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Fallout From the Credit Crunch May Squeeze Municipalities: Is It Time to Dust Off Rarely Used Chapter 9?

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Fallout from the credit crunch and other factors are conspiring to strain the finances of state and local governments and government sponsored entities. As a result, in the coming years we may witness an increase in defaults and filings under a rarely used provision of the Bankruptcy Code – chapter 9. While similar in many respects to chapter 11, chapter 9 only applies to municipalities and has its own special rules. Investors and insolvency professionals would be well-served to brush-up on chapter 9 before municipal finances crumble further.

Financial Problems Faced By Municipalities

For years, municipalities have had to deal with increases in federal mandates and the skyrocketing costs of providing pension and health care to workers, retirees and their families. Nevertheless, rising tax revenues during times of economic growth have offset these burdens. Now, as a result of turmoil in the credit markets, municipalities will face further burdens, and some municipalities may need to consider formal financial restructuring. For instance, many municipal agencies are facing losses on structured finance products and investments in SIVs. Rising foreclosure rates and decreasing home values will reduce the amount of real estate and transfer taxes collected. If consumers reduce spending as a result of an economic slowdown, then less will be collected in the form of sales taxes. Income tax receipts may drop as obligations to pay unemployment benefits rise. Problems faced by bond insurers may lead to downgrades in municipal debt, thereby requiring municipalities to offer higher interest rates on bonds. This situation may be exacerbated by demographic factors and cutbacks in federal spending. And of course, municipalities have to rebuild crumbling infrastructure, carry out unfunded mandates from Washington and meet their own rising operating budgets.

Types of Municipal Bonds

Municipal bonds fall into two major categories: general obligation (GO) bonds and revenue bonds. GO bonds are backed by the full faith and credit of the issuing entity such as a state, city, county or municipality, i.e., these bonds are backed by the taxing authority of the issuers. Revenue bonds are backed by the revenues from the project for which the debt was issued such as airports, public power facilities, toll roads, and water and sewer systems.

Default Risk

While current economic conditions may increase the likelihood of municipal defaults, rated municipal issuers have historically experienced very low default rates and consequently very few bankruptcies. This has been the case both on an absolute level and by comparison to similarly rated corporate debt. However, unrated municipal debt is much more prone to default. This is partially due to self-selection, in that issuers that are aware of their weaknesses do not apply for ratings. In addition, unrated issues tend to be smaller in face amount as the bonds are being raised for the purposes of funding smaller entities or projects.

Fitch Ratings[1] performed two comprehensive studies of municipal debt defaults in 1999 and 2003 and revisited its findings in 2007. The studies consisted of all municipal defaults including unrated issues. Based on these analyses, Fitch concluded that municipal default risk can be divided into three classifications:

1. **GO Bonds and Essential Purpose Revenue Bonds.** Tax-backed and appropriation-backed state and local government obligations have the lowest likelihood of default. Similarly, revenue bonds issued by long-standing essential purposes enterprises that are either monopolies or have strong barriers to competition have a low risk of default. Such issuers include public power, public higher education, single family housing and water and sewer systems. Fitch's default studies showed that from 1987 through 2002, the 5-to-15 year cumulative default rates for these sectors averaged 0.24%. This was less than the 0.43% 10-year cumulative default rate for AAA rated global corporate bonds.
2. **Entities Subject to Competition or Fluctuations in Demand.** The second least likely group to default is comprised of public entities that serve essential purposes, but are subject to competition or fluctuations in demand. This group includes airports, seaports, established toll roads, hospitals, private higher education institutions and military and state multi-family housing. Defaults in this group were greater than the first group but still relatively low. The 5-to-15 year cumulative default rates for this group was approximately 0.70% compared with the 10-year cumulative default rate of 0.76% for AA rated corporate bonds.
3. **Entities Competing with the Private Sector or with Volatile Revenue Streams.** This group includes industrial development bonds, local multi-family housing, nursing homes, continuing care retirement communities and transportation facilities without established traffic patterns (e.g., start-ups). This group's default history is similar to corporations. The 5-to-15 year cumulative default rates for this group averaged 3.65% compared with the 10-year cumulative default rate of 3.97% for BBB+ rated corporate bonds.

