despite the best of efforts, there will occasionally be deficiencies to the senior lienholder. At a minimum, the mortgagee should be required to do what prudent business people would do in disposing of their own property to enhance the results with reasonable effort and expense. That should be the apparatus criticus to state foreclosure laws. Unfortunately, state laws on foreclosure are not concerned with the collective creditor community or the debtor as the important considerations. The need is apparent and has inevitably produced the Durrett inspired solution.

Foreclosing parties should not limit themselves to minimum state statutory requirements but rather should conduct sales in a commercially reasonable manner in recognition of their fiduciary responsibilities. What is commercially reasonable may vary depending on the case but basically should include:

1. Written notice to parties in interest, known potential bidders including other creditors, attendees at adjourned sales, and anyone known to have expressed interest, of the time and place of sale with a description of the property and major attractions or detractions;

2. Obtaining a current appraisal at fair market value;

3. Newspaper notice of the sale and all continuances, including advertisements in the real estate sections of newspapers likely to reach the maximum number of potential purchasers;

4. Contact with local brokers with whom appropriate conditional commission arrangements might be negotiated.

If bankruptcy is to be true to its mission of providing a maximum recovery for creditors collectively without unduly disregarding state substantive law, it has to fill the gap left in state procedures. The uniqueness of bankruptcy is its ability to blend the goals of all interested parties by adding additional safeguards to minimal state law requirements. The bankruptcy approach to foreclosure maintains the priorities of secured creditors but adds an additional measure of protection for the collective interests of all by placing emphasis on the need for the process' insistence on meaningful notice. Bankruptcy's need to act and act now is best summed up by a paraphrase:

> If bankruptcy is not concerned with maximizing the return to each and every creditor, who will be?
>
> If it defers to state practices regardless of fairness, what is it?
>
> If it cannot act now, when?[9]

Durrett was decided eight years ago amid forecasts of dire consequences in the credit community. It was alleged that money would dry up and loans would become expensive, if it was possible to obtain a loan at all. Currently, instead of lending reluctance, there is avid competition among lenders to make new loans. Yet the myth persists that lending cannot exist without

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[9] Ethics of our Fathers, Chapter 1, Mishnah 14

Hillel said:

> If I am not for myself, who is for me
> If I am only for myself, what am I
> If not now, when

certainty in foreclosure sales. The Cardozo Law Review devotes the entire December 1987 issue to what is viewed as the Durrett problem, and it is only the latest in the parade of the doom and gloom tub thumping.

The tub thumpers try to obscure the fact that Ruebeck and the other similar decisions are simply demanding fair and reasonable notice of the foreclosure sale. This line of cases requires foreclosing parties to make good faith efforts to obtain the best prices by treating the sales as if they were selling their own property.

The need for fair notice has yet to be fully understood. For example, Arizona Senator Dennis DeConcini has submitted a bill to eliminate foreclosure from the ambit of fraudulent conveyances, but that is too simple an answer. The proposed legislation brings to mind the story set early in World War I of a great Russian general who, upon leaving Czar Nicholas' palace, was blown up with his carriage and horses, all in front of a large crowd. Soldiers watching in horror lamented the loss of their general; a carriage maker, the destruction of such a fabulous coach; animal lovers, the slaughter of such magnificent horses; however, a newspaper correspondent cabled his paper the real message: "The old order is passing, a new era is dawning."

The DeConcini solution is like the tunnel vision of the soldier, carriage maker, or animal lover. A broader view would recognize both the desire for finality of a foreclosure and the need for full and fair noticing. Legislation which, in or out of bankruptcy, protects the mortgagee, the debtor's other creditors and the debtor is needed to assure that the sale is conducted in a truly commercially reasonable way.

Suggestions for new standards to accomplish this goal are discussed in Nelson, Deficiency Judgments after Real Estate Foreclosures in Missouri: Some Modest Proposals, 47 Mo. L. Rev. 151 (1982). Confusing new standards are not needed. The successfully tested formula of the U.C.C. "commercially reasonable" standard, the parameters of which are already court defined,[10] should be adopted. Objective guidelines are set out in Ruebeck which are aimed at doing those things a prudent man would do in managing his own affairs. Absolute certainty may be illusive but parties secured under Article 9 of the U.C.C. have fared well without this absolute freedom from challenge. All professionals bear the risk of failing to exercise the proper standard when judgment calls must be made.

Both federal and state legislators must take the bull by the horns and bring the protection of foreclosure sales down to earth. Bankruptcy law could be amended to limit the use of the fraudulent conveyance provision to cases where it is found that a foreclosure sale was not conducted in a commercially reasonable manner. The remedy should be time limited with a reduced reach back in time to pre-filing foreclosure sales. This is a compromise that would address both creditors' and debtors' interests. Debtors benefit by being able to challenge the results of foreclosure sales, and the credit community benefits because the time in which foreclosure sales are subject to challenge would be strictly limited.

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10 See, e.g., In re General Industries, supra.

The bankruptcy fraudulent conveyance statute, 11 U.S.C. § 548, presently can reach back to transactions one year before the filing[11] to void a foreclosure sale, and that should be the outer limit. The bankruptcy preference section, 11 U.S.C. § 547, undoes preferential payments by a debtor to a creditor that were not in the ordinary course of business and made within 90 days of the filing of the bankruptcy. Since a questioned foreclosure sale might be considered a combination of a preferential transfer and a fraudulent conveyance, a reasonable time limitation on a challenge to a foreclosure should be more than the 90-day preference period and less than the year for a fraudulent conveyance. It is recommended the legislation reach back a maximum of 180 days pre-filing for foreclosures.

Likewise, the Massachusetts legislature might simply add a requirement that foreclosure sales should be conducted in a commercially reasonable manner.

Federal and state law should recognize that even the best advertised auction can still produce an inadequate price, and this statutory change does not seek to make the mortgagee the insurer of the auction price, as that would be an inequitable and onerous burden.

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11 While 11 U.S.C. § 544 allows use of the state fraudulent conveyance statute, Mass. Gen. Laws ch. 109A, with its longer statute of limitations, the differences in wording and definitions, for example, reasonably equivalent value and fair consideration, would seem to make the state statute inapplicable for this purpose.

APPENDIX: PROPOSED STATUTE

A suggestion for a change Congress could make to 11 U.C.C. § 548 and that Massachusetts could make to Mass. Gen. Laws ch. 244, § 14 would be the following:

FEDERAL LAW

The current 11 U.S.C. § 548(c) would be 11 U.S.C. § 548(c)(1).

Proposed 11 U.S.C. § 548(c)(2):

> The trustee may avoid any transfer of an interest of the debtor in property through a foreclosure sale, that was made on or within 180 days before the date of the filing of the petition, if the secured party, after default, disposed of the collateral in a commercially unreasonable manner, method, time or place. Mere inadequacy of price, without a showing that the method, manner, time or place of the sale was commercially unreasonable, does not of itself evidence a commercially unreasonable sale.

STATE LAW

Add to the end of Mass. Gen. Laws ch. 244, Sec. 14:

> Nothing in this section shall excuse the foreclosing party from selling or disposing of the property in a commercially reasonable manner. Mere inadequacy of price, without a showing that the method, manner, time or place of the sale was commercially unreasonable, does not of itself evidence a commercially unreasonable sale. Any action to challenge a foreclosure sale as not having been conducted in a commercially reasonable manner must be brought within six (6) months of the challenged sale.

NATIONAL COMMERCIAL FINANCE ASSOCIATION

ncfa

225 WEST 34TH STREET, NEW YORK, N.Y. 10001 (212) 594-3490

June 7, 1988

The Honorable Howell Heflin
Chairman
Subcommittee on Courts and
Administrative Practice
Room 223
Hart Senate Building
Washington, D.C. 20510

Re: S. 1358

Dear Senator Heflin:

We are General Counsel for the National Commercial Finance Association ("NCFA"), the trade association which represents banks, commercial finance companies and factors engaged in providing commercial asset-based financial services. It has more than 230 members, including small enterprises, large publicly-held companies, banks, and subsidiaries of bank holding companies. NCFA supports the enactment of S. 1358 to clarify the fraudulent conveyance provisions of the Bankruptcy Code in light of the decision of Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), and similar cases. Senator DeConcini introduced S. 1358 on June 11, 1987, and hearings on S. 1358 are scheduled for June 10, 1988.

1. The Interest of NCFA in Bankruptcy Legislation

The heart of the commercial finance business is the reliance placed upon collateral for repayment of loans and other financial accommodations. The realization of value from collateral requires that the security interest or lien be enforced or foreclosed in accordance with applicable laws, such as the Uniform Commercial Code and real estate foreclosure statutes. The Durrett line of cases holds that these

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foreclosures sales of collateral, whether judicial or non-judicial, can be set aside years later as fraudulent conveyances under the Bankruptcy Code if, in hindsight, and notwithstanding compliance with all applicable foreclosure laws and procedures, the value received at the sale fails to meet the reasonable equivalent value test in the Bankruptcy Code.

NCFA members extend secured credit to businesses on a national, regional and local scale. Most of these businesses are small and medium-sized enterprises that depend upon the availability of secured financing for their existence and growth. In response to the rapidly expanding needs of such borrowers, asset-based commercial financing has grown dramatically since the 1950's and has become a significant part of the national credit market. Total outstanding secured financing extended by NCFA members exceeds $68 billion.

Asset-based lending differs from other types of lending and financial services primarily because credit is extended in direct proportion to the value of the collateral. A business required to borrow on a secured basis is usually a greater credit risk than a borrower with available unsecured lines. Asset-based lenders obtain collateral to protect against that increased risk of default. Their loan agreements are prepared to facilitate prompt realization of collateral value by sale under state real estate foreclosure statutes, Article 9 of the Uniform Commercial Code and other applicable state and federal laws in the event of financial difficulties of borrowers.

2. The Bankruptcy Code Should be Amended to Restore Certainty and Confidence to Foreclosure Sales

S. 1358 was introduced for the purpose of clarifying the preference and fraudulent conveyance provisions, Sections 547 and 548 of the Bankruptcy Code, with regard to the decision of Durrett and a few other cases which have followed its doctrine. In Durrett, which was decided under Section 67d(1) of the Bankruptcy Act, the predecessor of the current Bankruptcy Code, the court avoided a noncollusive, regularly conducted foreclosure sale to a third party because the foreclosure sale price was determined to be only 58% of the fair market value of the property. As noted by Senator DeConcini when he introduced S. 1358, Durrett represented a dramatic change from prior fraudulent conveyance law in holding that a noncollusive, regularly conducted foreclosure sale could be challenged as a fraudulent conveyance.

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Durrett and the few cases that have followed it have introduced a high level of uncertainty as to foreclosure sales. Lenders who have in good faith complied with foreclosure procedures promulgated by state legislatures have no assurance that these foreclosure sales will not be overturned years later as fraudulent conveyances. Lenders with liens and security interests have been given no standards or procedures that they can seek to comply with in good faith to protect their interests, other than applicable state or federal laws relating to enforcement of security interests or liens. The dictum of Durrett, that a lender is protected so long as the foreclosure sale has resulted in at least 70% of the fair market value of the property, is hopelessly vague and subject to second-guessing by a later trustee in bankruptcy, since market values, particularly in real estate, are often not certain and may vary significantly during any relevant period.

The uncertainty created by Durrett will have the effect of continuing to suppress the amount of credit available to borrowers, or to raise the cost of such borrowing, or both, since there is uncertainty as to whether value realized from collateral can be retained. Third party purchasers at foreclosure sales can be expected to offer less for collateral since they are uncertain whether the purchase will be voided and because title post-foreclosure is clouded by this additional risk even if the foreclosure sale were concluded in compliance with state law in all respects.

There is no meaningful justification for the uncertainty and related impairment of asset-based lending caused by Durrett. Unlike fungible goods, such as wheat, oats, stocks and bonds, for which well-defined markets exist which continually provide market prices, most collateral, particularly real estate and used equipment, have vague and speculative "market" prices. For these types of collateral, the best evidence that the property has sold at "market" is the process used to sell that property.

The legislatures concerned with these matters have developed specified foreclosure procedures which have balanced the interests of secured parties and debtors, including those claiming through debtors, to generate a fair and reasonable result under the circumstances of an involuntary forced sale, and should be viewed as being in harmony with federal fraudulent conveyance laws in the Bankruptcy Code.

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3. S. 1358 will Restore Certainty to Foreclosure Sales by Defining Acceptable Foreclosure Procedures

S. 1358 restores certainty to the foreclosure and other enforcement processes and the resulting conveyance of real and personal property. NCFA therefore supports S. 1358 in its present form, with some suggested minor technical changes. By deeming a regularly conducted, noncollusive foreclosure sale to be for reasonably equivalent value, as that term in used in Section 548 of the Bankruptcy Code, the bill protects fairly conducted foreclosure sales from avoidance under Section 548 by a trustee or debtor-in-possession. Secured parties, mortgagees, and prospective purchasers will know that compliance with state foreclosure law will ensure that a foreclosure sale will be safe from attack in a later bankruptcy as a fraudulent conveyance.

States also have fraudulent conveyance laws and a trustee in bankruptcy has power under Section 544(b) to avoid fraudulent conveyances which are avoidable under applicable state law by a creditor holding an unsecured claim.

In order to bring the various state fraudulent conveyance laws into a current posture and provide uniformity for contemporary financial transactions, the National Conference of Commissioners on Uniform State Laws promulgated the Uniform Fraudulent Transfer Act ("UFTA") in 1984. Noncollusive foreclosure sales are considered in subsection 3(b), of the UFTA:

> A person gives a reasonably equivalent value if the person acquires an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale or execution of a power of sale for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, or security agreement.

This provision has been adopted in sixteen states as part of their enactment of the UFTA, including nine states in 1987, and in due course, should become the law in all or most states. Since state law is incorporated by Section 544(b) of the Bankruptcy Code, that section will accordingly protect regularly, conducted noncollusive foreclosure sales. Over time, were it not for the presence of Section 548 of the Bankruptcy Code, which represents the "federal" version of the fraudulent conveyance law, a trustee in bankruptcy would not be able to avoid appropriately conducted foreclosure sales.

The National Conference of Commissioners on Uniform State Laws - the promulgators of the UFTA - and the states that have enacted the UFTA have spoken clearly in reference to Durrett on the treatment to be accorded complying foreclosure sales under state fraudulent conveyance laws and, therefore, under Section 544(b) as it incorporates state law. Congress has been silent on the issue of how Section 548 should be applied to foreclosure sales, preferring instead, to let courts struggle to "find" Congress' intent. S. 1358 if enacted, would end that silence by affirmatively stating that a noncollusive, regularly conducted foreclosure sale be deemed to be for reasonably equivalent value and therefore free from attack under Section 548.

S. 1358 follows the approach taken in the UFTA and, in so doing, is well within the traditions of federal bankruptcy law. Prior to the enactment of the current Bankruptcy Code in 1978, the federal bankruptcy law had last been substantially rewritten in the Chandler Act, enacted in 1938, which amended the Bankruptcy Act of 1898. Twenty years before the Chandler Act, the National Conference of Commissioners on Uniform State Laws created the Uniform Fraudulent Conveyance Act ("UFCA") which was enacted in numerous states, and became in large measure the new fraudulent conveyance law of the Bankruptcy Act through the Chandler Act amendment. The House of Representatives report in connection with the Chandler Act revisions, stated its reasons for the inclusion of the UFCA as part of Section 67d, the proposed fraudulent conveyance provision:

> [t]he provision is expanded by incorporating into new subdivision d the salient provisions of the Uniform Fraudulent Conveyance Act. This would seem highly advisable because the Uniform Act is largely declaratory of the better decisions of American State courts construing the Statute of Elizabeth. It has been adopted in a large number of States, and will in time no doubt be adopted by most of the States. Since such uniformity is equally desirable under the Bankruptcy Act in respect to this particular subject, it is deemed advisable to set up here the essential provisions of this uniform State law dealing with such subject.

H.R. Rep. No. 1409, 75th Cong., 1st Sess. 32 (1937).

Thus, Congress, in the interests of uniformity in the law of fraudulent conveyances and of improving the law by adopting carefully considered and widely accepted standards, incorporated the UFCA into the Chandler Act amendments.

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As of 1978, the UFCA remained the dominant state version of the fraudulent conveyance law and its counterpart in the Bankruptcy Act, Section 67d, was carried over as Sections 544 and 548 of the currently enacted Bankruptcy Code. The promulgation of the UFTA in 1984 caused the federal bankruptcy law of fraudulent conveyances to lag behind the newly revised laws to be enacted by the states as had been the situation when the UFCA was promulgated before the Chandler Act.

There is no federal law which provides a procedure for enforcement and other foreclosure sales that, as a matter of law, is known to satisfy the fraudulent conveyance standards of Section 548 of the Code. Congress can and should eliminate the current untenable situation of unknown standards and eliminate the uncertainty created by Durrett by enacting a bill that contains the provisions of S. 1358 deeming a noncollusive properly conducted foreclosure or other enforcement sale to be for reasonably equivalent value. This would not only restore certainty as to title and retention rights to property in the foreclosure market, but also follows the tradition of bringing federal law in conformity with the current uniform law of fraudulent transfers, the UFTA.

S. 1358 protects foreclosure sales generally while leaving to state legislatures the job of choosing appropriate foreclosure procedures. State legislatures strive to protect the interests of the citizens of their states, including borrowers and their creditors, and thus can be expected to be responsive to their needs in formulating their foreclosure laws as well as those of secured creditors. States do not systematically discriminate against outsiders through their foreclosure laws which reflect the balance of interests of borrowers and creditors. That balance is peculiarly within the province of state legislatures. Nothing in the language of Section 548 or its legislative history indicates that Congress has sought to override that balance and S. 1358 confirms that point.

