negotiation is impracticable; or
(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under Section 547 of this Title.

[8] *See* Norton, *supra* note 12, at 90:5.
[9] *See In re Green County Hospital*, 59 B.R. 388, 389 (S.D. Miss. 1986).
[10] *See, e.g., Mason v. Paradise Irrigation District*, 326 U.S. 536, 66 S. Ct. 290 (1946) (cited in Norton, *supra* note 12, at 90:5 n. 6); *See also Mozingo v. York County Natural Gas Authority*, 352 F.2d 78 (4th Cir. 1965); *Buell v. City of Montague*, 190 F.2d 1019 (9th Cir. 1951); *Fano v. Newport Heights Irrigation District*, 114 F.2d 563 (9th Cir. 1940).
[11] Norton, *supra* note 12, at 90:5.
[12] *See In re City of Bridgeport*, 129 B.R. 322 (Bankr. D. Conn. 1991). The municipality will have the burden of proof on that issue.
[13] *See* Norton, *supra* note 12, at 90:5 and cases cited in the footnote.
[14] Insolvency appears to be a key issue in the bankruptcy of the City of Vallejo. *See* California Professional Firefighters website, *supra* note 9 (citing stopvallejobankruptcy.com and pointing to the independent auditor's report that Vallejo is not insolvent).
[15] *In re City of Vallejo, California*, 2008 WL 41800008, p. 22 (Bankr. E.D. Cal. 2008).
[16] *Id*.
[17] *Id*.
[18] Norton, *supra* note 12, at 90:5; 11 U.S.C. § 109(c)(4) § 941.
[19] *In re City of Vallejo, California*, 2008 WL 4146015, *27 (Bankr. E.D. Cal. 2008), citing *In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 78 (Bankr. D.N.H. 1994).
[20] 11 U.S.C. 109(c); Norton, *supra* note 12, at 90:5. Section 547 deals with voidable preferences—transfers that occur within a certain time before the bankruptcy filing that enable a creditor to obtain more than it would have received in liquidation in bankruptcy. Subject to limited defenses, a trustee has what are affectionately referred to as "Strong-arm" powers to reach into the pockets of such creditors who received pre-petition transfers. *See* "Avoidance Powers" in the following section.
[21] 11 U.S.C. § 923; Norton, *supra* note 12, at 90:9.
[22] 11 U.S.C. § 922; Norton, *supra* note 12, at 90:11.
[23] 11 U.S.C. § 922(c); 11 U.S.C. § 507(b); Norton, *supra* note 12, at 90:11. An administrative claim is a claim that is granted priority treatment and generally entitled to payment in full prior to the payment of creditors. Under 11 U.S.C. § 503(b), administrative claims expressly include "the actual, necessary costs and expenses of preserving the estate," such as wages, salaries or commissions owed for services rendered after the petition date and shipments delivered to the debtor that provided a benefit to the bankruptcy estate. Perhaps the most well-known category of administrative claims is that of the professional employed during the case seeking payment for

attorneys' or other fees. As a little incentive for representation, Congress ensured that the debtor's bankruptcy lawyers get paid first.

[24] 11 U.S.C. §§ 902(2), 922(d), 927.

[25] 11 U.S.C. § 362(a).

[26] *See* 11 U.S.C. §§ 547, 548, 549(a), and 901(a); *see also Matter of North and South Shenango Joint Municipal Auth.*, 14 B.R. 414, 420 (Bankr. W.D. Pa. 1981).

[27] See "Bankruptcy Preference Avoidance Actions and "Springing" Bond Claims?," Watt, Tieder, Hoffar & Fitzgerald, LLP, FROM THE GROUND UP, by Kirsten Worley and Kaysie Garcia, Spring 2012 ed., http://www.wthf.com/news/WTHF-Spring-2012-Newsletter

[28] *See* 11 U.S.C. § 926; *In re Alabama State Fair Authority*, 232 B.R. 252, 271 & n. 26 (N.D. Ala. 1999); Norton, *supra* note 12, at 90:15.

[29] Norton, *supra* note 12, at 90:10.

[30] *Id.* at 90:12.