Until recently, the availability of bond insurance gave issuers the ability to sell AAA rated bonds based on the AAA credit ratings of the insurance companies. The insurance gives purchasers extra security that the bonds will be repaid. It also gives the issuers the opportunity to borrow at lower interest rates than would be possible without the insurance. In the unusual event of a default, the insurance company steps in to cover any payments that the issuer fails to make. Unfortunately, even this once stalwart source of security for bondholders has been disturbed as the bond insurers have themselves been downgraded as a result of the fallout from the subprime mortgage markets. In the absence of dependable insurance, certain issuers will be faced with higher borrowing costs and bondholders will have to live with less certainty of repayment.

Recovery Rates

In its 2003 study, Fitch Ratings computed a dollar weighted average default recovery rate of 66.92% for municipal bonds versus an average long-term recovery rate of approximately 40% for public corporate bonds. The GO bond recovery rate was 100%, with other categories ranging from 15.85% to 91.01%. Typically, defaults on GO bonds and revenue bonds for essential purposes, such as water and sewer systems and toll roads, are cured by the resumption of payment of full debt service. In instances of defaults by issuers that have ceased operations because of competition or insufficient cash flow, bondholders may achieve significant recoveries from assets pledged as collateral.

Potential Advantages to Filing Chapter 9 Petition for Bankruptcy for Municipalities

1. Relief from debt service and opportunity to modify obligations.
2. Ability to bind non-consenting creditors due to the Bankruptcy Code's voting provisions (majority of creditors by class holding two-thirds of the debt in that class).
3. Ability to borrow post-petition for operating needs, as this debt will have priority over pre-petition debt.
4. Stay of creditors' legal actions to force payment.
5. Protection against forced tax increases that could be destructive to the municipality.

Potential Disadvantages to Filing Chapter 9 Petition for Bankruptcy for Municipalities

1. Negative impact on credit rating.
2. Restricted or lack of access to capital markets.
3. Inability to achieve expedient approvals for the filing from oversight authorities such as a state bond commission, governor or attorney general.
4. Costs of the proceeding, particularly in comparison to an out-of-court resolution.

Who Qualifies to File Chapter 9

Chapter 9 applies only to municipalities, which means any political subdivision, public agency or instrumentality of a state.[2] Thus, the term "municipality" includes cities, counties, townships, school districts, community hospitals, economic development authorities and other state and local governmental authorities. Municipalities must also satisfy four other filing requirements: (1) the municipality must be specifically authorized to be a debtor by state law or by a governmental officer or organization empowered by state law to authorize the municipality to be a debtor; (2) the municipality must be insolvent;[3] (3) the municipality must desire to effect a plan to adjust its debts; and (4) the municipality must meet one of four creditor consent provisions.[4] Creditors have the right to object to the chapter 9 petition, which the court may dismiss if the municipality did not file in good faith or if the municipality does not meet the eligibility requirements.[5] If the petition is not dismissed, the court shall order relief under chapter 9.[6]

How Chapter 9 Works

If fallout from the credit crunch and other factors strain the finances of municipalities, then chapter 9 may provide a remedy. Similar to chapter 11, chapter 9 provides the necessary breathing space and a framework for restructuring indebtedness. However, in light of the Tenth Amendment to the Constitution and the reservation to the states of sovereign immunity over their internal affairs, to ensure the constitutionality of chapter 9, the role of the Bankruptcy Court is far more circumscribed than under chapter 11. For instance, unless the debtor consents or the plan so provides, the Bankruptcy Court may not 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.[7] With two minor exceptions, chapter 9 does not limit or impair the power of a state to control a municipality in the exercise of the political or governmental powers of the municipality, including expenditures for such exercise.[8] The Court cannot appoint a trustee, except for the limited purpose of pursuing avoidance actions if the debtor refuses to do so.[9] Likewise, chapter 9 petitions may be dismissed, but not converted to a liquidation proceeding as with failed chapter 11 cases.[10]

In chapter 9, a creditors' committee is appointed to perform the functions that chapter 11 committees ordinarily perform.[11] However, under chapter 9, only the debtor may file a plan.[12] Importantly, municipalities may reject collective bargaining agreements and retiree benefit plans under section 365 of the Bankruptcy Code, which imposes a business judgment test, thereby avoiding the more stringent requirements applicable in chapter 11 cases.[13] Municipalities may borrow money during a chapter 9 case as an administrative expense without court authorization, but will need court authorization to grant super-priority claims or liens.[14]

Compared to chapter 11, bondholders receive enhanced treatment, although special revenue bonds fare much better than general obligation bonds. Holders of general obligation bonds will be treated as general unsecured creditors in a chapter 9 case. Nevertheless, unlike in chapter 11, all bondholders are insulated from preference litigation.[15] The automatic stay imposed under Section 362 of the Bankruptcy Code generally applies to prohibit creditor enforcement actions in chapter 9 cases.[16] Under chapter 9, however, there is no stay of the application of pledged special revenues to payment of indebtedness secured by such revenues.[17] In addition, while section 552(a) of the Bankruptcy Code ordinarily cuts off a security interest in after-acquired property as of the filing date, under chapter 9 post-petition special revenues remain subject to any pre-petition liens (although the security interest will be subject to the operating expenses of the project or system).[18] As a result, holders of special revenue bonds can continue to have their debt serviced post-petition.