Secured parties and mortgagees make every effort to comply in good faith with state and federal foreclosure laws because the collection of the indebtedness owing to them depends on this compliance. Secured lenders have always relied on their compliance with these laws to protect foreclosure sales from attack by a subsequent trustee in bankruptcy. Secured creditors should be able to rely on a specific procedure when foreclosing on property. Durrett eliminated much of the force of that reliance and secured creditors now are not sure as to which steps they need to take to protect their foreclosure sales from subsequent avoidance by a bankruptcy trustee. Uncertainty serves no significant interest and the relevant legislative bodies should act to eliminate it. State legislatures are doing so through the enactment of the Uniform Fraudulent Transfer Act. Congress can do so by passing S. 1358. NCFA urges Congress to pass S. 1358.

Sincerely,

A. Bruce Schimberg
Sidley & Austin
One First National Plaza
Chicago, Ilinois 60603
Telephone 312: 853-7525

ABS:jlk

SIDLEY & AUSTIN

A PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

ONE FIRST NATIONAL PLAZA
CHICAGO, ILLINOIS 60603
TELEPHONE 312: 853-7000
TELEX 25-4364

2049 CENTURY PARK EAST
LOS ANGELES, CALIFORNIA 90067
213 553-8100 TELEX 18-1391

520 MADISON AVENUE
NEW YORK, NEW YORK 10022
212: 418-2100 TELEX 97-1696

1722 EYE STREET, N.W.
WASHINGTON, D.C. 20006
202. 429-4000 TELEX 89-463

18 KING WILLIAM STREET
LONDON, EC4N 7SA, ENGLAND
441 621-1616 TELEX 924125

5 SHENTON WAY
SINGAPORE 0106
65 224-5000 TELEX 20754

June 7, 1988

The Honorable Howell Heflin
Chairman
Subcommittee on Courts and
Administrative Practice
Room 223
Hart Senate Building
Washington, D.C. 20510

Re: S. 1358

Dear Senator Heflin:

We are General Counsel to the National Commercial Finance Association ("NCFA"), a trade association comprised of banks, commercial finance companies and factors engaged in providing commercial asset-based financial services. In connection with that role, we have prepared the enclosed letter to you setting forth NCFA's reasons for supporting the enactment of S. 1358, a bill that is currently under consideration before the Subcommittee and that will clarify the fraudulent conveyance provisions of the Bankruptcy Code. Hearings for S. 1358 are scheduled for June 10, 1988.

Apart from the discussion of the merits of S. 1358 set forth in the enclosed letter, NCFA would suggest two slight technical amendments to Section 2 of S. 1358. That section would read, after inclusion of the technical amendments, as follows:

> "(h) For purposes of this section, the acquisition of an interest of the debtor in an asset pursuant to a regularly conducted, noncollusive foreclosure sale, exercise of a power of sale, or other procedure permitted by law for the acquisition or disposition of the interest of the debtor upon default under a mortgage, deed of trust, land sale contract, or security agreement, is deemed to be taken for new value and not in consideration of an antecedent debt."

We assume that the omissions of the two underscored terms were inadvertent rather than substantive.

NCFA wishes to continue to be of assistance to you and the Subcommittee in connection with the passage of S. 1358, including the testimony of an NCFA officer, or if necessary, the submission of additional recommendations to resolve controversies which may arise.

Sincerely,

A. Bruce Schimberg
Sidley & Austin
One First National Plaza
Chicago, Illinois 60603
Telephone: 312: 853-7525

ABS/jh

AMERICAN BAR ASSOCIATION
GOVERNMENTAL AFFAIRS OFFICE • 1800 M STREET, N.W. • WASHINGTON, D.C. 20036 • (202) 331-2200

Statement of

ANTHONY B. KURLIN, CHAIRMAN
SECTION OF REAL PROPERTY, PROBATE AND TRUST LAW

on behalf of the

AMERICAN BAR ASSOCIATION

submitted to the

SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

concerning

S. 1358, LEGISLATION TO OVERRULE
DURRETT V. WASHINGTON NATIONAL INSURANCE COMPANY

June 10, 1988

My name is Anthony B. Kuklin and I am Chairman of the Section of Real Property, Probate and Trust Law of the American Bar Association. I submit this statement on behalf of the American Bar Association in favor of the enactment of S.1358, which would overrule the holding in Durrett v. Washington National Insurance Company, 621 F.2d 201 (5th Cir., 1980) by making it clear that a non-collusive, regularly conducted foreclosure sale will not be subject to attack as a fraudulent transfer under the constructive fraud provisions of Section 548 of the Bankruptcy Code.

Durrett has the effect of: (1) creating unjust and unreasonable risks on non-collusive real estate mortgage transactions; (2) discouraging competitive bidding at foreclosure sales to the detriment of both borrower and lender; (3) making borrowing more expensive as increased lending costs become a part of interest rates; (4) making mortgage loans harder to obtain by those most in need of mortgage financing; (5) unreasonably disrupting land records; (6) placing legitimate leasehold transactions in jeopardy; and (7) restricting small business financing under Article 9 of the Uniform Commercial Code.

Attached is a copy of the resolution of the American Bar Association's House of Delegates of August 3, 1983, which urged Federal legislation to overrule Durrett. Also appended is the background report that the ABA's House of Delegates considered when adopting the resolution. The background report discusses some of the reasons corrective legislation is necessary to overcome Durrett.* We are pleased that the ABA's efforts have culminated in the introduction of S.1358 by Senator Dennis DeConcini, and we strongly urge its enactment by Congress.

*Background reports are not considered ABA policy. ABA policy is contained in the resolution adopted by the House of Delegates.

RESOLUTION OF THE HOUSE OF DELEGATES OF THE AMERICAN BAR ASSOCIATION

ADOPTED AUGUST, 1983

BE IT RESOLVED, That the American Bar Association support legislation to amend the fraudulent conveyance provisions of state law and the federal Bankruptcy Code to make it clear that property purchased at a properly conducted non-collusive foreclosure sale is to be considered transferred for reasonably equivalent value.

REPORT

1. The Section of Real Property, Probate and Trust Law supports legislation which would make it clear that a properly conducted non-collusive foreclosure sale would not produce a fraudulent conveyance under the terms of the Bankruptcy Code or state law.

   Such legislation would overrule the decision of the court in *Durrett v. Washington Nat. Ins. Co.*, 621 F.2d 201 (5th Cir., 1980) and several other subsequent cases supporting that decision, and codify the contrary decision in *Lawyers Title Ins. Corp. v. Madrid*, 21 B.R. 424 (B.A.P. 9th Cir. 1982), *reversing*, *In re Madrid*, 10 B.R. 795 (D. Nev. 1981).

   The *Durrett* case held that a nonjudicial foreclosure sale was a transfer within the meaning of the former Bankruptcy Act and subject to being set aside as being fraudulent if made without fair consideration within one year prior to the filing of the bankruptcy petition. This decision would seem equally applicable to cases under the Bankruptcy Code. In Durrett it was agreed that the purchaser at the foreclosure sale was an innocent third party who saw the advertised sale in the paper, attended the sale and bid the amount of the mortgage indebtedness. In the absence of actual fraud, the court invoked the constructive fraud provision of section 548(a)(2) of the Bankruptcy Code. Durrett was followed in several cases including Abramson v. Lakewood Bank and Trust Co., 647 F. 2d 547 (5th Cir. 1981) cert. denied 454 U.S. 1164 (1982), and rejected in Lawyers Title Ins. Corp. v. Madrid, supra, and In re Alsop, 14 B.R. 982 (D. Alaska 1981), aff'd, 22 B.R. 1017 (D. Alaska 1982) (holding in Alsop limited to mortgages recorded more than one year before bankruptcy).

If the court finds a foreclosure sale to be a fraudulent transfer, the court is permitted under section 548 to set aside the sale, or under section 550 to require a transferee it deems not in "good faith" to pay to the debtor the difference between the amount of the mortgage and what the court determined the value of the property to be.

Similar provisions are found in many state fraudulent conveyance acts and the Uniform Fraudulent Conveyance Act (adopted by 24 states and the Virgin Islands). The major difference between the fraudulent conveyance acts and the Bankruptcy Code is that there is no limitation in the state statutes and the Uniform Fraudulent Conveyance Act to a one-year period prior to bankruptcy, and thus any creditor may bring an action to set aside a conveyance as fraudulent subject only to state statutes of limitation. The bankruptcy trustee may act either under sections 548 and 550 of the Bankruptcy Code for transactions occurring within one year of bankruptcy or under section 544 of the Bankruptcy Code which gives the trustee the rights of any creditor under state law who has a right to set aside a transfer.

It should be clear that the Section is not suggesting any amendment to section 548(a)(1) or similar provisions of state law which would permit avoidance of transfers intended to hinder, delay or defraud creditors. The amendment is solely addressed to the provisions of these statutes constructively determining fraud regardless of the intent of the parties.

2. The Section believes that the Durrett case incorrectly interprets the fraudulent conveyance law.

Ever since the first fraudulent conveyance act over 400 years ago (Statute 13 Elizabeth (1570)) no case that we have found, until Durrett, has applied the constructive fraudulent transfer provisions to set aside a properly conducted non-collusive foreclosure sale. As pointed out above, if a foreclosure sale is not in good faith or is intended to hinder, delay or defraud creditors, the sale can readily be set aside under the actual fraud sections of the Bankruptcy Code and state fraudulent conveyance law. Of course, the sale may also be set aside in exceptional circumstances by a court relying on state foreclosure law and general equitable principles.

The proposed resolution is consistent with the disposition of security after the debtor's default under Article 9 of the Uniform Commercial Code. The UCC provides for the disposition of collateral in any "commercially reasonable" manner, and makes the manner of transfer, but not the price received, dispositive of whether the sale has adequately protected the debtor's rights.

Thus, the Durrett decision, rather than stating the law as it existed, carves out new principles of law contrary to pre-existing law and places in question the ability of the secured party to realize upon its security upon the debtor's default.

3. Foreclosure sales are distinguishable from execution sales which would not be affected by the proposed resolution.

There have also been cases setting aside execution sales under the fraudulent conveyance provisions. The proposed resolution is not intended to cover such execution sales, which involve considerations far different from mortgage or security interest foreclosure sales. There are policy reasons for limiting the rights of a judgment creditor from obtaining a property at the expense of other creditors of the debtor. Mortgage foreclosures involve secured transactions under which a lender has extended credit to a borrower secured by a lien on property of the debtor upon which the secured party may realize upon the borrower's default. The lien is of record and subsequent creditors are on notice of the secured party's rights when they extend credit.

4. The Section believes that the Durrett decision will cause serious dislocation in all forms of commercial and real property financing and will hurt the very people it is intended to help.

Under the Bankruptcy Code and state law, Durrett creates a period of many years of uncertainty that will overhang any foreclosure.

a. Foreclosure Sales

The immediate effect is to make it unlikely that purchasers other than mortgagees will buy at a foreclosure sale; to inhibit competitive bidding at such a sale; to increase the likelihood of deficiency judgments; and to decrease the likelihood of bids in excess of the mortgage balance -- amounts that otherwise would have gone to the owner-debtor.

b. Creditors

Creditors will hesitate to make any mortgage loans under conditions where they may not be able to realize upon their security in the event of default, and those that make such loans will make them only to people with the highest credit rating or with higher interest rates to cover the increased risk.

c. Borrowers

Borrowers most in need of secured credit will not be able to get it. On initial default, lenders will be discouraged from working with borrowers and will be forced to foreclose as soon as possible to lower the risk that the debtor will file for bankruptcy during the following years.

d. Inventory and Receivables Financing

In the area of commercial financing, banks and other institutions, encouraged to lend on inventory and receivables by the provisions of Article 9 of the Uniform Commercial Code which provide an orderly method of realizing upon security in the event of default, will undoubtedly revert to their pre-UCC position of refusing to make loans on what they considered to be questionable security.

e. The Economy

The entire result will have a severe adverse effect on the economy and stifle mortgage and other secured investments at a time when they should be encouraged.

f. State Law and Equity Courts

It will play havoc with state foreclosure and default statutes which are designed to effect a fair balance between the rights of the creditor and the rights of the debtor, as well as with well-established equitable principles. Such state foreclosure and default statutes provide for redemption periods or provide that the sale would not be confirmed unless certain statutory criteria are met. Also, courts of equity have refused to confirm sales where the price bid is so inadequate as to "shock the conscience of the courts," but have otherwise refused to substitute the court's determination of fair value for the amount realized at the sale.

While a foreclosure sale by its nature is a forced sale and thus will bring in a price less than what could be obtained under normal market conditions, it is the experience of the Section that where property has value substantially in excess of the mortgage balance, the borrower can arrange for substitute financing or for the sale of the property, or for competitive bidding that will bring the sale price close to the value of the property. If there are a few instances where this has not worked, the matter should be handled through amendments to the foreclosure and default statutes and not collaterally attacked by fraudulent conveyance and transfer laws in the

Bankruptcy Code or by state law.

Respectfully submitted,

Malcolm A. Moore, Chairman

August, 1983

Senator HEFLIN. The next panel is on provisions governing municipal bankruptcies. Mr. James Perkins of Boston, and Mr. King of New York.

[A copy of S. 1863 follows:]

II

100TH CONGRESS
1ST SESSION

S. 1863

To amend the bankruptcy law to provide for special revenue bonds, and for other purposes.

IN THE SENATE OF THE UNITED STATES

NOVEMBER 12, 1987

Mr. DECONCINI introduced the following bill; which was read twice and referred to the Committee on the Judiciary

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A BILL

To amend the bankruptcy law to provide for special revenue bonds, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 109(c)(3) of title 11, United States Code, is amended by striking out "or unable to meet such entity's debts as such debts mature".

SEC. 2. Section 901(a) of title 11, United States Code, is amended by inserting "1129(a)(6)," between "1129(a)(3)," and "1129(a)(8)".

SEC. 3. Section 902 of title 11, United States Code, is amended by—

(1) redesignating paragraphs (2), (3), and (4) as paragraphs (4), (5), and (6), respectively;

(2) redesignating paragraph (1) as paragraph (2);

(3) inserting before paragraph (1), as redesignated herein, a new paragraph (1), as follows:

"(1) 'insolvent', notwithstanding section 101(29) of this title, when used in a section that is made applicable in a case under this chapter by section 103(e) or 901 of this title, means financial condition such that the municipality is generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute, or is unable to pay its debts as they become due;"; and

(4) inserting between paragraph (2) and paragraph (4), as redesignated herein, the following:

"(3) 'special revenues' means—

"(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, and

"(E) taxes specifically levied to finance one or more projects or systems, but not including (except for tax-increment financing) receipts from general property, sales, or income taxes levied to finance the general purposes of the debtor.".

SEC. 4. Section 922 of title 11, United States Code, is amended by adding at the end thereof the following:

"(c) If the debtor, under this section, or section 362 or 364 of this title, provides adequate protection of the interest of the holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection such creditor has a claim arising from the stay of action against such property under this section or section 362 of this title or from the granting of a lien under section 364(d) of this title, then such claim shall be allowable as an administrative expense under section 503(b) of this title.

"(d) Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.".

SEC. 5. (a) Section 925 of title 11, United States Code, is amended by—

(1) adding to the section heading the following: **"and certain secured claims"**;

(2) striking out "A" and inserting in lieu thereof "(a) A"; and

(3) adding at the end thereof the following:

"(b) 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 pursuant to section 1111(b) of this title.".

(b) The table of sections for chapter 9 of title 11, United States Code, is amended by adding before the period in the item relating to section 925, "and certain secured claims".

SEC. 6. Section 926 of title 11, United States Code, is amended by—

(1) inserting "(a)" before "If"; and

(2) adding at the end thereof the following:

"(b) A transfer of property of the debtor to or for the benefit of any holder of a bond or note, on account of such bond or note, may not be avoided under section 547 of this title.".

SEC. 7. (a) Section 927 of title 11, United States Code, is redesignated as section 929.

(b) Title 11 of the United States Code is amended by adding between section 926 and section 929, as herein redesignated, the following new sections:

"§ 927. Post petition effect of security interest

"(a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

"(b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system is subject to the necessary operating expenses of such project or system, as the case may be.

"§ 928. Municipal leases

"A lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of section 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent.".

(c) The table of sections for subchapter II of chapter 9 of title 11, United States Code, is amended by striking out the item relating to section 927 and inserting in lieu thereof the following:

"927. Post petition effect of security interest.
"928. Municipal leases.
"929. Dismissal.".

SEC. 8. Section 943(b) of title 11, United States Code, is amended by—

(1) striking out "and" at the end of paragraph (5);

(2) striking out the period at the end of paragraph (6) and inserting in lieu thereof a semicolon;

(3) redesignating paragraph (6) as paragraph (7); and

(4) inserting between paragraph (5) and paragraph (7), the following:

"(6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and".

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Senator HEFLIN. I see that there is a vote on right now so we will have to take a recess. We will be back in about 15 minutes.

[A short recess was taken.]

Senator HEFLIN. Mr. Perkins, Mr. King, and Mr. Spiotto. Mr. Perkins, if you would go ahead and begin, we would be delighted to hear from you.