[31] Norton, *supra* note 12, at 90:16

[32] 11 U.S.C. § 901. Section 901(a) provides as follows:

> **(a)** Sections 301, 344, 347(b), 349, 350(b), 361, 362, 364(c), 364(d), 364(e), 364(f), 365, 366, 501, 502, 503, 504, 506, 507(a)(2), 509, 510, 524(a)(1), 524(a)(2), 544, 545, 546, 547, 548, 549(a), 549(c), 549(d), 550, 551, 552, 553, 555, 556, 557, 559, 560, 561, 562, 1102, 1103, 1109, 1111(b), 1122, 1123(a)(1), 1123(a)(2), 1123(a)(3), 1123(a)(4), 1123(a)(5), 1123(b), 1123(d), 1124, 1125, 1126(a), 1126(b), 1126(c), 1126(e), 1126(f), 1126(g), 1127(d), 1128, 1129(a)(2), 1129(a)(3), 1129(a)(6), 1129(a)(8), 1129(a)(10), 1129(b)(1), 1129(b)(2)(A), 1129(b)(2)(B), 1142(b), 1143, 1144, and 1145 of this title apply in a case under this chapter.

[33] Norton, *supra* note 12, at 90:16.

[34] *Id.*; 11 U.S.C. §§ 901(a), 1124(1), 1124(2), and 1124(3).

[35] Norton, *supra* note 12, at 90:16.

[36] *Id.* at 90:18; 11 U.S.C. §§ 901(a), 1125(a)(1).

[37] Norton, *supra* note 12, at 90:18.

[38] *Id.* at 90:21; 11 U.S.C. §§ 901(a), 1129(a)(10).

[39] 11 U.S.C. §§ 901(a), 1126(c); Norton, *supra* note 12, at 90:19.

[40] 11 U.S.C. §§ 901(a), 1129(b); Norton, *supra* note 12, at 90:21.

[41] 11 U.S.C. §§ 901(a), 1129(b)(1); Norton, *supra* note 12, at 90:21.

[42] *See, e.g., Matter of Jersey City Medical Center*, 817 F.2d 1055 (3rd Cir. 1987).

[43] Norton, *supra* note 12, at 90:21. Professor Norton cites to the legislative history of the Act, H.R. Rep. No. 686, 94th Cong. 1st Sess. 32 to 33 (1977) ("[W]here future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available basis for appraising the respective interests of different classes of creditors. In order that a court may determine the fairness of the total amount of cash or securities offered to creditors by the plan, the court must have data which will permit a reasonable, intense and informed, estimate of the probable future revenues available for satisfaction of creditors.")

[44] 11 U.S.C. §§ 901(a), 1129(a)(3).

[45] *See In re Mount Carbon Metropolitan District*, 242 B.R. 18, 39 and 40 (Bankr. D. Colo. 1999). In analyzing those factors, the court outlines the standards (and highlights their vagueness and arbitrariness) as follows:

> Under one view, the good faith requirement of § 1129(a)(3) is met if the plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code. Under another view, the good faith requirement is met if the plan was proposed with honesty and good intentions, and with a basis for expecting that a reorganization can be effected. Under a third view, good faith requires fundamental fairness in dealing with one's creditors. *Tenn-Fla. Partners*, 229 B.R. at 734 (W.D.Tenn.1999), *quoting In re Gregory Boat Co.*, 144 B.R. 361, 366 (Bankr.E.D.Mich.1992) (citations and footnote omitted).

[46] *Ault v. Emblem, Corp.* (*In re Wolfcreek Valley Metropolitan Dist. No. IV*), 138 B.R. 610 (D. Colo. 1992) (cited in Nortons, *supra* note 12.
[47] *In re Town of Westlake*, 211 B.R. 860 (Bankr. N.D. Tex. 1997).
[48] 11 U.S.C. § 943(b)(1).
[49] 11 U.S.C. § 943(b)(2); Norton, *supra* note 12, at 90:20; *see also In re Castle Pines North Metropolitan District*, 129 B.R. 233 (Bankr. D. Colo. 1991).
[50] 11 U.S.C. § 943(b)(3).
[51] 11 U.S.C. § 943(b)(5).
[52] 11 U.S.C. § 943(b)(6).
[53] Norton, *supra* note 12, at 90:20, citing Epling, *Fine Tuning Chapter 9 Municipal Debt Adjustments*, 21 ARIZONA STATE L.J., 403, 419 (1989).
[54] *In re Mount Carbon Metropolitan District*, 242 B.R. 18, 39 (Bankr. D. Colo. 1999).
[55] *Id.* at 34.
[56] Norton, *supra* note 12, at 90:20. Two key cases dealing with the best interest test are *Fano v. Newport Heights Irrigation District*, 114 F.2d 563 (9th Circuit 1940), and *Kelley v. Everglades Drainage District*, 319 U.S. 415, 63 S. Ct. 1141 (1943).
[57] *In re Mount Carbon Metropolitan District*, 242 B.R. at 35 (citations omitted).
[58] *Id.* (citations omitted).
[59] Norton, *supra* note 12, at 90:22; 11 U.S.C. § 944(a).
[60] 11 U.S.C. § 944(b); *In re Matter of Sanitary and Improvement Dist. No. 7 Lancaster County*, 112 B.R. 900 (Bankr. D. Neb. 1990); Norton, *supra* note 12, at 90:20.
[61] 11 U.S.C. § 930(b)
[62] Norton, *supra* note 12, at 90:23
[63] *See In re County of Orange*, 183 B.R. 594 (C.D. Cal. 1995)
[64] *In re City of Vallejo, California*, 408 B.R. 280, 291 (9th Cir. B.A.P. 2009).
[65] *In re City of Vallejo, California*, 2008 WL 4180008 (Bankr. E.D. Cal. 2008).
[66] *Id*.
[67] *In re City of Vallejo, California*, 408 B.R. 280, 291 (9th Cir. B.A.P. 2009)
[68] *Id*.
[69] For instance, posted at website http://www.dof.ca.gov/html/bud_docs/fndclass.pdf is a "Description of Fund Classifications in the Treasury" for the State of California, which provides