The requirements for confirmation of a chapter 9 plan are similar to and incorporate many of the plan confirmation criteria in chapter 11.[19] An important exception is the "best interests of creditors" test found in section 1129(a)(7), which requires that creditors in chapter 11 receive at least as much under the plan as they would if the debtor were liquidated under chapter 7. Because liquidation of the debtor is not possible in chapter 9, section 943 contains its own formulation of the "best interests of creditors" test, which has generally been interpreted to mean that the plan must be better than other alternatives available to creditors such as dismissal of the case.[20]

Investment Considerations

Municipal bonds may prove to be an interesting play in the distressed credit markets. The volume of corporate defaults is widely predicted to increase this year. As a result, there should be plenty of opportunities for distressed debt investors to invest in familiar territory. However, those investors that want to play in a different sandbox should keep an eye on the municipal market.

Municipal bonds have not typically been an active area for distressed investing. This would give opportunistic investors a chance to accumulate positions at favorable prices. It would also give the investors a head start in taking an active role in negotiating a restructuring. As noted above, recovery rates for municipal bond issue defaults are markedly greater than corporate bonds. Hence, if purchased at significant discounts from par, defaulted municipal bonds have the potential for superior returns.

Conclusion

If fallout from the credit crunch and other factors further strain the finances of state and local governments and government sponsored entities, we may see an increase in the restructuring of municipal debts whether in or out of chapter 9. The ability of municipalities to reject collective bargaining agreements and retiree benefit plans under section 365 of the Bankruptcy Code is an important power that chapter 11 debtors do not enjoy. Chapter 9 contains important safeguards for bondholders, especially holders of special revenue bonds. Moreover, the fewer opportunities for court intervention inherent in chapter 9 will militate in favor of a consensual process. Creditors will need to be aware of the special rules applicable under chapter 9 so as to maximize their recoveries.

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[1] David T. Litvack, Thomas J. Abruzzo and Mia Koo, Special Report: Default Risk and Recovery Rates on U.S. Municipal Bonds, Fitch Ratings, January 9, 2007.
[2] 11 U.S.C. § 101(40).
[3] While insolvency of corporations, partnerships and other entities is determined on a balance sheet basis, a municipality is insolvent if it is generally not paying its debts as they become due. 11 U.S.C. § 101(32)(C).
[4] 11 U.S.C. § 109(c). The four creditor consent provisions are that the municipality: (1) obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a chapter 9 plan; (2) negotiate in good faith with creditors and fail to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan; (3) be unable to negotiate with creditors because such negotiation is impracticable; or (4) reasonably believe that a creditor may attempt to obtain a preference.
[5] 11 U.S.C. § 921(c).
[6] 11 U.S.C. § 921(d).
[7] 11 U.S.C. § 904.
[8] 11 U.S.C. § 903. The two exceptions are (1) a state law prescribing a method of composition of municipal debt does not bind any non-consenting creditor, and (2) a judgment entered under such state law may not bind a creditor that does not consent to such composition.
[9] 11 U.S.C. § 926(a).
[10] *Compare* 11 U.S.C. § 930 with 11 U.S.C. § 1112(b).
[11] 11 U.S.C. §§ 901(a), 1103.
[12] 11 U.S.C. § 941.
[13] While some provisions of chapter 11 apply in chapter 9 cases, sections 1113 and 1114, governing rejection of collective bargaining agreements and modification of retiree benefits, respectively, do not apply in chapter 9 cases. 11 U.S.C. §§ 901(a).
[14] 11 U.S.C. §§ 364, 901(a).
[15] 11 U.S.C. § 926(b).
[16] 11 U.S.C. § 922.
[17] 11 U.S.C. § 922(d). Such claim will, however, be treated as non-recourse. 11 U.S.C. § 927. "Special revenues" are defined in section 902(2).
[18] 11 U.S.C. § 928.
[19] 11 U.S.C. § 943(b), 901(a).
[20] 11 U.S.C. § 943(b)(7).