S. 1863: MUNICIPAL BANKRUPTCY

STATEMENT OF A PANEL CONSISTING OF JAMES W. PERKINS, PALMER & DODGE, BOSTON, MA; AND LAWRENCE P. KING, NATIONAL BANKRUPTCY CONFERENCE, NEW YORK, NY

STATEMENT OF JAMES W. PERKINS

Mr. PERKINS. Thank you, Mr. Chairman. Mr. Spiotto is delayed and we hope he will be here before we finish, but we are not certain.

Commercial concepts were applied to municipalities by the 1978 revision of the Code. Some of these do not fit. The legislation before you is the culmination of a long effort by the bankruptcy and municipal bars to repair this lack of fit.

We are grateful to Senator DeConcini for introducing the bill and to the committee for giving its thoughtful consideration.

I hope you will forgive me for taking a moment to describe the difference between municipal revenue bonds and general obligations before describing, in very brief compass, the features of the Code that could destroy that difference and divert municipal funds in contradiction of State law, without serving a Federal purpose.

General obligations, which we often call GO, are like your credit card borrowing. There is no collateral for the loan. It is repayable from any funds the municipality can scrape up, just as your credit card balance is payable from any funds you can scrape up.

Revenue bonds are a bit like your home mortgage, but the mortgage is on the money receipts of an enterprise, such as a water or electric plant, not on the plant itself. The reason for not mortgaging the plant itself is that it would be against public policy to allow foreclosure on a public facility. Revenue bonds are usually payable solely from plant revenues. Other funds cannot be tapped to pay them.

Municipalities have two kinds of operations. One is the general operations, such as police, fire, and school. The other is revenue producing operations, such as water and electric systems. Cities and counties across the country, small and large, issue revenue bonds rather than general obligation bonds to pay for these systems, so that the taxpayers will not have to pay if the plant fails.

In considering the impact of the Code on these bonds, one must bear in mind that a municipality may go into bankruptcy either because its general operations go broke or because its revenue producing systems go broke. What this exercise is all about is if one fails, must it bring down the other?

If the general operations run out of money, must the municipal utilities also fail? If a revenue-producing function fails, must the general operations go down, as well?

Section 552 of the Code appears to terminate the revenue bondholder's lien on revenues received by the municipality after it files in bankruptcy. This is because these revenues are technically after-acquired property, so-called, and the Code terminates liens on after-acquired property.

This does not work very well in the case of a municipality. What it means that if the general operations go down, the municipal utility system will go down with them because utility revenues will be diverted in bankruptcy to non-utility purposes.

The proposed legislation preserves the lien on the utility revenues subject to an important qualification. Operating expenses of the revenue producing system must be paid first. Thus, the bondholder cannot impair the ability of the system to continue to serve the public by asserting a lien on operating funds.

A converse problem arises under section 1111(b) of the present Code. It allows the conversion of nonrecourse debt into recourse debt. These terms, recourse and nonrecourse, are not used in municipal finance. But general obligation bonds look and smell like recourse debt and revenue bonds look and smell like nonrecourse debt.

There is therefore a severe risk that revenue bonds will be converted in bankruptcy into GO's, causing the taxpayers to be tapped to pay off those bonds.

Senator HEFLIN. If you would, try to finalize, Mr. Perkins.

Mr. PERKINS. Thank you, Mr. Chairman.

By maintaining the lien on net revenues and preventing the conversion of revenue bonds into GO's, the bill preserves the bargain that was made.

Thank you very much.

[The prepared statement of Mr. Perkins follows:]

UNITED STATES OF AMERICA

Senate Committee on the Judiciary

Subcommittee on Courts and Administrative Practice

HEARING ON S. 1863

RELATING TO MUNICIPAL BANKRUPTCIES

June 10, 1988

Testimony by James W. Perkins*

Prologue

Commercial concepts were applied to municipalities by the 1978 revisions of the Bankruptcy Code. Some of these do not fit municipalities, especially in regard to municipal bonds, which are very different from commercial borrowings by business corporations. If these problems are not corrected, serious damage is likely to municipal financial markets through the diversion of municipal revenues in bankruptcy to purposes for which they are not available under state law or under the contracts underlying the bonds in a manner never considered or contemplated by the Congress.

It little credits us in the municipal bar that we slept while Chapter 9 was rewritten without our participation. But that is what happened. The legislation before you is the culmination of a long effort by the bankruptcy and municipal bars to undo the damage.

We came at it from different directions. Frankly, most municipal finance lawyers were ignorant of bankruptcy law and most bankruptcy experts were ignorant of municipal finance.

But that is prologue. We worked together laboriously to produce corrective legislation that preserved the underlying bargain made through the issuance of municipal bonds while at the same time implementing the "fresh-start" approach underlying the Code.

Association Endorsements

The resulting legislation is endorsed by the National Bankruptcy Conference, the National Governors Association, the National League of Cities, the United States Conference

*Mr. Perkins is Managing Partner of Palmer & Dodge in Boston, former Chairman of the Section of Local Government of the American Bar Association and former President of the National Association of Bond Lawyers.

of Mayors, the Government Finance Officers Association, the National Association of Counties, the National Association of State Budget Officers, the National Conference of State Legislatures and, last and least, the National Association of Bond Lawyers.

Bankruptcy Conference Report

It's a difficult topic to explain. The 31-page report of the National Bankruptcy Conference does it well. But I will attempt to do so in shorter compass. I hope you will forgive me for going back to basics and explaining what a municipal bond is before describing the principal features of the 1978 Code that could bring about the diversion of municipal funds in contradiction of state law without serving a federal purpose.

What is a Municipal Bond?

Municipalities issue bonds to raise capital - principally for public facilities (now often called "infrastructure").

A municipal bond is a promise to pay back the money the municipality has borrowed.

GOs and Revenue Bonds

There are two kinds.

The first is general obligations (often called "GOs"). They are like your credit-card borrowing. There is no collateral for the loan. The loan is repayable from any and all funds the municipality can scrape up, just as your credit-card balance is payable from any and all funds you can scrape up.

The other kind is revenue bonds. These are a bit like your home mortgage. But the mortgage is on the money receipts from an enterprise (e.g. a water or electric plant), not on the plant itself. The reason for not mortgaging the plant itself is that it is against public policy to allow foreclosure on a public facility in the event of default.

Revenue bonds are usually repayable <u>solely</u> from the plant revenues. Other funds of the <u>municipality</u> cannot be tapped to pay them.

"Conduit" Bonds

There is a third kind of municipal bond, a "conduit" bond, where a private party borrows through a municipality.

Conduit bonds are beyond the scope of S. 1863 since they are not considered debt of the municipality in bankruptcy.

General Operations and Revenue-Producing Operations

Municipalities have two kinds of operations: (i) general, non-revenue-producing operations, such as police, fire and public schools, and (ii) revenue-producing operations, such as public water and electric systems.

Revenue bonds are issued so that the taxpayers won't have to pay if the plant fails. The revenues of the plant are mortgaged to provide collateral for the bonds and thereby keep interest costs down.

Bankruptcy may ensue either because the general operations go broke or because the revenue-producing system goes broke.

What this exercise is all about is, if one fails, must it bring down the other with it? If the general operations run out of money, must the municipal utilities also fail? If a revenue-producing function fails, must the general operations go down as well?

The bill does a number of things. I will limit my testimony to the ways in which the bill saves the division between general operations and revenue-producing functions or, more specifically, how it preserves the distinction between general obligations and revenue bonds.

Termination of Security for Revenue Bonds

Section 552 of the Code appears to terminate the revenue bondholder's lien or mortgage on revenues received by the municipality after it files in bankruptcy. This is because, as the Code is now written, these revenues are "after-acquired property" and the Code is intended to terminate liens on after-acquired property in the event of bankruptcy. This does not work in the case of a municipality. What it means is that, if the general operations go down, the municipal utility system will go down with them because utility revenues will be diverted to non-utility purposes.

The proposed legislation preserves the lien on utility revenues, subject to an important qualification. Operating expenses of the revenue producing system must be paid first. Thus, the bondholders cannot impair the ability of the system to continue to serve the public by asserting a lien on its operating funds.

Conversion of Revenue Bonds into GOs

Section 1111(b) of the Code allows the conversion of "non-recourse" debt into "recourse" debt. These terms - "recourse" and "non-recourse" - are not used in municipal finance. But municipal general obligation bonds look and smell like recourse debt and revenue bonds look and smell like non-recourse debt. Thus, there is a severe risk that revenue bonds will be converted in bankruptcy into GOs. The bill provides that municipal revenue bonds will not be converted into general obligations. This avoids a collision between federal bankruptcy law and state constitutional and statutory limitations on the issuance of general obligation bonds.

Preserving the Bargain

By maintaining the revenue bondholder's mortgage on pledged net revenues and by preventing the conversion of revenue bonds into GOs in disregard of state law, the bill preserves the bargain that was made by all the parties - the bondholder, the municipality, the taxpayers of the municipality, and the municipal ratepayers. If this bargain is broken by bankruptcy judges, and taxpayers are required to pay revenue bonds, or pledged revenues of a healthy utility system are diverted to other municipal functions, the reverberations will be loud and clear. The time to avoid this unintended result is before it happens.

STATEMENT OF LAWRENCE P. KING

Mr. KING. Thank you, Senator.

I am the Charles Seligson professor of law at the New York University School of Law and counsel to the firm of Wachtell, Lipton, Rosen & Katz in New York City. I am appearing here on behalf of the National Bankruptcy Conference which has worked very closely with Mr. Perkins and his organization in drafting these amendments to chapter 9 of the Bankruptcy Code.

I will not repeat anything that Mr. Perkins said. I will simply say that, first of all, I think we have been very fortunate since 1975 and 1976, when the predecessor amendments to the Bankruptcy Act were passed by Congress that led to the 1978 amendments, that municipalities have not had to use chapter 9, so we have no real experience with chapter 9. Hopefully, we will not have any experience with chapter 9. And even further, hopefully, we will not have any experience with these proposed amendments, if they are enacted by Congress.

But the amendments themselves, I believe and the National Bankruptcy Conference believes, are necessary for clarification purposes, to get rid of some ambiguities, and also to make certain that some of the commercial aspects that are applicable in the normal corporate reorganization or business reorganization situations, do not apply because they are not meant to apply; they cannot apply in situations involving municipalities and municipal bonds.

I would say the basic purpose of these amendments is really to make it more feasible and possible for the actual sale of and to increase the value of municipal bonds, and to be very helpful to the whole area of municipal finance.

Just one point with respect to a matter that Mr. Perkins did not raise, in terms of one of the amendments contained in the bill. One can see this distinction that I was trying to point out, in the amendment that would change the definition of the word insolvent or insolvency. As defined in the Bankruptcy Code today, without the amendment, the word does not work when applied to a municipality because one cannot use the balance sheet test of assets over liabilities; most of the assets of a municipality are not subject to creditors' claims in the first place.

The new definition or the suggested amendment to the definition applicable to municipalities takes a more practical view and would, instead, use the concept of when the municipality is unable to pay its debts or is, in fact, not paying its debts as, if you go back to 1975, was almost the case of New York City.

Thank you, very much.

[The prepared statement of Mr. King follows:]

HEARINGS BEFORE THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE OF THE SENATE COMMITTEE ON THE JUDICIARY, JUNE 10, 1988 ON

S. 1863

STATEMENT OF THE NATIONAL BANKRUPTCY CONFERENCE SUBMITTED BY RICHARD B. LEVIN AND LAWRENCE P. KING

Following is the Statement of the National Bankruptcy Conference with respect to the above hearings. The National Bankruptcy Conference is an organization of lawyers, judges and professors which was established at the behest of the Congress in the mid-1930's to assist it in the formulation and promulgation of what came to be known as the Chandler Amendments to the Bankruptcy Act of 1898. Since that time, the National Bankruptcy Conference has devoted its efforts to the improvement of the bankruptcy laws of the United States and the practice of bankruptcy law through the legislative process.

Richard Levin served as Associate Counsel to the House Subcommittee on Civil and Constitutional Rights during the time of drafting the Bankruptcy Reform Act of 1978. He is presently a partner in the Los Angeles law firm of Stutman, Treister and Glatt which specializes in the area of bankruptcy and reorganization law.

Lawrence P. King is the Charles Seligson Professor of Law at New York University School of Law and is of counsel to the New York City firm of Wachtell, Lipton, Rosen and Katz.

REPORT OF THE NATIONAL BANKRUPTCY CONFERENCE

ON PROPOSED MUNICIPAL BANKRUPTCY AMENDMENTS

In 1978, Congress enacted sweeping revisions of all aspects of the bankruptcy law. One of the five major purposes of the revision, as stated in the Report of the House Judiciary Committee, was to conform bankruptcy law in many respects to the vast changes in commercial law that had taken place since the last prior revisions of the bankruptcy law 40 years before. In particular, the House Report noted the near universal adoption of the Uniform Commercial Code and the consequent change in lending practices. In addition, Congress modernized business reorganization procedures, authorizing more consensual plans of reorganization and providing additional protection to secured lenders in the wake of several decisions under the former Bankruptcy Act in the mid-1970s that seriously impaired their position in reorganization cases.

For the most part, these changes were carefully considered only after extensive hearings, debate, and discussions. They have generally been well received and have worked as intended. Although some significant amendments were made in 1984, the basic structure of the amendments made in 1978 has survived intact.

However, the care that was used in the drafting of the provisions relating to ordinary business bankruptcies and reorganizations was not carried over into the revisions of the municipal bankruptcy law, contained in chapter 9 of the Bankruptcy Code. Chapter IX of the former Bankruptcy Act had been recently amended in 1976 as a result of New York City's financial crisis. The 1978 revision largely adopted the decisions made in 1976 and incorporated by reference most of the business bankruptcy amendments made in 1978 insofar as they related to general matters such as a treatment of secured claims, avoiding powers, and plans of reorganization. Because the worlds of commercial finance and municipal finance are so diverse, the simple incorporation by reference of the 1978 commercial finance concepts into the municipal bankruptcy arena simply did not work. Fortunately, no major municipal bankruptcy has tested the potential shortcomings of chapter 9 as it was enacted in 1978. However, more considered study in the past several years by municipal finance practitioners and members of the bankruptcy bar has led the National Bankruptcy Conference to conclude that chapter 9 of the Bankruptcy Code needs revision in specific areas.

HISTORY OF THE PROPOSED AMENDMENTS

The potential problems created by the incorporation of general commercial finance concepts into the municipal bankruptcy provisions first came to light as a result of the financial crisis confronting the City of Cleveland, Ohio, in 1979. Cleveland needed additional financing, but lenders were unwilling to lend for a variety of reasons, including the incorporation into chapter 9 of the general bankruptcy concept that a lien on after-acquired property will not attach to property acquired after bankruptcy by a reorganizing debtor, unless the property acquired after bankruptcy constitutes proceeds of property held at the time of bankruptcy. Hasty attempts were made during 1979 and 1980 in connection with then-pending legislation to correct technical errors in the 1978 Act. Corrective provisions were included in bills that passed both the House and the Senate in 1980, but the legislation foundered on other issues and was not enacted.

The 1979-80 attempt at corrective legislation was hasty and ill-considered. After the immediate crisis passed, cooler heads prevailed, and a more thorough study of the problems of municipal bankruptcy was undertaken by the National Association of Bond Lawyers ("NABL"). NABL identified several areas in which the general incorporation into chapter 9 of business reorganization concepts simply did not work. Members of NABL contacted members of the National Bankruptcy Conference ("NBC") to explore means of solving the problems for municipal finance presented by the 1978 Bankruptcy Code in a manner that was consistent with sound bankruptcy policy. Representatives of these two groups met during 1983 and 1984 to develop corrective legislation. The legislation proposed by this Report is the direct result of those efforts. It was approved by the Executive Committee of the NBC during its March 1985 meeting.

NEED FOR THE AMENDMENTS

The current deficiencies in chapter 9 of the Bankruptcy Code primarily affect "revenue bonds," that is, obligations of a municipality that are secured by a lien on specific revenue to be received by the municipality. These differ from "general obligation bonds", which constitute simply the promise by the municipality to use its taxing power to collect sufficient funds to pay the principal and interest on the bonds. Over the years, revenue bonds have occupied an increasing portion of the municipal bond market. As of 1983, they constituted about half of the bonds issued by state and local governmental units for publicly owned and operated facilities.

Chapter 9 as currently written could easily be read to terminate a lien on revenues upon the filing of a municipal bankruptcy by the bond issuer and could also be read to convert bonds payable solely from specific revenues into general obligations of the debtor municipality. These results are wholly inconsistent with municipal finance principles and many State and local constitutional and statutory provisions authorizing the issuance of bonds. If chapter 9 were interpreted in this way, the burden of bonds designed to be paid only from special revenues could be imposed on the people generally through taxation, despite the fact that the bonds might thereby exceed the municipality's debt limit or would require a vote if originally issued as general obligation bonds.

Similarly, a municipality often has enterprises with separate funds, and, except to the extent specifically permitted, the funds derived from one source are often legally unavailable for other enterprises or for general governmental purposes. Thus, for example, water receipts may be legally unavailable under nonbankruptcy law for general governmental purposes except to the extent that provision is made by law for payments by the water department in lieu of local property taxes. Although the various enterprises are not separate entities, they are operated almost as if they were. In many cases they are managed by separate autonomous governing boards.

If a municipality if unable to meet its obligations for general governmental purposes and for that reason files a bankruptcy petition, the assets of its water department should not be reached to pay general creditors of the municipality unless they could be reached under applicable nonbankruptcy law. Conversely, if water revenues are insufficient to pay operating expenses and the debt service on water revenue bonds, other funds of the city should not be reachable to pay the bonds. In many cases it would violate state constitutional limitations to do so. Similarly, insolvency in the

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water department should not trigger preference treatment of payments made to general fund creditors, or vice versa.