a multitude of potential special funds without much authority in terms of whether they are restricted funds or not.

[70] Several articles have recently appeared suggesting trends in public finance to borrow against special funds. *See, e.g.,* "California scrambles to pay its bills with more borrowing," LOS ANGELES TIMES, August 13, 2012, http://latimesblogs.latimes.com/california-politics/2012/08/california-cash-budget.html. See also, "California borrowing from special funds accounts surges; audit under way," THE SACRAMENTO BEE, July 31, 2012, http://www.sacbee.com/2012/07/31/4676348/state-borrowing-from-special-fund.html

[71] *In re Eufaula Industrial Authority*, 266 B.R. 483 (10th Cir. 2001).

[72] While a number of definitions exist for the concept of an "executory contract," a number of courts have relied on the "Countryman" test:

> a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

Vern Countryman, *Executory Contracts in Bankruptcy: Part 1*, 57 MINN. L. REV. 439, 460 (1973) (cited in *In re Teligent, Inc.*, 268 B.R. 723, 730 (Bankr. S.D.N.Y. 2001).

[73] 11 U.S.C. § 365(b).

[74] *Alliance Capital Management, LP v. County of Orange*, 179 B.R. 185 (Bankr. C. D. Cal. 1995) (quoted in Pommer and Friedman, *Municipal Bankruptcy and its Effect on Government Contractors*, 25 PUBLIC CONTRACT LAW JOURNAL 249, 256, Winter, 1996). The concept of "adequate protection" appears in various provisions of the Bankruptcy Code and generally refers to the debtor's duty to ensure that certain creditors (generally secured creditors) are protected against the loss or diminution of the value of their collateral or claim.

[75] *See* 11 U.S.C. § 365(g); *see also* Pommer and Friedman, *supra* note 42, at 257.

[76] Pommer and Friedman, *supra* note 42, at 257.

[77] *Id.*

[78] *Id.* at 257-58.

[79] 11 U.S.C. § 365(d)(2); *see also In re Physicians Health Corp.*, 262 B.R. 290, 292 (Bankr. D. Del. 2001)

[80] *In re Physicians Health Corp.*,290 B.R. at 292 (citations omitted).

[81]*In re Teligent, Inc.*, 268 B.R. at 738-39.

[82]*In re Physicians Health Corp.*,290 B.R. at 295.

[83] For example, a municipality could reduce the scope of a building renovation project, scale back on the size of the construction of a public library, or determine that rather than improve and repair ten miles of county roads, it will only improve five. Such an attempt to reduce scope is less of a risk in, say, construction of a bridge. The contractor and surety would have much better leverage in negotiating with the municipality that a bridge in mid-construction at bankruptcy filing should, in fact, reach the other shore.

[84] 11 U.S.C. § 901 (making 11 U.S.C. § 365's right to accept or reject executory contracts fully applicable in Chapter 9 cases).

[85] *In re City of Vallejo*, No. 08-26813-A-9 (Bankr. E.D. Cal. March 13, 2009) (Memorandum Order).

[86] *Id.*

[87] *Id.*
[88] *Id.*
[89] Pommer and Friedman, *supra* note 42, at 257; *In re Nut Co. (SNA Nut Co. v. The Haagen-Dazs Co., Inc.)*, 1996 WL 596731 (Bankr. N.D. Ill. 1996)..
[90] 166 B.R. 677 (Bankr.C.D.Ill.1994),
[91] *Id.* at 680, cited in *In re Nut Co.*, 1996 WL 596731, at *3.
[92] Pommer and Friedman, *supra* note 42, at 257 n 70, citing *Stewart Foods Inc. v. Boecker*, 64 F.3d 141 (4th Cir. 1995).
[93] See, e.g., "California's Charter Cities Are Under the Microscope," WALL STREET JOURNAL, July 18, 2012, http://online.wsj.com/article/SB10001424052702303612804577531181167707276.html.
[94] See, e.g., "Moody's: More Calif. Cities At Risk Of Bankruptcy," August 17, 2012, http://www.businessweek.com/ap/2012-08-17/moodys-more-calif-dot-cities-at-risk-of-bankruptcy
[95] *Id.*
[96] See, e.g., "Peek into municipal bankruptcy crystal ball," THE ORANGE COUNTY REGISTER, July 27, 2012, http://taxdollars.ocregister.com/2012/07/27/peek-into-municipal-bankruptcy-crystal-ball/158936/. The authors do not endorse this article but offer it as another opinion.

EXHIBIT A

STATE LAW AUTHORIZATION TO FILE CHAPTER 9

CHAPTER 9
STATE STATUTES[1]

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
Alabama	Yes ALA. CODE § 11-81-3	Applies to "the governing body of any county, city or town, or municipal authority organized under Art. 9, Chapter 47 of Title 11."
Alaska	No	Not applicable
Arizona	Yes ARIZ. REV. STAT. ANN. § 35-603	Applies to "taxing districts," which references language from the 1898 Bankruptcy Code.
Arkansas	Yes ARK. CODE ANN. § 14-74-103	Applies to "taxing agencies," which references language from the 1898 Bankruptcy Code, and "instrumentalities," which is included in the list of entities that are eligible for Chapter 9 filings in the most recent amendments to the Bankruptcy Code.
California	Yes CAL. GOV'T CODE § 53760	Applies to a "local public entity" but defines this broadly as any "municipality" as defined in the Bankruptcy Code.
Colorado	Yes COLO. REV. STAT. ANN. §§ 32-1-1403 and 37-32-102	Section 32-1-1403 applies to "any insolvent taxing district," which is defined as a "special district which is organized or acting under the provisions" of the state's Special District Act. Section 37-32-102 applies to any "irrigation or drainage district organized under the laws of the state of Colorado."
Connecticut	Yes CONN. GEN. STAT. ANN. § 7-566	Applies to municipalities and requires "express prior written consent of the Governor."
Delaware	No	Not applicable
District of Columbia	No	Not applicable

[1] Current as of March 15, 2010.

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
Florida	Yes FLA. STAT. ANN. § 218.01	Applies to "municipalities, taxing districts and political subdivisions," referencing the current Bankruptcy Code language.
Georgia	No GA. CODE ANN. § 36-80-5	Expressly prevents any "county, municipality, school district, authority, division, instrumentality, political subdivision, or public body corporate" from filing a bankruptcy petition.
Hawaii	No	Not applicable
Idaho	Yes IDAHO CODE ANN. § 67-3903	Applies to any "taxing district," which is defined in the Idaho Code as "any entity or unit with the statutory authority to levy a property tax." (IDAHO CODE ANN. § 63-201).
Illinois	No	Although not specifically authorized, the state in 50 ILCA § 320/9(b)(4) contemplates that a municipality may file a bankruptcy case by giving the Financial Planning and Supervision Commission the power to recommend that municipalities file a petition under Chapter 9.
Indiana	No	Not applicable
Iowa	Yes IOWA CODE ANN. § 76.16A	Permits "a city, county, or other political subdivision" to become a Chapter 9 debtor only if it is rendered insolvent as a result of debt (a defined term in the state statute) *involuntarily* incurred.
Kansas	No	Not applicable
Kentucky	Yes KY. REV. STAT. ANN. § 66.400	Applies to any "taxing agency or instrumentality," referencing the 1940 Bankruptcy Code and its amendments. A county may not file unless the proposed plan is first approved by the state local debt officer and the state local finance officer.