State "joint action" agencies often finance electric generating units and transmission lines for the benefit of their municipal members on a project-by-project basis under documents which permit funds derived from each project to be used only for the purpose of that project. In such a case the funds of one project should not be reachable for the purposes of another project in the event the agency files a bankruptcy petition.

These conclusions are really truisms under State law, but it is not sufficiently clear that they would apply in municipal bankruptcy proceedings under federal law. There is no clear statement that the Bankruptcy Code cannot be applied so as to make obligations payable from a source from which they are not payable under applicable nonbankruptcy law. Nor is there any provision to the effect that administrative expenses attributable to any function or project of the municipality will not be charged against funds derived from other functions or projects except as permitted by nonbankruptcy law.

In one respect, by its express terms, the Bankruptcy Code creates an apparent risk that revenue bonds can be converted into general obligation bonds. Under section 1111(b), unless the property subject to the lien is "sold" under the plan, a partially secured bondholder (i.e., one whose lien on revenues is insufficient to pay his bonds), if he does not have "recourse" against the debtor for the remainder of his claim under nonbankruptcy law, will be treated as if he did have "recourse." Although the term "recourse" fits municipal revenue bonds only poorly, this could be read as converting revenue bonds into general obligations.

The same problems could be said to exist with respect to "conduit" financing where bonds are issued for an industrial or nonprofit user and are payable solely from payments to be made by the user. But in pure conduit financing, where the municipality has no financial interest in the enterprise and no direct or contingent obligation to pay the bonds from other funds, the payments by one conduit user are probably safe from being reached to pay the bonds issued for another user since, according to the legislative history, these transactions do not create either assets or debts of the municipal issuer for bankruptcy purposes. S. Rep. 95-989, 95th Cong., 2d Sess. 109-10 (1978).

While the fresh start policy of bankruptcy embodied in the termination after bankruptcy of liens on after-acquired property and the equality of distribution policy embodied in the nonrecognition (at least in business debtors) of separate though unencumbered funds for separate groups of creditors are important, the Bankruptcy Code also strongly embodies the policies of protecting the rights of secured creditors in their collateral and of protecting State control over its municipalities. See Bankruptcy Code § 903. On the one hand, if the municipality's revenues could be pledged in perpetuity, the rehabilitative prospects for a financially distressed municipality would be impaired or non-existent. The only asset that a municipality has to offer its creditors in a municipal reorganization is its future revenues. If some creditors have obtained a priority with respect to these revenues due to prior financing, then reorganization would be next to impossible unless other creditors are willing to give up their claims entirely. On the other hand, reorganization should not be at the expense of a legitimate expectation to rely on and receive specific collateral, nor should it redo established procedures for handling separate municipal funds. Clearly, a compromise is in order. It is needed to protect the integrity of the municipal finance process in the event of a significant municipal bankruptcy and to protect the fresh start and ability to reorganize offered to municipal debtors by the Municipal Bankruptcy Act.

GENERAL ANALYSIS OF THE PURPOSES AND EFFECTS OF THE AMENDMENTS

A. Revenue Pledge Protection and Preferences

Revenue bonds are generally secured by revenue derived from a system, project, or facility, or by an interest in a specific tax levy. Mortgages or liens on the system, project, or facility itself are rare. They are usually forbidden by law and almost always considered to be against public policy. Under section 552 of the Bankruptcy Code, incorporated by section 901 into chapter 9, a lien on after-acquired revenues is only valid to the extent that the revenues constitute "proceeds" of other property that is subject to a lien. Uniform Commercial Code section 9-306(1) defines "proceeds" to include "whatever is received upon the "sale, exchange, collection or other disposition of collateral." Section 552 was written with the Uniform Commercial Code definition in mind. To the extent that section 552 is construed in harmony with the U.C.C., the lien on a municipality's revenues after bankruptcy would be defeated.

Similarly, section 547(e)(3) may have the effect of moving the lien termination back to the ninetieth day before bankruptcy. Section 547(e)(3) provides that for purposes of determining when a preferential transfer is "made", "the transfer is not made until the debtor has acquired rights in the property transferred". A debtor does not acquire rights in revenues until the tax or assessment is levied or the service from which the revenue is derived is provided. Thus, a lien on revenues received during the 90 days before bankruptcy (or possibly on rights to revenues which arise during that period) is deemed made within the preference period, even though the grant of the security interest was made long before bankruptcy.

This provision was designed to overrule cases such as DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), and Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), cert. denied, 396 U.S. 827 (1969). H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 374 (1977). In the commercial context, it works well, because it was matched with an exception to the preference section that preserves liens on after-acquired inventory and receivables to the extent that the secured creditor does not improve its position during the 90 days before bankruptcy. 11 U.S.C. § 547(c)(5). In the municipal context, however, no comparable savings provision is possible, because the revenue pledges are not related to inventory and receivable financing, as they are in the commercial context, and there is no collateral from which the revenues are derived.

The proposed legislation undoes the effect of these provisions in a chapter 9 case. It recognizes a postpetition security interest in revenue under certain specified circumstances, more fully described below. And it makes the preference section inapplicable to payments on bonds or notes of a municipality. The former change corrects the problem posed by section 552. It also makes it more difficult, if not impossible, for a municipal debtor to utilize the preference section (even without the latter change) to recover payments to bond holders made from pledged revenues within 90 days before bankruptcy, because it will be difficult to prove the "more than liquidation" test of section 547(b)(5). The latter change has the same effect and in addition protects ordinary "defeasance" transactions.

Bond indentures generally provide for "defeasance" by "irrevocably" depositing a sufficient sum (usually with earnings thereon) to retire the outstanding bonds. In view of the possibility that the municipality may file a bankruptcy petition within 90 days, the deposit may be a preference and therefore, might not be "irrevocable." Defeasance with revenues received within 90 days before a bankruptcy may be riskier. This applies equally to unpledged revenues and to revenues which are already subject to a lien to pay the bonds if that lien can be defeated by virtue of section 547(e)(3). It is especially troublesome if a defeasance can be "avoided" as a preference where another transaction (such as a new bond issue) has occurred in reliance on it.

A more difficult analysis applies to the use of refunding proceeds for defeasance. Generally speaking, it is not a preference to borrow from Peter to pay Paul if that use of the borrowing proceeds is required by the terms of the borrowing. See, e.g., Virginia National Bank v. Woodson, 329 F.2d 836 (4th Cir. 1964). But the application of this principle to a defeasance by "advance" refunding is disturbingly unclear, because interest rate differences on the two issues may mean that principal amounts differ, resulting in a posible preference. The proposed amendments remove this danger.

B. "Insolvent"

Chapter 9 uses the term "insolvent" in two important contexts. First, in order for a municipality to be eligible to file a chapter 9 petition, it must be "insolvent or unable to meet its debts as they mature." Section 109(c)(3). Second, certain prebankruptcy transfers are avoidable as preferences or fraudulent transfers only if the debtor was "insolvent" at the time of the transfer. Sections 547(b)(3); 548(a)(2)(B)(i). These are general bankruptcy sections that are incorporated by reference into chapter 9. In none of these instances does the use of the word "insolvent", as defined in Code § 101(29), work.

"Insolvent" is defined as liabilities in excess of fair market value of nonexempt assets. By the nature of municipalities and generally by State law, most of the assets of a municipality are exempt from process to satisfy the claims of creditors. As such, virtually every municipality, by definition, is insolvent. But because a municipality's assets could not be seized or sold to pay debts, or are so tailored to a specific purpose that their value is uncertain at best, it should make little difference to creditors what the "value," for example, of City Hall is. A more reasonable test would be whether the municipality is paying or is able to pay its debts as they become due, which are the alternate standards for filing a municipal bankruptcy petition under section 109(c)(3) and the test for an involuntary bankruptcy against a non-municipal debtor contained in section 303(h)(1). This test is directly relevant to the financial health of the municipality. Thus, one of the proposed amendments provides that in a chapter 9 case, "insolvent" means only a nonpayment of debts or inability to pay debts as they come due. The assets versus liabilities test is made inapplicable.

C. Nonrecourse Debt

In order to solve a specific problem arising in nonrecourse commercial lending, section 1111(b) of the Bankruptcy Code permits a nonrecourse claim to be treated as having recourse against the general assets of the debtor. This provision, being part of the general plan provisions of chapter 11, was incorporated into chapter 9. However, if applied to municipal revenue bonds, it could convert them into general obligations of the municipality in violation of State or local constitutional or statutory provisions. For example, in many States, State law requires a vote of the people for the issuance of general obligation debt by a municipality, but does not require a vote on bonds payable solely from pledged revenues. One proposed amendment prevents the application of section 1111(b) and thereby prevents the conversion of bonds backed only by specific revenues into general obligation bonds. The amendment does so in a manner that is consistent with the general scheme of the reorganization provisions of chapters 9 and 11 by preventing the bifurcation of partially secured claims.

D. Automatic Stay

The automatic stay of Bankruptcy Code section 362 is extremely broad, preventing any postpetition collection activities against the debtor, including application of the debtor's funds held by a secured lender to secured indebtedness. This provision is overly broad in chapter 9, requiring the delay and expense attendant upon a request for relief from the automatic stay to accomplish what the statute contemplates -- the application of pledged revenues (after payment of operating expenses) to the payment of secured bonds. One of the proposed amendments so provides by making the automatic stay inapplicable to application of such revenues. The bankruptcy court would retain the power to enjoin application of proceeds, however, upon a specific showing of need, for example, where a secured creditor was about to apply proceeds of a gross revenue pledge in a manner inconsistent with the policies of proposed section 927.

E. Financing Leases

A "financing lease" is generally treated as debt in bankruptcy and not as a true "lease" subject to rejection under section 365 or to the claim limitation under section 502(b)(6). The 1984 amendment (Code § 365(m)), providing that "any rental agreement to use real property" will be treated as a "lease" under § 365 has generated a fear that a more expansive view will now be taken of "true leases" and a less expansive view of "financing leases". Because of State law restrictions, most municipal financing leases are subject to termination if the "rent" is not appropriated. Under a more restrictive conception of financing leases, these may now arguably be treated as "true leases" for bankruptcy purposes although they are treated as debt for tax purposes and sold as debt in the tax-exempt bond market. The amendments treat them the same way for bankruptcy purposes.

F. Rate Regulation

In a corporate reorganization, a change in the debtor's rates is subject to applicable rate regulation. Code § 1129(a)(6). Municipal utilities are subject to rate regulation in a number of States, and the same provisions should apply to them as to private corporations. A proposed amendment makes this provision applicable to municipal bankruptcies.

Municipal systems are often also subject to other regulatory requirements and to political requirements, unique to governments, such as voter approval of additional debt. Another amendment makes a municipal plan of adjustment subject to these requirements. Some have expressed a concern that a failure to make a plan subject to requirements of this sort could override State and local financial and political controls and raise constitutional issues as to the scope of the bankruptcy power that need not be resolved to further sound municipal bankruptcy policy.

G. <u>Adequate Protection</u>

Sections 362 and 364 require adequate protection to secured creditors in order to continue an automatic stay or to permit a priority borrowing by the bankruptcy trustee. These provisions apply to all bankruptcies. If the "adequate protection" in fact proves to be inadequate, the secured creditor has a "superpriority" claim under section 507(b). But this applies only to individual and corporate bankruptcies and not to municipal bankruptcies.

In municipal bankruptcy, since liquidation is not permissible and since all priority claims must be paid as a condition to plan confirmation, the ranking of various types of administrative expenses in a priority or super-priority order may not add anything to the statute. However, there should not be any doubt that a failure of adequate protection should give rise to an administrative expense claim. One amendment makes this explicit.

<u>DETAILED ANALYSIS OF REVENUE PLEDGE AMENDMENTS</u>

Under Bankruptcy Code § 552, except for "proceeds, product, offspring, rents, or profits" of other "property" already subject to a preexisting security interest,

> ". . . property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by

the debtor before the commencement of the case."

As applied in the municipal context, in which a security interest in underlying assets is rare, section 552 appears to terminate a security interest in revenues received after the commencement of the bankruptcy case, regardless of the validity of the lien under State law. The problem is particularly acute with respect to project or system financing, such as bonds secured by municipal utility revenues or other nontax revenues. The problem also presents itself in certain instances in which tax revenues act as collateral for bonds.

There are exceptions to the rule that underlying assets are not given as collateral for revenue bonds. For example, in South Dakota, there may be a "statutory mortgage lien" on plant assets. See, e.g., 9 S.Dak. Codified Laws Sections 9-40-25 to 9-40-27. It would be highly artificial for the result under Bankruptcy Code section 552 to turn on the difference between the statutory mortgage and the more customary pledge of revenues without a lien on the plant. Even where foreclosure on the underlying assets is permitted, there appears to be little, if any, practical difference between the two situations. See Fordham, Revenue Bonds Sanctions, 42 Col.L.Rev. 395, 432-33 (1942).

Proposed section 927, along with the definition of "special revenues" in proposed section 902(2), protects the lien on revenues. It is closely modeled on section 552(a).

It is intended to negate section 552(a) in the municipal context and to go no further. In other words, it is not intended to create new rights that otherwise would not exist. Section 552(a) limits preexisting rights. The proposed amendment only removes that limitation in the circumstances described in proposed section 927(a).

The proposed amendment applies only to "special revenues," as defined in proposed section 902(2). Examples of the kinds of revenues included within the definition are revenues from municipally-owned utility systems, betterment assessments, special excise taxes and fees, and in some instances local sales, income, or property taxes.

Utility revenues include revenues from the sale of water, power, natural gas or other energy sources. It also includes revenues from a toll highway or bridge or other projects or systems which impose user fees.

Betterment assessments are typically imposed on landowners benefitted by particular improvements to finance the cost of those improvements. In most states, betterment assessments are constitutionally required to bear a reasonable relationship to the benefit conferred. Bonds (known as "special assessment bonds"), payable solely from these assessments, are sometimes issued to pay the cost of the improvement, but general obligation bonds are also issued for this purpose.

Hotel-motel taxes, meal taxes, and license fees are included in special excise taxes. They are often imposed for particular purposes. For example, a hotel-motel excise or a meal tax might be imposed in a particular area of a municipality or throughout a city to finance the construction and operation of a convention center. Bonds secured by the special excise tax are issued to finance construction.

Tax increment financing will also receive the benefit of the proposed amendment. A city may finance street, utility, and land assembly costs for a downtown renewal project on a tax increment basis. That is, the bonds issued to pay for the project are payable solely from and are secured by a lien on the additional tax resulting from the increased valuations in the project area.

Property, sales, and income taxes would generally not be considered special revenues. However, some exceptions may exist. For example, where a special property tax is levied and collected for the specific purpose of paying principal and interest coming due on bonds issued in conjunction with the levy of the property tax, the revenues may constitute special revenues. In these cases, there is generally a prohibition under State law on using the special tax revenue for any purpose other than payment of bonds. However, where the revenue may be used for other purposes, it should not constitute "special revenues." Similarly, a city may impose an additional one-half percent or one percent sales tax to finance a particular project, such as rapid transit. While general sales taxes would not constitute special revenues, with appropriate limitations on the use of the additional sales tax, it could constitute special revenues.

Project financing can also create special revenues. A municipality may attempt to finance separate projects by liens on the revenue of each project, issuing separate bonds for each project. Project revenues, whether based on sale of goods or services or based on cost-sharing among users, would constitute special revenues.

In all of these cases, communities have determined it to be financially or politically unsound to finance a major utility or other project or system with general obligation debt, i.e., debt payable from the general funds of the municipality including tax receipts. Accordingly, they issue revenue bonds payable solely from the revenues of the project or system. To make sure that those revenues are not converted to other purposes, they pledge or assign revenues as security for the bonds, usually under State enabling legislation which provides expressly that they can do so.

Absent the mortgage, there is really no alternative for the municipality. The effect of the pledge of revenues is not unlike the result of a private utility's mortgage of its entire plant to a trustee for the benefit of bondholders. Nor is it unlike the lien on "proceeds" which is recognized in the Code. The proposed amendment amounts to a recognition of a hypothetical mortgage on the plant from which the revenues are derived where a "real" mortgage cannot be created either for legal reasons or because of compelling considerations of public policy.

Proposed section 927 does not distinguish between bonds backed solely by special revenues and so-called double-barrelled bonds. These latter bonds are backed not only by special revenues but also by the general credit of the municipality, including its power to levy property and other taxes. There is no security interest, however, in the general property tax receipts.

Nor does section 927 distinguish between projects or systems owned and operated by a municipality that also performs other functions or by a so-called special purpose municipality, such as a separate "body politic and corporate" established to finance, construct, and operate a utility system or other project or system.

These latter distinctions only go to the issue of whether the bondholders have a recourse against the general municipality on any shortfall of project or system revenues to pay amounts owed under the revenue bonds. This is an issue addressed by proposed section 925(b), which renders ineffective Bankruptcy Code § 1111(b) in the revenue bond context.

Subsection (b) of proposed section 927 provides for the payment from pledged special revenues of operating expenses of the project or system producing the revenues before use of those revenues to pay interest or principal on the bonds. In very general terms, a net revenue pledge would survive, and a gross revenue pledge would be treated as if it were a net revenue pledge. Pledged revenues received after the commencement of the bankruptcy case would be applied first to the operating expenses of the system, project or function producing the revenues (whether or not the bonds financed construction or purchase of the system, project, or function producing the revenues) before application to the indebtedness for which the revenues were pledged and only then to other lawful purposes.

The general purpose of this approach is to permit the continued operation or functioning of the system, project, or function that was financed by the revenue bonds. Without such continued operation, there is not likely to be a continued source of funds from which to service the bonds. The pledged revenues would not be permitted to be used for any other governmental purpose, but would be used to pay operating expenses to facilitate a workout and successful confirmation of an adjustment plan.

This approach should work fairly easily in utility situations or in user fee situations such as toll bridge authorities, and the like. Other situations may require more explanation. One such situation is tax increment financing. In this type of financing, bonds issued for public improvements are secured by a pledge of the additional tax resulting from the increased valuations in the area affected by the project. In this context, the pledged revenues could be used for operating expenses of the improvements before being applied to the secured indebtedness. Another situation might concern a project financed by a pledge, not of project revenue, but of revenue from some other special source. An example would be a convention center financed by a pledge of hotel-motel excise taxes or a rapid transit system financed by an increased sales tax. Here again, the pledged revenues could be used first for operating expenses of the project and second to pay the secured debt.

However, these revenues would not necessarily be subordinate to all of the operating expenses of the center or the improvements if they had their own source of revenues, such as from user fees. In each case, the court will be required to examine the need to protect the source of the pledged revenue and to determine whether maintaining operating expenses of the project, system or function contributes to the ability of the project, system, or function to continue to produce the revenues needed to operate and service the bonds.

In determining whether operating expenses are "necessary," as provided in subsection (b), the court should not step beyond the bounds of Bankruptcy Code sections 903 and 904. This provision, like all others in chapter 9, are subject to the limitations of those sections. The provision should not permit the court to become involved in possible control over political or governmental functions. At most, the court should use a "business judgment" test in applying the provision, examining only whether the business judgment of the debtor's management in incurring or proposing the expenditure (or proposed expenditure) is a reasonable one. The court should not substitute its own business judgment. See Group of Institutional Investors v. Chicago M., St.P., & P.Ry. Co., 318 U.S. 523 (1943). Moreover, the phrase "operating expenses" should not be construed to exclude capital expenses or expenditures, because they may be as necessary as ordinary operating expenses to maintain the source of revenue from which bonds are to be paid.

Finally, in developing and adopting a plan of adjustment, a gross revenue pledge would be treated in the same manner as during the case, under section 927. It will be analyzed and evaluated as it provided for the use of future revenues to pay operating expenses of the system, project, or function first and debt service on the secured indebtedness second.

SECTION BY SECTION ANALYSIS

Sec. 1.

This amendment and the proposed § 902(1) (see section 3 below) go together. They make a general failure to pay debts the criterion for municipal insolvency and eligibility for filing. They replace the assets vs. liabilities test. The assets vs. liabilities test is not meaningful in the case of a municipality. See the Comment on proposed § 902(1) below.

Sec. 2.

Section 1129(a)(6) should apply to municipalities, as it does to other debtors, since municipal utilities are subject to rate regulation in a number of states.

Sec. 3.

Section 101(26) defines insolvency as debts exceeding the fair value of assets. Many municipal assets are special-purpose assets and have a highly uncertain market value, which is probably less than cost. Under these circumstances, many healthy municipalities would be treated as "insolvent". Also many municipal assets cannot be reached to pay debts, rendering the assets vs. liabilities test somewhat irrelevant to creditors. This amendment uses a more realistic test to determine whether the municipality is insolvent. It is the same as that applicable to involuntary bankruptcy under section 303(h)(1) and the alternate eligibility test for a municipality under current law. The change in § 109(c)(3) (above) is correlative to this change.

If a department of a municipality is financed by indebtedness payable solely from revenues attributable to that department a general failure or inability to pay such indebtedness as it becomes due would, if it is substantial in amount, cause the municipality to be considered insolvent.

The present tense in the definition of "insolvent" refers to the time at which the definition is important, i.e., at the petition date for purposes of § 109(c), at the transfer date for purposes of § 547, and the like.

A deliberate failure to pay indebtedness in order to create eligibility to file a petition under this chapter would be grounds for dismissal under section 921(c) as a failure to file in good faith.

The definition of special revenues is needed for the purposes of revised sections 922, 925 and 927. Examples of the special revenues mentioned in clause (a) include receipts from the operation of a municipal water or electric system.

An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (b). A general sales tax would not.

In a typical tax-increment financing public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts are part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the pre-existing tax base of the community.

Examples of revenues from particular functions under clause (d) would include regulatory fees and stamp taxes imposed for the recording of deeds.

Under clause (e) an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered special revenues. For this purpose a project or system may or may not be revenue-producing.

Sec. 4.

Where a pledge of revenues survives under section 927, it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay.

This super-priority granted by section 507(b) for a failure of adequate protection does not apply in chapter 9, Nevertheless, the creditor's loss from the automatic stay or from the granting of a priming borrowing lien should be entitled to administrative expense priority, because the creditor's loss came as a result of an attempt to benefit the postpetition debtor. This amendment makes explicit, therefore, what is implicit in section 507(b).

Sec. 5.

Section 1111(b) provides that in some circumstances nonrecourse debt may be treated as recourse debt. Many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to nonrecourse financing.

Sec. 6.

In the case of a municipality it is not considered necessary to legislate broadly against preferential treatment of bond and noteholders. There is not likely to be a high incidence of preferential treatment of these creditors and, where there is an actual intent to hinder, delay or defraud other creditors, section 548 would apply. The existing law, under which section 547 applies to municipal bonds and notes, creates unforeseen problems and uncertainties. For example, most municipal revenue bonds involve a pledge of special revenues but do not include a mortgage or other security interest on any revenue source. The application of section 547 to them could cause payments of such bonds in the normal course to be treated as preferences since the lien on revenues received during the preference period would be treated as coming into existence during the preference period and not before. In addition, the deposit of money or securities in escrow to "defease" the lien of a prior bond indenture, which is a common occurrence, could also be treated as a preference notwithstanding the absence of any preferential intent or actual damage to other creditors.

Sec. 7(a).

This section simply redisignates section numbers to provide for the new sections added by section of the bill.

Sec. 7(b).

If deemed to apply, section 552(a) could terminate the security for municipal revenue bonds upon commencement of the case where (as is usually the case) there is no mortgage or security interest on any revenue source. Paragraph (a) makes it clear that such a result is not intended. It permits a lien on special revenues to continue under state law but, under paragraph (b), a lien on project or system revenues would be subordinate to necessary operating expenses of the project or system. Necessary operating expenses are operating expenses which are necessary to keep the project or system going. Prepetition operating expenses are included to the extent payment is deemed necessary by the court for this purpose.

In the case of a project financing the lien would be subordinate to the necessary operating expenses of the project. In the case of a system financing the lien would be subordinate to the necessary operating expenses of the system. An example of a project financing would be the financing of an electric generating plant by indebtedness secured by a lien on revenues from the sale of output of the particular facility. An example of system financing would be the financing of improvements to a local electric distribution system secured by a lien on revenues of the entire system.

Subsection (b) reflects the fact that betterment assessments are levied to finance the construction costs of sewers, streets, and the like and that the operating costs are financed separately out of current user charges or taxation. In the case of bonds secured by these assessments, subordinating the lien to operating expenses would materially change the bargain.

Subsection (b) sets forth a minimum standard for paying operating expenses ahead of debt service where revenues are pledged. It is not intended to displace any broader standard contained in the terms of the pledge or applicable nonbankruptcy law.

For reasons unique to municipalities, many financing leases are required to be subject to appropriation of the rent. These are generally marketed as debt obligations and treated as debt obligations for tax purposes. They should be treated in the same way for bankruptcy purposes.

Section 943(b) of title 11 of the United States Code is amended by:

Sec. 8.

Many municipal actions require regulatory or electoral approval under constitutional, statutory or charter provisions. These approvals are not limited to rates but extend often to such other matters as the acquisition or disposition of property or the incurring of indebtedness. A plan of adjustment should not call for action to be taken without the requisite approval. Paragraph (6) does not require voter approval for the plan but only for actions to be taken under the plan which would require such approval if taken otherwise than under the plan.

Senator HEFLIN. Thank you, gentlemen.

As I understand it, there has been no court case, but it is more of anticipation that the language of the present law presents problems and that therefore you want to take remedial steps to eliminate problems that could arise?

Mr. PERKINS. That is correct. This is preventive medicine, Mr. Chairman.

Senator HEFLIN. Basically, as I understand it, what you are talking about is that your revenue bonds are specifically earmarked revenues that would come from taxes. Suppose a municipality passes a 1-cent sales tax and the municipality says that it would build a hospital from those revenues. In connection with the payment there should be, in effect, a category unto itself until that obligation has been paid and it should not become a part of any general obligation?

Mr. PERKINS. That is correct, Mr. Chairman. If that sales tax is specifically levied for that special purpose. But that is not correct if the sales tax is part of the general tax of the municipality. This is a very important distinction to preserve the general tax receipts of the municipality for the general purposes of the municipality.

Senator HEFLIN. Well, if a city also were to build a water works, say that the revenues from the water customers would be given priority to pay the obligations arising out of the construction of the water system, then that would mean that the construction costs and obligations, if it went into bankruptcy, would be recognized to come out of those revenues, as opposed to the rights of people under the general obligation to seek those revenues?

Mr. PERKINS. That is exactly correct. If those water revenues have been pledged to pay for those bonds, to finance that water system, they under this legislation would have to be used for that purpose, subject to paying operating expenses first.

Mr. KING. The fact is that under the State legislation they would have to be used to pay those bonds. All these amendments do is basically to incorporate that State law into the bankruptcy system, should that municipality have to go into reorganization.

Senator HEFLIN. And if they issue general obligation bonds and they default on the payment, the water system has been constructed. Would it depend on interpretation of the obligations and the instruments of obligation, as well the law, as to after the bonds had been completed, as to whether or not they would become—in other words, I suppose that would depend on the language, of the way the ordinance is adopted and the way the instruments of credit are involved, as to whether or not the revenue after the completion of the water works, whether they would become revenues that could go towards general obligations?

Mr. PERKINS. That would be, I believe, a question of State law and in the States in which I primarily practice those revenues would ordinarily be available to pay the general obligations to the extent that they exceeded the amount necessary to pay the water revenue bonds.

Mr. KING. I do not think that is a problem. I know in New York City and my recollection is that years and years ago the concept was that the tolls from the Triborough Bridge and other tunnels operated by the Triborough Bridge Authority would cease being collected once the cost of construction was paid off. I know that 150 years later we are still paying tolls on those bridges and in those tunnels.

I do not know if anything ever gets paid off.

Senator HEFLIN. If you go into the 16th section lands that were set aside for school purposes, some of them were sold for many varied purposes. There were various interpretations given, as to whether it ever got to the schools or not, and that sort of thing.

Is there any opposition to this bill? What are the arguments against it?

Mr. PERKINS. I am not hearing any opposition or arguments against it, Mr. Chairman.

Mr. KING. I am not aware of any opposition to it.

Senator HEFLIN. We may submit some questions in writing to you. If so, we appreciate your prompt response.

Thank you very much.

[The prepared statements of Mr. Spiotto, who was unable to testify in person, follow:]

Law Offices of

CHAPMAN AND CUTLER

a partnership including professional corporations

Theodore S. Chapman
18[illegible] 1943
Henry E. Cutler
1879 1959

111 West Monroe Street, Chicago, Illinois 60603
TWX 910-221-2103 Telex 206281
FAX (312) 701-2361
Telephone (312) 845-3000

2 North Central Avenue
Phoenix Arizona 85004
(602) 256-4060

100 Peachtree Street N.W.
Atlanta Georgia 30303
(404) 420 1420

50 South Main Street
Salt Lake City Utah 84144
(801) 533-0066

APPLICABILITY OF MUNICIPAL BANKRUPTCY AMENDMENTS

James E. Spiotto
Partner
Chapman and Cutler
111 West Monroe Street
Chicago, Illinois

June 10, 1988

Law Offices of
CHAPMAN AND CUTLER

APPLICABILITY OF MUNICIPAL BANKRUPTCY AMENDMENTS

I. SUMMARY OF PROPOSED AMENDMENTS

A. Elimination of Applicability of Section 552 to Chapter 9 Proceeding

Section 552 of the Bankruptcy Code is currently made applicable to a Chapter 9 proceeding by reference in Section 901(a) of the Bankruptcy Code. Various questions have been raised that a pledge of municipal revenue and the lien created thereby will be terminated in a municipal bankruptcy due to the application of Section 552(a) to Chapter 9. To eliminate the confusion and to confirm various state laws and constitutional provisions regarding the rights of bondholders to receive the revenues pledged to them in payment of debt obligations of a municipality, a new Section is proposed to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them.

B. Clarification of the Applicability of Section 547 and Lifting of Automatic Stay

In order to clarify that payment of a Bond or Note is not a preferential transfer under Section 547 of the Bankruptcy Code if such is made within 90 days of the filing of the Bankruptcy Petition, a new Section is proposed to be added to specifically so state. Likewise, the automatic stay that becomes effective against creditors of a municipality is made inapplicable to the payment of principal and interest on municipal bonds paid from pledged special revenues.

C. Transformation of Revenue Bond Issue Into General Obligation

In order to avoid use by a municipality in a Chapter 9 proceeding of revenues pledged pursuant to revenue bond issue, thereby allowing the relevant bondholders to transform that revenue bond issue (liability limited to project revenues) into a general obligation (full faith and credit of municipality) under the terms of Section 1111(b) of the Bankruptcy Code, Section 925 of Title 11 is proposed to be amended by adding a new subsection (b) to specifically articulate that the holder of such a revenue bond claim shall not be treated as having recourse against the debtor under Section 1111(b).

II. PURPOSE OF PROPOSED AMENDMENTS

The proposed amendments clarify current ambiguities which exist between municipal law and bankruptcy law. The proposed amendments articulate principles which have long been the premise for municipal finance but which have not been specifically stated in the Bankruptcy Code and dispel the confusion which has resulted from the general statement in Section 901 of the Bankruptcy Code that Sections 547, 552, 1111(b) are currently applicable to a Chapter 9 proceeding. The effect of these Chapter 11 sections on a municipal bankruptcy due to the unique nature of municipal finance was never considered by the drafters of the Bankruptcy Code.

III. SCOPE OF THE APPLICABILITY OF THE AMENDMENTS IF PASSED

Under long-standing principles, the municipal bankruptcy amendments should apply to any bankruptcy cases pending upon the effective date of the amendments. A discussion of the basic rules governing application of amendatory provisions of statutes was articulated by the United States Supreme Court in Bradley v. School Board of the City of Richmond, 416 U.S. 696, 711, 94 S.Ct. 2006, 2016, L.Ed.2d 476 (1974): "We anchor our holding in this case on the principle that a court is to apply the law in effect at the time it renders its decision, unless doing so would result in manifest injustice or there is a statutory direction or legislative history to the contrary." The origin and the justification for this rule are found in the words of Mr. Chief Justice Marshall in United States v. Schooner Peggy, [5 U.S.] 1 Cranch 103 [2 L.Ed. 49] (1801): "It is in the general true that the province of an appellate court is only to inquire whether a judgment when rendered was erroneous or not. But if subsequent to the judgment and before the decision of the appellate court, a law intervenes and positively changes the rule which governs, the law must be obeyed or its obligation denied. If the law be constitutional . . . I know of no court which can contest its obligation."

The rule of United States v. Schooner Peggy was clarified in Thorpe v. Housing Authority of the City of Durham, 393 U.S. 268, 89 S.Ct. 518, 21 L.Ed.2d 474 (1969), where the Supreme Court ruled that a court must apply the law in effect at the time it renders its decision, noting that the Schooner Peggy reasoning had been applied whether the change was constitutional, statutory or judicial. This principle was utilized in a case involving a bankruptcy statute in Carpenter v. Wabash Railway Company, 309 U.S. 23, 60 S.Ct. 416, 84 L.Ed. 558 (1940) (amendment to bankruptcy statute enacted while case pending for review held applicable).

The Schooner Peggy doctrine has recently been applied to amendments to the Bankruptcy Code which were effective August 13, 1981 which held that certain child support obligations were non-dischargeable. The first court to face the issue held that the amendments were applicable to pending cases on the reasoning on the Schooner Peggy case. In re: Kuehndorf, 24 B.R. 555 (W.Dist. Wis. 1982). Further, such position was adopted by the United States Court of Appeals for the Ninth Circuit in Matter of Reynolds, 726 F.2d 1420 (9th Cir. 1984).

Another rule may be applicable where legislation may be held to abrogate vested property rights. (See, e.g., Halt v. Henley, 232 U.S. 637, 34 S.Ct. 459, 58 L.Ed. 767 (1914); Union Pacific Railway Company v. Laramie Stockyards Company, 23 U.S. 190, 34 S.Ct. 101, 58 L.Ed. 179 (1913); Auffm'ordt v. Rosin, 102 U.S. 620, 26 L.Ed. 262 (1881); United States v. Security Industrial Bank, 459 U.S. 70, 103 S.Ct. 407, 74 L.Ed.2d 235 (1982). In such situations, subsequent statutes may not act to interfere with fixed property interests. However, the proposed Municipal Bankruptcy Amendments only serve to clarify long standing principles and in fact preserve rather than abrogate existing rights. Therefore, there is no reason to depart from the general rule that the Municipal Bankruptcy Amendments should apply t all pending cases on the effective date.

The application of the Amendments to cases pending as of the effective date is not a critical issue because the amendments clarify the Bankruptcy Code to eliminate conflicts with state municipal law provisions and practices. If the Amendments are not applicable to pending Chapter 9 cases as of the effective date, the Bankruptcy Court should reason to the same result given the clarification contained in the Amendments. If the Amendments are made applicable, the effect is only to less than 20

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Chapter 9 cases pending for small municipal bodies. (See attached listing of Chapter 9 cases filed since the effective date of Chapter 9). The Amendments need not specify that they are applicable to pending Chapter 9 cases and can be silent on that issue.