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
Louisiana	Yes LA. REV. STAT. ANN. §§ 13:4741 and 39:619-620	Section 13:4741 applies to "any parish, municipality, political subdivision, public board or public corporation, taxing district, or other agency of the state." The state bond and tax board must give written approval for the petition and plan. Section 39:619-620 applies to any "political subdivision, public board or corporation, parish, municipality, road or subroad district, school district, sewerage district, drainage or subdrainage district, levee district, waterworks or sub-waterworks district, irrigation district, road lighting district, harbor or terminal district, or other taxing district." The Governor and Attorney General must give written approval for the petition and plan.
Maine	No	Not applicable
Maryland	No	Not applicable
Massachusetts	No	Not applicable
Michigan	Yes MICH. COMP. LAWS ANN. §§ 141.1222 and 141.1241	Section 141.1222 applies to any "local government," which is defined as "a city, a village, a township, a county, an authority established by law, or a public utility owned by a city, village, township, or county." Requires written notice to be given to the local emergency financial assistance loan board and authorization from the emergency financial manager. Section 141.1241 applies to any "school district for which an emergency financial manager has been appointed." Requires written notice to be given to the superintendent of public instruction.
Minnesota	Yes MINN. STAT. ANN. § 471.831	Applies to a municipality, as defined by the Bankruptcy Code as amended in 1996, "but limited to a county, statutory or home rule charter city, or town; or a housing and redevelopment authority, economic development authority, or rural development financing authority . . . ."
Mississippi	No	Not applicable

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
Missouri	Yes MO. ANN. STAT. § 427.100	Applies to any municipality or political subdivision, referencing the current Bankruptcy Code language.
Montana	Yes MONT. CODE ANN. §§ 7-7-132 and 85-7-2041	Section 7-7-132 applies to a "local entity," which is defined as a "district created under Title 7, chapter 12, a city, or a town." Counties are specifically excluded from the definition of "local entity." The local entity's legislative body must pass an ordinance or resolution declaring that it meets all eligibility requirements found in § 109 of the Bankruptcy Code. Section 85-7-2041 applies to any "irrigation district."
Nebraska	Yes NEB. REV. STAT. ANN. § 13-402	Applies to "any county, city, village, school district, agency of the state government, drainage district, sanitary and improvement district, or other political subdivision of the State."
Nevada	No	Not applicable
New Hampshire	No	Not applicable
New Jersey	Yes N.J. STAT. ANN. § 52:27-40	Applies to "any county, municipality, school district or other political subdivision of this State." The political subdivision must get the approval of the municipal finance commission before filing the petition.
New Mexico	No	Not applicable
New York	Yes N.Y. LOCAL FIN. LAW § 85.30	Applies to "a municipality or its emergency financial control board." Municipality is defined as a "county, city, town, or village." (N.Y. LOCAL FIN. LAW § 2.00).
North Carolina	Yes N.C. GEN. STAT. ANN. § 23-48	Applies to "any taxing district, local improvement district, school district, county, city, town, or village." "Taxing district" is not defined in the state statute, but refers to this term as used in the 1939 version of the Bankruptcy Code. The local unit must get the approval of the Local Government Commission of North Carolina.

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
North Dakota	No	Not applicable
Ohio	Yes OHIO REV. CODE ANN. § 133.36	Applies to "the taxing authority of any subdivision provided for" in the Bankruptcy Code. The taxing authority may file a petition after the approval of the tax commissioner.
Oklahoma	Yes OKLA. STAT. ANN. tit. 62, § 283	Applies to "debtor municipal corporation or political subdivision" of the state.
Oregon	Yes OR. REV. STAT. ANN. § 548.705	Applies only to "any irrigation or drainage district of this state."
Pennsylvania	Yes 53 PA. CONS. STAT. ANN. § 11701.261	Applies to a political subdivision, which must submit its petition to the State Department of Internal Affairs for written approval before filing. (53 PA. CONS. STAT. ANN. § 5571).
Rhode Island	No	Not applicable
South Carolina	Yes S.C. CODE ANN. § 6-1-10	Applies to "any county, municipal corporation, township, school district, drainage district or other taxing or governmental unit organized under the laws of the State."
South Dakota	No	Not applicable
Tennessee	No	Not applicable
Texas	Yes TEX. REV. CIV. STAT. ANN. § 140.001	Applies to "a municipality, taxing district, or other political subdivision." This applies to any taxing district or other political subdivision that "has the power to incur indebtedness either through the action of its governing body or through that of the county or municipality in which it is located." This applies to any municipality that "has the power to incur indebtedness through the action of its governing body."
Utah	No	Not applicable
Vermont	No	Not applicable
Virginia	No	Not applicable

State	Statute Specifically Authorizing Chapter 9 Filing	Scope of Statute
Washington	Yes WASH. REV. CODE ANN. § 39.64.040	Applies to "any taxing district," referencing the definition of taxing district from the 1898 Bankruptcy Code.
West Virginia	No	Not applicable
Wisconsin	No	Not applicable
Wyoming	No	Not applicable