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CHAPTER NINE CASES FILED

June, 1988

YEAR	DEBTOR	COURT DISTRICT	DOCKET NUMBER
1980	Grimes County Municipal Utility District #1	Southern Texas	80-010948
1981	The Management Institute of San Leandro	N. California	81-02265
1981	North & South Shenango Joint Municipal Authority	W. Penn.	81-00408
1982	Wapanucka, Oklahoma	E. Oklahoma	82-00231
1982	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139
1982	Sanitary & Improvement District #5 of Cass County, Nebraska	Nebraska	82-01671
1983	Sanitary & Improvement District #4 of Lancaster County, Nebraska	Nebraska	83-01456
1983	Sanitary & Improvement District #42 of Sarpy County, Nebraska	Nebraska	83-00956
1983	Jersey City Medical Center	N. Jersey	83-00829
1983	South Tucson, Arizona	Arizona	83-00866
1983	San Jose School District	N. California	83-02387
1984	Whitley County Water District	E. Kentucky	84-00089
1984	Sanitary & Improvement District #63 of Sarpy County, Nebraska	Nebraska	84-01263
1984	Pulaski Memorial Hospital	Mo.	84-00082
1984	Wellston, Missouri	Mo.	84-01492(3)

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1985	Sanitary & Improvement District #7 of Lancaster County, Nebraska	Nebraska	85-0039
1985	Monterey County Special Health Care Authority	N. California	85-00649
1985	Sanitary and Improvement District No. 265 of Douglas County, Nebraska	Nebraska	85-2384
1985	Badger Mountain Irrigation District	Washington	03136-299
1985	Bell County Garbage and Refuse Disposal District	Kentucky	85-143
1986	Lassen Community College District	California	2-86-01379
1986	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798
1986	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885
1986	Cooper River School District	Alaska	3-86-00820
1987	Northwest Harris County Municipal Utility District No. 19	Southern Texas	87-02498-H-2-9
1987	Village of Merrill, Michigan	Michigan	87-09455
1987	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590
1987	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218
1987	Eagles Nest Metropolitan District	Colorado	87B1512E
1987	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1

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1988	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	18810005
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a partnership including professional corporations

Theodore S. Chapman
1877-1943
Henry E. Cutler
1879-1959

111 West Monroe Street, Chicago, Illinois 60603

TWX 910-221-2103 Telex 206281

FAX (312) 701-2361

Telephone (312) 845-3000

2 North Central Avenue
Phoenix, Arizona 85004
(602) 256-4060

100 Peachtree Street, N.W.
Atlanta, Georgia 30303
(404) 420-1420

50 South Main Street
Salt Lake City, Utah 84144
(801) 533-0066

CURRENT ISSUES REGARDING MUNICIPAL BANKRUPTCY

James E. Spiotto
Partner
Chapman and Cutler
Chicago, Illinois

June 10, 1988

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CHAPTER I

CURRENT PROBLEMS WITH CHAPTER 9 AND NEED FOR LEGISLATIVE CHANGE

I. *EXISTING LEGISLATION*

The Enactment of the Current Chapter 9

Current provisions regarding municipal bankruptcy find their origin in the 1970's. Having observed the deficiencies of the old Chapter IX in practice, especially with regard to New York City's problems in 1975, Congress set about creating a mechanism to be responsive to the financial troubles of a municipality. On April 8, 1976, the bill amending Chapter IX of the Bankruptcy Act was signed into law, Public Law 94-260 (hereinafter referred to as "1976 Legislation"). 90 Stat. 315 (1976). Among the major changes was the elimination of the previous requirement that the municipality obtain the prepetition consent of 51% of its creditors. The 1976 Legislation allowed the city to file for bankruptcy without the approval of its creditors and permitted the city to continue borrowing for essential government services. The provisions regarding municipal bankruptcy were further modified in the Bankruptcy Reform Act of 1978 (hereinafter referred to as the "Bankruptcy Code"), 11 U.S.C. §101 et seq., whereby Chapter IX was redesignated Chapter 9. Chapter 9 was amended slightly by the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984 (hereinafter referred to as "1984 Act"). Pub L No. 98-353. The purpose of the legislation was to cure inconsistencies and problem areas in the application of the Bankruptcy Code as experienced over the first five years under the Code. Unfortunately, the proposed amendments to Chapter 9 were not passed.

Chapter 9 is not a vehicle for elimination of debt but rather for debt adjustment. A Chapter 9 proceeding is a mechanism for a debtor municipality, through a court-supervised proceeding, to attempt to settle disputes with its creditors. Since a municipal unit cannot liquidate its assets to satisfy creditors and continue to function as a municipality, the primary purpose of the 1976 Legislation was to allow the municipal unit to continue operating while it adjusted or refinanced creditor claims. Indeed, one of the stated purposes of the Bankruptcy Code was to provide a workable procedure so that a municipality of any size that has encountered financial difficulties may work with its creditors to adjust its debts. Under this legislation, a city cannot be forced to take any specific action without the city's consent. Since the effective date of the Bankruptcy Reform Act of 1978 (October 1, 1979), there have been approximately 32 Chapter 9 petitions filed.

The causes of these recent municipal bankruptcies include large judgments which the local governments are unable to pay (South Tucson, Arizona, Wapanucka, Okla.), other court action (North and South Shenango Joint Municipal Authority), burdensome labor contracts (San Jose School Dist.), related real estate developments which went into private bankruptcy (Grimes County Municipal Utility Dist. No. 1), changes in government structure (New Jersey City Medical Center), or poor financial planning (Pleasant View Utility District).

II. CURRENT AREAS OF CONCERN REGARDING EXISTING LEGISLATION

A. Pledged Revenues

Revenue bonds generally are secured by revenues derived from the project or by a specific tax levy because municipal law prohibits the encumbrance of municipal property with mortgages. Under § 552 of the Bankruptcy Code applicable to Chapter 9, a lien terminates upon bankruptcy as to property acquired after the filing of a petition except for "proceeds, product, . . . etc." of property already subject to the lien. 11 U.S.C. § 552(b). This section invalidates the reach of after-acquired property clauses to property acquired by the debtor after the filing of the petition regardless of the validity of the lien under state law. Thus, a significant problem is created for various types of revenue bonds. The only exception is for proceeds, a term that is largely undefined by the Code or cases. (Most cases defining the term follow its use in the UCC). Unless the revenues collected after the filing of the petition can be traced as proceeds of some other property of the debtor which was subject to a lien prior to the filing, such revenues are not subject to a lien in favor of the bondholders. There is a real concern that revenues dedicated to the repayment of state and local obligations will be diverted to other purposes once a state or local government enters bankruptcy. If the municipality files for bankruptcy, Section 552(b) may permit general creditors of the municipality to seek payment from the pledged revenues. Such an interpretation would effectively destroy the distinction between general obligation debt and limited obligation debt.

It can be argued that the right to receive revenues is "property." If the trust indenture or bond resolution specifies that the lien extends to "proceeds" of such property, it can be argued that the revenues are proceeds of that property. Perhaps one should distinguish those revenues which are collected after the filing, but which are proceeds of tax assessments or levies made before the filing, from those which are assessed, levied and collected after filing. The right to collect an assessed tax, where the only matter remaining outstanding is the collection of the revenue, would seem to be "property" and the subsequent revenue would be "proceeds" thereof. [This is analogous to accounts receivable, where checks received by a debtor in collection of accounts receivable are considered to be proceeds of the preexisting accounts under the UCC, and accordingly are subject to the prepetition lien]. One possible method of solving the § 552 problem is providing, under § 545 of the Bankruptcy Code, for a statutory lien on revenues as part of the security for the bonds. Such an effective statutory lien is not terminated upon the filing of a Chapter 9 proceeding provided it is fully perfected and enforceable prior to filing. (But see the district court decision in the Badger Mountain Irrigation District case, to be discussed below, where the Court found that the holders had no right to assess in the future lands within the district for payment of the Bonds).

The application of § 552 in a Chapter 9 bankruptcy proceeding may also defy practical reality and state law mandates. As in the case of the San Jose School District, In re San Jose Unified School District, No. 5-83-02387-A-9, (B.C.N.D. Cal. 1983), the continued payment of interest to bondholders not only helps ensure the debtor's continued access to credit markets but also helps fulfill the requirement of state law that such collected funds be used to pay bondholders. Cal. Educ. Code Ann. 15251.

Accordingly, as a practical matter, even though § 552 of the Bankruptcy Code provides that the pledge is terminated, given the mandate of the law and the practical reality of municipal finance, a municipality might well ignore that provision and continue to pay the bondholders as originally promised. Municipalities such as the San Jose School District and Medley, Florida, In re City of Medley, Fla., No B68-236, (B.C.S.D. Fla. 1968), have so acted. Such disregard for § 552 can lead to a problem in obtaining confirmation of a Plan given the requirement of compliance with the provisions of the Bankruptcy Code.

In the municipal context, the simple answer to the § 552 problem is that § 904 and the Tenth Amendment prohibit the interpretation that pledges of revenues granted pursuant to state statutory or constitutional provision to bondholders can be terminated by the filing of a Chapter 9 proceeding. Further, state law prescribing a method of composition does not bind any creditor that does not consent as recognized by § 903(1) of the Bankruptcy Code. Likewise, under the contract clause of the Constitution (Article I, Section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a Chapter 9 proceeding. See United States Trust Co. v. New Jersey, 431 U.S. 1073 (1977); Davies v. Minneapolis, 316 N.W.2d 498 (Minn., 1982). However, clarification of the law is necessary.

B. *Payments to Retire Bonds as Preferences*

It may be argued that a lien on revenues collected by a municipality during 90 days prior to the filing of a petition in bankruptcy pursuant to Chapter 9 is a voidable preference because § 547(e)(3) of the Bankruptcy Code, applicable to Chapter 9, 11 U.S.C. § 901, provides that a transfer (including transfer of a security interest) is not made until the debtor has rights in the property. A debtor does not acquire rights in revenues until the tax or assessment is levied or the service from which the revenue is derived is provided. Under this view, to the extent that the pledge of such revenues would give a creditor more than he would otherwise receive in liquidation, the attempt to create a security interest therein would constitute a voidable preference. Thus, Section 547(e)(3) may have the effect of making the date of termination of preexisting liens on revenues a date ninety days prior to filing. In certain instances, this would result in demands for repayment of principal and interest received by revenue bondholders during the ninety day period. How such money is to be collected from the holders of a widely held issue is not clear.

However, pledged municipal revenues may fall within the exception to voidable preferences relating to exchanges for new value. 11 U.S.C. § 547. See §9-306 of Uniform Commercial Code. Another view is that the pledged municipal revenues constitute "receivables" and hence only a partial preference results, to the extent of any net reduction in the excess of the secured claim over the value of the security. Section 547(a)(3) of the Bankruptcy Code defines a receivable as "a right to payment, whether or not such right has been earned by performance." (Note: the definition is broader than that of the Uniform Commercial Code for "accounts"). Also, in the municipal finance context, if the lien on future revenues is voided as a preference, the result is at odds with public policy and state enabling legislation which almost invariably provides that pledges of such revenues are effective when made and good against other creditors.

If proceeds of a new bond issue (i.e., a "refunding issue") acquired during the preference period are specifically designated by the terms of the issue to be used to defease a prior indenture (predating the preference period) then probably no preference problems are presented. Generally, new unsecured loans or payments to creditors by a third party are not transfers of debtor's property. If the property is never in the debtor's estate but goes directly from a third party to creditor, the estate of debtor is not diminished. If the debtor gives new security for the refunding bond issue, then it may be argued that there is a diminution of the estate and there is a preferential transfer to the extent of collateral's value. See Virginia Nat. Bank v. Woodson, 329 F.2d 836 (CA4, 1964); Steel Structures, Inc. v. Star Mfg. Co., 466 F.2d 207, 217 (CA6, 1972); Grubb v. General Contract Purchasing Corp., 94 F.2d 70, 72 (CA2, 1938); National Bank of Newport v. National Kerkimer County Bank, 225 U.S. 178 (1912).

Similarly, use of funds deposited in a debt service reserve fund or with an indenture trustee prior to the preference period and paid out to bondholders during the preference period probably is not a voidable preference. The "transfer" occurred before the preference period, and the debtor's estate was not diminished. No additional security was given. Also, a payment into a debt reserve service fund during such preference period may be argued not to be a preference if funds were previously pledged and collected prior to the preference period.

By reason of § 547(e)(3) of the Bankruptcy Code, the use of other previously accumulated revenues to retire bonds or defease an indenture during the preference period probably constitutes a preference to the extent the funds were received during the preference period. Any other payment to defease an indenture or retire bonds or to pay interest during the preference period probably constitutes a preference. A defeasance by advance refunding raises concerns because interest rate differences on the two issues means that principal amounts differ, resulting in a possible preference. Troubled municipalities which desperately need additional financing may experience the reluctance of the market to purchase securities because under the Bankruptcy Code a refunding issue might be termed a preference or the payment of pledged revenues within the 90 day period would be deemed under Section 547 to be a preference.

C. *Transformation of Revenue Bond Issue Into General Obligation*

The Bankruptcy Code can be interpreted as changing the very essence of certain municipal obligations upon the filing of a Chapter 9 proceeding. Section 1111(b) can be interpreted as converting revenue bondholders from creditors with rights to certain specific revenues into general creditors with a claim against the full faith and credit of the municipality. For example, if a pledge of future revenues is defeated by §§ 547(e)(3) and 552 of the Bankruptcy Code as a preference or as an impermissible postpetition lien, or if a municipality seeks to use property of the estate which is secured by a lien on revenues which is without recourse to the municipality, as would be the case in a revenue bond issue, the revenue bonds may be transformed into, in effect, a recourse claim changing a revenue bond issue into a general obligation of the debtor.

Under § 1111(b) of the Bankruptcy Code, the bondholders may elect as a class to have their entire claim treated as secured by the revenues or as with recourse. Such an election to be secured by revenues cannot be made if the collateral revenues pledged or held are used by the debtor for other purposes or "sold" (pledged for other purposes) under the plan. Even revenue bonds arguably should be treated by the holders as providing "recourse" against the debtor because of the state law liability of the debtor for pledging future revenues. Even if the bonds are treated as nonrecourse, where the revenues are used for other purposes or "sold", the separate unsecured portion pursuant to the plan would be an allowable recourse claim. See First Nat. Bank of Colorado Springs v. Hamilton, 8 BCD 1116, 18 BR 868, 6 CBC 2d 482 (D. Colo. 1982); In re Whitaker, 8 BCD 1187, 18 BR 314, 6 CBC 2d 205 (D. Kan. 1982).

Moreover, even if a creditor makes an election under § 1111(b) to transform a nonrecourse claim into a recourse claim, the question is posed whether the revenue issue is transformed, in effect, into a general obligation of the municipal body contrary to the state constitutional or statutory debt limitation. The problem is created by using private corporate debt principles and applying them in a municipal financing context. While nonrecourse financing is a method of "off balance sheet" financing with a lien against certain assets so that if the assets are sold or the lien terminated by bankruptcy, the resulting election of recourse or nonrecourse actually preserves the benefit of the bargain payment for the debt. However, in the municipal context, the benefit of the bargain is solely the revenues from the project and never the full faith and credit of the municipality. This essential difference and balancing of risk demonstrates the different perspectives regarding the application of § 1111(b) to a private corporation financing as compared to a municipal financing. Further, the effect of the application of § 1111(b) to municipal financing is prohibited by § 904; the transformation of revenue bond (non-recourse) financing into general obligation bond (recourse) financing permits municipalities to violate state statutory and constitutional provisions which prohibit such recourse debt (general obligation bonds) above a certain percentage of assessed value or other limits without voter approval.

III. CLEVELAND, THE SAN JOSE SCHOOL DISTRICT, MEDLEY, FLORIDA, AND BADGER MOUNTAIN IRRIGATION DISTRICT

In 1979, the City of Cleveland faced a real financial emergency caused by borrowing to pay overdue debts. The city's bank lenders were unwilling to lend to Cleveland at that time in part because of the fear of the applicability of Section 552 of the Bankruptcy Code. The lenders feared the application of the concept that a lien on after-acquired property will not attach to property acquired after bankruptcy by a reorganizing debtor, unless the property acquired after bankruptcy constitutes proceeds of property held at the time of filing. Attempts to clarify the law at that time were not successful and a resort to municipal bankruptcy never considered by Cleveland.

The thirty two cases which have been filed since October 1, 1979 under Chapter 9 of the Bankruptcy Code will provide examples of the application of the above cited sections. One of the largest cases has been that of the San Jose Schcol District which instituted a Chapter 9 proceeding on June 30, 1983.

At the time of the filing, the average teacher in the school district made $27,000 a year. The labor problems, coupled with the Proposition 13 restrictions, were apparently the primary causes of the municipal insolvency as indicated by the school district's list of its 20 largest creditors. While the school district showed indebtedness to utilities such as Pacific Telephone and San Jose Water Works, the vast majority of creditors appeared to be individual teachers.

Bonded debt was not listed by the school district as part of the debt to be reorganized. Prior to 1978, the school district had issued general obligation bonds pursuant to the California Education Code. Section 15250 of the Education Code of California provides that it is the duty of the board of supervisors of the county to levy taxes sufficient to pay the principal, interest and an annual reserve to insure required payments of bonds issued by such school districts. Furthermore, § 15251 indicates that the proceeds of such levies can be used only for payment of principal and interest of the bonds. By its terms, Article XIIIB § 1 of the California Constitution, commonly known as Proposition 13, indicated that nothing in Proposition 13 should be construed to impair the ability of any local government to meet its obligations with respect to existing bonded indebtedness. Moreover, Article XIIIB excluded from the limitation taxes necessary to pay the principal and interest on indebtedness incurred prior to the adoption of Proposition 13.

Therefore, the San Jose School District made it clear that it did not in any way intend to impair the rights of its bondholders by this bankruptcy. Accordingly, the

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school district stated that the bonds were secured by a property tax assessed by the county controller's office on property within the school district at rates sufficient to make principal and interest payments. Since the school district had neither the authority to levy taxes nor access to bond reserve funds in the controller's office, the school district argued that the bondholders were not proper parties to the bankruptcy proceedings.

On February 7, 1984, the school district filed its Plan of Reorganization with the court. From the papers filed, it is clear that the claims of the bondholders remained unimpaired by the Plan. In the spring of 1984, the school district resolved its differences with its employees. The settlement gave the employees approximately 60% of the increases promised in prior years. Therefore, on June 8, 1984, the Chapter 9 proceeding was dismissed.

The San Jose School District filed bankruptcy at the same time that an interest payment was due to its bondholders. The school district allowed the tax funds which had been collected to be used to pay the interest payment which was due at the time the school district filed its Chapter 9 proceeding. Accordingly, the § 547 "voidable preference" argument was purportedly rejected by the school district as inappropriate. This was clear recognition by that state and school district of the continuing duty of municipalities to pay the obligations which they have incurred. Further, with regard to § 552(a) of the Bankruptcy Code, the San Jose School District did not treat the pledge, given to the bondholders pursuant to the California statutes and the bond resolution, as terminated but rather, during bankruptcy, continued to collect taxes and make payments to the bondholders. It is clear that the San Jose School District clearly recognized the need for continuing financing through the municipal bond market and decided that it would be inappropriate and detrimental to the municipality's continued operation to strictly follow §§ 547 and 552 so as to confirm its plan under § 943(b)(1).

The conclusion reached by the San Jose School District is not unprecedented. In 1968, the City of Medley, Florida, a small city of approximately 350 people, instituted a Chapter IX proceeding. The City was then involved in numerous judgments and writs of mandamus issued in favor of creditors. The City stated that it did not seek in the Chapter IX proceeding to adjust the $850,000 bonded indebtedness but only $700,000 of nonbonded indebtedness. The City proceeded to propose a plan not altering or impairing bonded indebtedness but merely extending the repayment of its nonbonded indebtedness by up to ten years.

It is clear that in practice, §§ 547, 552(a) and 1111(b) which were created by the Bankruptcy Code after the Medley case, if strictly applied, could seriously impair not only the ability of the municipality in a Chapter 9 proceeding to obtain continued financing, but also the ability of other municipalities to obtain needed municipal financing.

A recent Chapter 9 case has raised the issue of the nature and extent of a lien of bondholders in a Chapter 9 case. Unlike the San Jose School District, the Debtor here sought to attack the secured status of the bondholders. In re Badger Mountain Irrigation District, Secured Bondholder Committee v. Badger Mountain Irrigation District, U.S. District Court, Eastern District of Washington, No. C-87-161-RJM, the District Court rejected the position of the Debtor that the statutory and consensual lien of the holders was avoidable in Bankruptcy under §§ 544, 545 or 552. The court chided the District regarding its attempts to walk away from its obligations to the holders. However, the bondholders argued that their lien covered, not just the physical property owned by the District, but the power of the District to assess in the future bonds within its boundaries for payment on the bonds. The court found that such would amount to the conferral of the power to tax upon individuals. The result is to render the bondholders unsecured with respect to future assessments of lands within the District but not owned by the District. If the decision is allowed to stand, Chapter 9 will likely be viewed with disfavor by investors in municipal securities dispute the court's refusal to set aside the lien of the holders because of the filing. The bondholders' motion to reconsider was denied on November 12, 1987, and an appeal by the bondholders and cross-appeal by the District is pending in the Ninth Circuit.

IV. *CHAPTER 9 HAS NOT BEEN VIEWED AS A REAL ALTERNATIVE BY MOST MUNICIPALITIES*

While Chapter 9 may be viewed as an option by special tax districts and other small special purpose municipal corporations, a review of the entities filing Chapter 9's since the effective date of the Bankruptcy Code reveals that the Chapter is not widely utilized. Any entity which is subject to political dynamics appears to view Chapter 9 as a step to be avoided. It is well known that, currently, schools, housing and mass transit are facing severe hardships. Yet, for example, in Illinois alone, neither the Chicago Housing Authority, when faced with the appointment of a receiver, or the Chicago Skyway, when faced with default, losses, and lengthy litigation, have chosen Chapter 9 as a means of debt adjustment. Some courts have found that defaulted municipal debt can be compromised outside of Chapter 9, see, e.g., Centerre Trust Co. v. Jackson Saw Mill Co., 736 S.W.2d 486 (Mo. Ct. App. 1987), and municipalities and debt holders alike seem to be more comfortable outside of a Chapter 9 proceeding. Clearly, much of this reluctance is due to the uncertainty of the effect of Chapter 9 on municipal debt. The future may present great problems for municipalities in the form of pension and toxic waste liability. The viability of Chapter 9 as means of survival for municipalities may well depend on the adoption of the proposed legislation.

V. *BENEFITS OF PROPOSED LEGISLATION*

Sections 547, 552(a), and 1111(b) of the Bankruptcy Code are not headless nails, which, once put into Chapter 9, are difficult or impossible to remove. In fact, the removal of §§ 547, 552(a), and 1111(b) from Chapter 9 as to bond indebtedness is not only simple and painless but in conformity with the law and reality of municipal finance. It is clear that municipalities, and, most specifically small and medium sized municipalities, may very well need to avail themselves of a Chapter 9 proceeding. However, given the uncertainties that §§ 552(a), 547, and 1111(b) place on bonded indebtedness, municipalities will continue to refrain from using Chapter 9 rather than risk their ability for future financing through the municipal bond market. It has been the municipal bond market, at least up to th is point, which has been the life blood of municipal financing in this country. The constitutional dilemmas presented by §§ 547, 552, and 1111(b) are a further incentive to eliminate sections of the Bankruptcy Code which may be determined to be unconstitutional as applied to Chapter 9.

It is up to Congress to decide whether or not, given present economic conditions, municipalities should be able to use in an effective manner Chapter 9 proceedings to help resolve their financial crises. If Congress desires effective use of a Chapter 9 proceeding, the only way to avoid the stigma of a Chapter 9 proceeding in the municipal bond market is to assure that the statutory and constitutional pledges and rights granted to bondholders remain in effect during the Chapter 9 proceeding and that the adverse effects of §§ 547, 552(a), 1111(b) and other provisions are eliminated. If Congress decides Chapter 9 should not be used effectively by municipalities, the law and the Code can remain unchanged and municipalities will, as has been the practice in the last four years, use Chapter 9 rarely, if at all. Since there appears to be no benefit in having an ineffective and seldom-used Chapter 9, the proposed legislative changes are warranted.

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Municipalities vitally need access to the municipal bond market for the continued financing necessary for public improvements. Municipalities have been reluctant to consider a Chapter 9 proceeding given the stigma of such action due in part to the adverse effects of §§ 547, 552(a), and 1111(b) on bonded indebtedness. Municipalities, and, in particular, small and medium sized municipalities, need to consider the use of a Chapter 9 given the significant cash flow problems projected for the near future. The proposed legislation will allow municipalities to consider the use of a Chapter 9 proceeding. Without the proposed legislation, municipalities will either not use Chapter 9 or, as in the case of the San Jose School District, proceed contrary to the express terms of §§ 547, 552(a), and 1111(b) if such is in the best interest of the municipality and its constituents.

The best way to analyze the need for and benefit of the proposed legislation is to put oneself in the position of the municipal bond market and to ask whether you would extend credit to a financial troubled municipality realizing that:

1. Any pledge of revenues or payment within ninety days of the filing of a Chapter 9 will be terminated and any payment received must be repaid under § 547 of the Bankruptcy Code; and

2. Any pledge of revenues, notwithstanding state constitutional and statutory guarantees, will be terminated on the filing of a Chapter 9 and the agreed upon source of payment will not be available.

The answer to the question is clear, and so is the need and benefit of the proposed legislation.

CHAPTER II

MUNICIPAL DEFAULTS AND BANKRUPTCY: MYTH AND REALITY

There is a saying that "while doctors bury their mistakes, in municipal financing, they are refunded." There comes a time, however, when certain mistakes cannot be refunded. Given present conditions, the probability has increased that a municipality will be faced with a bond default and will consider instituting a proceeding for municipal debt adjustment under Chapter 9 of the Bankruptcy Code. It is important that certain myths that exist concerning municipal bond defaults and municipal bankruptcy are dispelled and that the municipal bond market is aware from an historical and legal basis of the true reality.

REASONS FOR DEFAULT

Before discussing myths and realities, it is important to note briefly that defaults occur for at least one of the following reasons:

1. GENERAL ECONOMIC CONDITIONS are such that the municipality cannot pay from its current revenues its current obligations as they become due and provide the type of service necessary for operation of the municipal body. The "Proposition 13" mentality is one of the manifestations of the difficulties of continually increasing tax levies in order to pay for increasing costs of municipal services.

2. INCOMPETENCY OF MANAGEMENT of the municipal body in failing to increase revenues to meet costs.

3. FRAUD AND DISHONESTY by municipal officials by either abusing their powers and misusing municipal financing for their own political profit and gain or by actually converting municipal funds to their own personal benefit.

The problem of municipal default and bankruptcy is today more of a concern than it was in the past forty years. There currently exist a number of factors which tend to make it more difficult for certain municipalities to be able to meet their municipal obligations as they become due. These factors include the following:

1. Movement in both population and manufacturing capabilities from the snowbelt to the sunbelt. (This is due not only to climate but also to the perception of individuals and corporations that there are higher tax levies in certain snowbelt states).

2. The decline of urban areas and the present need in the 1980's for major capital improvements and repairs in many metropolitan areas.

3. The increasing percentage of municipal budgets devoted to the cost of personnel and personnel-related expenses which for the most part have been tied to cost of living increases and at times somewhat unrealistic union contracts.

4. The growing unrest among taxpayers in the face of increasing taxation without commensurate increase of benefits. "Proposition 13" mentality is just the beginning of that manifestation which should continue during the 1980's.

5. Adverse effects of inflation which have significantly increased the cost of maintenance, repair and operation of a municipality beyond what was projected at the time many municipal obligations were assumed.

It was the defaults in the latter part of the 1800's and the beginning part of the 1900's that brought about changes in procedures, documents, and structuring in municipal finance in order to reduce the rate of municipal defaults. Any future increase in municipal bond defaults most likely will be met with appropriate corrective action mandated by the municipal bond market as was done in the past.

MYTH I:

THE DEFAULT RATE FOR MUNICIPAL BONDS IS APPROXIMATELY THE SAME AS THAT FOR CORPORATE BONDS.

REALITY

The first recorded default of a municipal obligation was the city of Mobile in 1839 which was a default of an issue in the principal amount of $513,000. After 1839, numerous municipalities and states failed to pay their debt obligations. During the 1850's and 60's, such cities as San Francisco, Philadelphia, Detroit and Chicago defaulted on their municipal bonds. One of the causes was the excessive cost of municipal financing. Another reason for municipal default was speculation by municipalities in real estate and other ventures unrelated to necessary municipal services that such bodies were established to perform.

Approximately 77% of all municipal defaults occurred during the 1930's when 4,770 municipal units defaulted in the payment of interest or principal on some 10% of the then outstanding total of $15 billion of municipal bonds. The default rate for corporate bonds was greater. By way of comparison, for example, in 1932 there were defaults in 1.8% of all municipal bonds, 3.5% of railroad bonds, 5.4% of public utility bonds, 7.2% of industrial bonds and 19.4% of all foreign bonds. Thereafter, in the 1930's, the respective percentages increased, but, for the most part, the lowest percentage of principal amount of outstanding bonds in default was in municipal bonds.

Approximately 75% of all municipal bond defaults have occurred in bonds issued by a municipality to finance revenue producing enterprises (i.e., highways, bridges, utilities, swimming pools, harbors, etc.). During the 1940's, there were only 79 defaults by municipal bodies on indebtedness; during the 50's, 112; and during the 60's, 294. As we progress into the present economic times, the defaults increase.

Between 1945 and 1970, there were $450,000,000 of principal amount of municipal bonds which went into default constituting .4% of the principal amount outstanding of all municipal bonds in 1970. In one year, 1970, .9% of the outstanding of all corporate bonds or $1,005,000,000 of corporate bonds went into default.

While the default rate per principal amount of outstanding corporate bonds went down from 3.2% in the 1930's to 4% in the 1940's, .04% in the 1950's, .03% in the 1960's, it has risen to approximately .2% in the 1970's and appears to equal or exceed the 1940's rate in the first part of the 1980's. Between 1966 and 1977, there were over $2.5 billion in principal amount of corporate bonds which went into default as compared with

1986 when the Petition filed in the LTV Bankruptcy resulted in the default of $2.2 billion in long-term debt, mostly debentures held by many mutual funds. According to Standard & Poor's Corporation, United States corporations defaulted on $9 billion of debt in 1987. Texaco, Inc. and Public Service Company of New Hampshire accounted for about $8 billion of last year's defaults.

The Pacific States (Alaska, California, Hawaii, Oregon and Washington) had 654 municipal units default in the payment of principal or interest from 1839-1969; of these 520 (79%) occurred during 1930-1939; 5 during 1940s; 1 during 1950's; 13 during 1960's. The Mountain States (Colorado, Idaho, Montana, Nevada, Utah and Wyoming) had 329 municipal units default in the payment of principal or interest from 1839-1969); of these, 270 (82%) occurred during 1930-1939; 6 during the 1940's; 4 during the 1950's; 3 during the 1960's.

It has been true in the past that the percentage of principal amount of municipal bonds that are in default is less than the percentage of principal amount of corporate bonds that are in default. This fact is due in part to the constructive response which the municipal bond market has made to the problems of the past.

The total principal amount of the WPPSS Bonds of approximately $8.3 billion is equal to approximately 2.4% of the U.S. municipal debt currently outstanding. In 1975, New York City had approximately $14 Billion of principal amount of Bonds and Notes outstanding of which approximately $6 Billion was Short Term Debt (Notes). In 1976, with the help of the federal government, New York City proceeded to avoid bankruptcy and to workout of the troubled situation. The LTV Bankruptcy triggered defaults in more than $550 million of outstanding tax-exempt pollution control bonds. Technically, Texaco's municipal debt was not included in the bankruptcy filings of Texaco, Inc., the holding company, and its two finance subsidiaries, Texaco Capital and Texaco Capital N.V. The subsidiaries responsible for paying the municipal debt, Texaco Refining and Marketing (R&M) and Texaco Convent Refining, Inc. were not the subject of Chapter 11 filings.

MYTH II:

MUNICIPAL BANKRUPTCY IS JUST AS COMMON AS CORPORATE BANKRUPTCY.

REALITY

From 1937 when the Municipal Bankruptcy Act was passed to 1972, there were over 362 cases filed involving municipal bodies. These 362 cases involved admitted debts of approximately $217 million. The amount paid on such debts exceeded $140 million and the amount of the loss was approximately $77 million. For the most part, municipal bondholders in such Chapter IX proceedings received principal and interest on their bonds, the only modification being either an extension of the maturity date or a reduction in the interest rate. It was the trade creditors and employees of municipalities who for the most part suffered the losses in such proceedings. Between 1972 and October 1, 1982, nine cases were filed under Chapter IX by municipal bodies. Since the enacting of the Bankruptcy Code which became effective on October 1, 1979, there have been only 32 Chapter 9 bankruptcy proceedings instituted involving special tax districts and small municipalities or counties. In contrast, there were over 88,278 business bankruptcies filed in the United States in 1987. Bankruptcy has been viewed by some financially troubled corporations as a safe harbor; however, there are serious adverse effects to financially troubled municipalities instituting a Chapter 9 proceeding.

MYTH III:

MUNICIPAL DEFAULTS HAVE LITTLE EFFECT ON THE MUNICIPAL BOND MARKET AND THE DEFAULTING MUNICIPALITY'S ABILITY TO OBTAIN FUTURE FINANCING.

REALITY

At the time of the first municipal default in the city of Mobile in 1839, commentators were quite apologetic for the city citing two major fires in 1839, the panic of 1837, and a resulting yellow fever epidemic as some of the factors that caused this then unprecedented municipal default. Thereafter, there were defaults by various cities in the 1850's and the 1860's. A somewhat graver situation was the fact that in the 1840s, 50's and 60's, a number of states repudiated their indebtedness to bondholders. The first such repudiation was by Mississippi in the 1840's. Florida, Alabama, North Carolina, South Carolina, Georgia, Louisiana, Arkansas, Tennessee, Minnesota, Michigan, and Virginia also repudiated their indebtedness in the late 1800's. Such repudiation along with the defaults that occurred in the 1800's brought into question the security of investment in municipal obligations. It was the municipal bond market which reacted to these defaults and demanded that there be appropriate changes and assurances given in order to insure the security of investment in municipal obligations. As a result of the problems referred to above, legislation was enacted to give bondholders greater rights and protection in order to prevent unnecessary defaults on municipal obligations. The municipal bond market in effect mandated changes in documentation, legal authorization, and structure of municipal financing which now are considered basic. Such changes included:

a. debt limitations on municipal issues to prevent excessive borrowing caused by speculative growth in real estate valuation;

b. clearly defined bondholder rights in the event of default supported by statutory and case law;

c. use of bond counsel to determine the legality of a bond issue before the sale to avoid technical legal defects that could allow an Issuer to repudiate the debt;

d. development of credit rating agencies as well as thorough credit review by investment firms and many institutional investors;

e. statutory restrictions against municipal issuers borrowing for chronic deficiencies; and

f. the use of indenture trustees, paying agents, and others who have certain fiduciary duties in order to protect the rights and interests of bondholders.

It is clear that whenever municipal bond defaults have become a significant percentage of the outstanding municipal bonds, the municipal bond market has reacted and demanded that there be corrective action in order to insure payment of principal and interest when such becomes due. Whenever any municipality believed it could avoid a payment to bondholders based on technical legal arguments or present economic conditions, the past has demonstrated the price for avoiding such payment is quite high and the ability to obtain financing from the municipal bond market in the future quite questionable.

MYTH IV:

REMEDIES AVAILABLE TO MUNICIPAL BONDHOLDERS ARE IDENTICAL TO THOSE AVAILABLE TO CORPORATE BONDHOLDERS IN A DEFAULT SITUATION.

REALITY

There are significant differences between the types of remedies available to municipal bondholders in a default situation and those available to the holders of corporate bonds. In a municipal default, unlike a default on corporate bonds, the bondholders cannot seize collateral or pledge or attach property of the municipality, initiate a bankruptcy proceeding for the municipality, or liquidate the assets of the municipality. The usual remedies available to a municipal bondholder include the following:

1. Acceleration. The documentation for both corporate and municipal bonds normally provides that upon the occurrence of an event of default as defined in those documents, the bondholders by a certain percentage (normally 25% or more), or the indenture trustee may declare the principal and all accrued and unpaid interest immediately due and payable. It is important for the municipal bondholders to understand the effects of acceleration and the relative benefits and detriment to holders. It is not necessary to accelerate for the institution of equitable remedies or to file a proof of claim in a bankruptcy proceeding or to seek appropriate non-accelerated remedies. For example, in a default by a municipality in failing to comply with a covenant in the indenture such as maintaining a certain ratio between tax revenues and existing obligations, that breach can be enforced through the institution of an appropriate legal action seeking to require a municipality to comply with the terms and there is no need for acceleration. Also, if there is an impairment in the security of the issue on account of certain persons connected with a municipality maintaining that the pledge of revenues is invalid, bondholders or the indenture trustee may institute an action seeking an appropriate declaratory judgment resolving the matter without acceleration. Generally, acceleration is necessary if one desires to obtain: (a) an increased interest rate as may be provided for in the documents upon the occurrence of acceleration or (b) a judgment or deficiency judgment for principal and accrued and unpaid interest against the obligor. As a practical matter, acceleration decreases the ease and ability of the municipality to cure a default. The waiver of acceleration of a widely held public issue is difficult to achieve. Normally, it requires a higher percentage (50% or more) to rescind than to accelerate (25% or less). It is important for the municipal bondholder (including underwriters and dealers) to remember there are few benefits to acceleration and there are difficulties that are created by acceleration since the municipality is faced with the demand for immediate payment of the full amount of principal and accrued and unpaid interest which may paralyze the ability of the municipality to ever cure the default.

2. Institution of lawsuits.

(a) Request for monetary judgment. Bondholders may institute a lawsuit requesting the municipality to take action to immediately pay all amounts due and owing to the bondholders or otherwise cure the default by a suit for money judgment, mandamus, specific performance or other equitable relief.

Bondholders have a right to sue on their bonds for past due interest or principal without requesting the indenture trustee or other party to take action. As we have seen in the case of New York City, the municipal body can take no action to seek a moratorium against suits by bondholders for past due principal and interest except to rely upon the automatic stay that occurs upon filing a petition under Chapter 9 of the Bankruptcy Code as will be discussed later. Generally, the indenture should have a prohibition of the payment upon default of coupons detached from the bonds prior to the payment of the bonds. The purpose of such a provision is to prevent the trading of coupons, the purchasing of coupons and the directing of the trustee or others to take actions based upon a discounted purchase of such coupons which had been detached from the bonds.

(b) The collection of a money judgment. A money judgment against a municipality is complicated by the fact that, generally, the courts, on public policy grounds, do not allow the seizing of municipal property to pay the municipality's debts and obligations since the seizure would disrupt local government. Some courts have held that if there are funds which are surplus and not dedicated for any public purpose, a bondholder may be able to attach and obtain those funds which are purely surplus and not necessary for the normal operation of the municipality. Likewise, in the absence of specific statutory authority for seizure of private property in order to satisfy a judgment on a defaulted bond, there can be no remedy directed to the property held by the resident or the inhabitant of a municipal body.

(c) Mandamus action. Given the difficulties of collecting on money judgments against a municipal body, an available and most appropriate remedy to bondholders of defaulted municipal bonds that are without recourse to specific collateral is to proceed with an action in mandamus ordering the municipal body to increase taxes sufficiently to pay the obligation owed to the bondholders. However, bondholders in a mancamus action cannot require the municipal body to levy a tax which would exceed the applicable constitutional or statutory debt limitations. There are, too, practical problems in a mandamus action such as vacancies in offices, resignation by municipal officers thereby mooting the effect of any mandamus (command to a ministerial officer to levy taxes to pay the amount due) without the bondholders or the court having a right to cause such vacancies to be filled. The only alternative the court has if a municipality refuses to act as ordered by the court in the mandamus action is to hold the officers in contempt and render civil or criminal penalties. If there have been any improper expenditures by the municipal body or if other action is taken which impairs the security for the obligation, injunctive relief may be sought. It should be apparent given the problems inherent in other forms of relief that such equitable and declaratory action should be sought first before resorting to other remedies.

3. Municipal Insolvency: Debt Adjustment.

If a municipal body cannot pay its municipal obligations as they become due, it may consider proceeding to seek remedies under Chapter 9 of the Bankruptcy Code. Even if a court were to determine that a municipality was in fact insolvent and its revenues were not sufficient to meet its current debt obligations, as a practical matter, such determination would be of little help to the bondholders since there would be certain necessary expenses in order to generate any municipal revenue that a municipal body would have to incur and there would be a significant question of whether liquidating municipal assets in an insolvency situation is in the best interests of the bondholders. There is no authority for the proposition that poverty may be successfully interposed as a defense to the payment of lawful obligations. There is some thought that if bondholders obtain a judgment against a municipality, they have a benefit if that municipality is later declared insolvent. However, given the new Chapter 9 provisions, it appears to make little difference whether one is a bondholder or a judgment creditor of a municipality. Obviously, a municipality on its own or at the urging of the bondholders may seek relief under the federal bankruptcy law. A Chapter 9 proceeding can only be instituted by the municipal taxing body and, unlike the corporate situation, such a proceeding cannot be instituted by creditors involuntarily against the municipality.

4. Appointment or Use of Consultants, Financial Advisors or Financing Authorities.

In troubled financial situations, where the municipality lacks the confidence of the investing public that the municipality will continue to make the right decisions with regard to its operations, there exists a possible solution whereby such confidence can be increased by the use of financial advisers or financing authorities. In such use, the municipality should be able to proceed with operations without the threat of continued default and exercise of remedies. Some defaults may have as their most appropriate cure appointment or use of a consultant or financial advisor to guide the municipality to the degree permitted by law in the operation and management of the enterprise involved. Legislatures and other governmental bodies have desired to aid in a default situation by the establishment of a finance authority with the powers to issue debt obligations and set or approve an appropriate budget for municipal bodies in question. It should be remembered that consultants, financial advisors or financing authorities cannot alter the bondholders' rights and remedies without consent. Such consultants, advisors or authorities cannot improperly exercise the power of a municipal body which they supervise or have an improper delegation by the municipal body of the powers that are vested in the troubled municipality.

5. Tax-exempt Conduit Financing.

When the municipal bonds are based upon tax-exempt conduit financing either for industrial development or social benefits of the municipal body and its inhabitants, there is normally provided an alternative source of recovery for the bondholders other than the governmental body's ability to levy taxes to pay off the indebtedness. The collateral takes the form of a guaranty by a corporation of the indebtedness to the bondholders and a mortgage or a security interest in the collateral which is financed by the tax-exempt bonds. In these situations, the municipality should be aware that these financings are structured as revenue bond issues and that the municipal body is not liable for the indebtedness incurred but is merely used as the conduit for the public purpose financing which has been approved by that municipal body. The remedies of the bondholders should not be directed against the municipality as such remedies are outlined above but rather against the collateral and the corporation which has received the benefits of such conduit financing. Some of the specific remedies regarding conduit municipal financing are as follows: (a) request for judicial foreclosure and sale of collateral, (b) non-judicial sale of collateral, (c) suit against guarantor, and (d) right of entry.

6. Filing Proof of Claim in Bankruptcy.

The bondholders may file a proof of claim in bankruptcy for the amount of the bonds they hold. The indenture trustee has the authority under most indentures to file a proof of claim on behalf of all bondholders whether bankruptcy be of the municipality or of the conduit tax-exempt financing of the corporation which was liable on the bonds. The indenture trustee is not authorized to vote on a plan of reorganization or debt adjustment; however, the Indenture trustee may object to plans of reorganization and should object to plans of reorganization that such trustee knows are woefully inadequate or not appropriate. Likewise, a municipality in a tax-exempt conduit financing is not liable on the bonds but has a fiduciary duty to the bondholders to file a proof of claim, if appropriate, or to object to any plan of reorganization which in the opinion of the municipality is not in the best interests of the municipality and the bondholders.

7. Security Fraud Action.

One court has held that the Tenth Amendment to the U.S. Constitution does not protect a municipality's issuance of industrial revenue bonds from the application of the federal securities laws since the issuance of such bonds does not rise to the level of traditional governmental functions. There is a recent trend in case law towards increasing the use of federal security fraud actions against issuers, underwriters and others, including municipalities. The best defense to such actions is the careful consideration of tax-exempt conduit financing in order to insure that the bondholders and the municipality do not become victims of a prearranged scheme to defraud both of them. Security fraud action should be one of the last remedies to be taken.

8. Supplemental Indenture.

Almost every indenture provides and should provide a mechanism of allowing the indenture to be supplemented or modified with or without appropriate approval of the bondholders. Modification of the indenture without consent of the bondholders is only proper when it does not affect the rights of the holders or if the modification gives additional security to the holders. Supplemental indentures have been successfully used when the approval of the holders is necessary in order to resolve the defaulted Issue and the proposal is deemed to be meritorious by the holders.

9. Recision Of Acceleration And Waiver Of Default.

Sometimes the obligor after being informed of the acceleration of an issue might be able to cure the defaults that caused acceleration but may not be able to get the required approval of the bondholders to rescind the acceleration. The indenture should provide that acceleration, notice to sell collateral or entry of final judgment or decree against a municipality can be rescinded and annulled if the obligor pays all amounts due and owing plus fees and expenses of the indenture trustee and bondholders provided all defaults have been cured and a majority of holders approve the recision of acceleration, sale or judgment.

10. Acceptance Of Default.

Sometimes, in widely held public issues, it may be impossible to get an appropriate percentage of holders to direct certain action to be taken to resolve the defaulted issue. Circumstances may be that the above cited remedies are inappropriate,

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and it is in the best interests of the holders to accept the default. Court approval of the acceptance of the default may be in the best interests of the municipality, the indenture trustee and the bondholders. Accordingly, the bondholders should consider whether they should accept the default and proceed with discussing the resolution without taking legal action except, if necessary, court approval for the acceptance of the default.

11. Application of Proceeds.

The indenture should have appropriate provisions with regard to how to disburse funds that are collected pursuant to the exercised remedy. Normally, such indenture provisions provide funds are to be disbursed as follows: first to pay costs and expenses of the indenture trustee, then to the holders, and if there is any surplus after payment of principal and interest to the holders, to the municipality or obligor. Funds collected for holders who cannot be located and who are not known cannot be paid as a windfall to known holders. Usually, any surplus money collected that cannot be distributed because the holders are not known or cannot be located goes either to the state or to the municipality.

MYTH V:

A CHAPTER 9 BANKRUPTCY PROCEEDING IS THE ONLY MEANS BY WHICH A MUNICIPALITY WHICH CANNOT MEET ITS CURRENT DEBT PAYMENT OBLIGATIONS CAN RESOLVE THE PROBLEM.

REALITY

The Municipal Bankruptcy Act was enacted in the late 1930's in an attempt to protect municipalities from a long series of acrimonious lawsuits injurious to municipalities and unproductive in furnishing funds to pay off creditors. Chapter 9 of the Bankruptcy Code was not intended as an exclusive remedy for municipal bodies who are unable to meet their current debt obligations. Since 1930, numerous states have provided for a state receiver or a state agency to act as receiver when a local governmental unit defaults on its financial obligations. A receivership is an available remedy which, given the enactment of appropriate legislation establishing a mechanism to control acrimonious lawsuits, allows bondholders and other creditors of the municipality to obtain the relief in a default situation. As recently as May 14, 1987, a Federal Judge in Chicago appointed a receiver for the beleaguered Chicago Housing Authority. It is the state created agencies, such as a State Agency for Emergency Municipal Finance, which have prevented a number of municipalities from having to seek relief under Chapter 9 and have allowed a troubled municipality to work out of its problems under state supervision while providing to bondholders the assurance that the amounts due and owing to them will be paid. Another mechanism if a municipal body finds that its function and purpose have been eliminated is to petition the legislature for the revocation of its charter seeking an appropriate state court to supervise the liquidation of municipal assets. This remedy is probably more appropriate to special tax districts and local governmental agencies which experience financial difficulties and no current public purpose for their continued operation and existence (Municipal Hospital, Waste treatment facilities, etc.). Given the stigma many believe to exist with regard to a municipal bankruptcy, consideration should first be given to the use of state agencies, state receiverships, supervised liquidation of municipal assets or the enactment of legislation establishing finance authorities (to issue debt to finance and refund existing obligations) as available and in many instances preferable to municipal bankruptcy.

For example, in Pennsylvania, if a local government revenue project is in default for 30 days on the principal or interest due for any bond or note, the holders may appoint a trustee who may petition the court for a receiver to take over the operation of the project and the collection of all moneys due to it. The receiver may operate, maintain, repair, and reconstruct project facilities and collect any rents or revenues due on the project. However, he shall not perform any essential government functions. One should not forget that a receivership is an available remedy which, given the enactment of appropriate legislation establishing a mechanism to control acrimonious lawsuits, allows bondholders and other creditors of the municipality to obtain the relief in a default situation.

A composition is an agreement between an insolvent debtor and the creditors to scale down the former's obligations. The Bankruptcy Code does not preclude state compositions provided that they are not binding on nonconsenting creditors. In Ohio, for example, the Local Fiscal Emergencies Law provides for the appointment of a seven member board to supervise a local government's finances upon the declaration of a fiscal emergency. Within 120 days after the first meeting of the board, the mayor must submit to the board a feasible, bona fide plan, approved by the appropriate legislative body, setting forth the time schedule and method by which the municipality will, inter alia, satisfy past due obligations and restore the municipality's ability to market long-term general obligation bonds. The board must report annually to the state speaker of the house and president of the senate and is subject to the supervision of the state auditor. During the emergency, the municipality may issue notes secured by a pledge of revenue from the State Local Government Fund.

In New Jersey, any petition for municipal readjustment must be approved by the state municipal finance commission, and any public debt issued as part of a plan of reorganization must be approved by the commission. Further, a board is created which is authorized to liquidate assets pledged to a special fund and to apply the proceeds to the fund. Warrants for funding or refunding indebtedness may be issued and may be secured by the proceeds of the sale of real estate acquired by the city for taxes.

Given the stigma many believe to exist with regard to a municipal bankruptcy (as demonstrated by its use in the last 50 years only by a few smaller municipal bodies), consideration should first be given to the use of state agencies, state receiverships, supervised liquidation of municipal assets, or enactment of legislation establishing finance or refinance authorities (to issue debt to finance and refund existing obligations) as available and in many instances preferable to municipal bankruptcy.

Workouts are normally tailored to specific situations, and are an attempt to see if there is a common ground on which the municipality and creditors can agree without the necessity of having Bankruptcy Court supervision. As set forth above, a workout can take various forms including:

A. Use of Consultants and Advisers to set rates which will be sufficient to generate revenues to pay debt service pursuant to an agreed upon debt service program.

B. Use of a refinancing authority or state composition which provides additional state or federal guarantees to refinance debt and to pay off old debt either in full or at an agreed upon discount through tender offers or exchange offers.

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C. Use of state receiverships where assets are liquidated under state court supervision and proceeds are disbursed to creditors based on a court determined schedule of payment.

The advantages of a workout include: the stigma of bankruptcy is not placed on a municipal body, the bond market is anticipated to view the municipality as capable of resolving and paying off its debt obligations, making the possibility of future financing at market more likely, and the acrimony and uncertainty of bankruptcy are replaced by the certitude of an agreed upon program.

Disadvantages of a workout include: lawsuits are not automatically stayed unless there is legislation or a court order staying such during the workout; there is not necessarily an efficient and practical method whereby all creditors would be bound by the agreement of the majority (except perhaps in a state receivership where such matters could be resolved); bankruptcy puts all creditors in one forum rather than a multitude of various forums, staying litigation and providing a mechanism of binding all creditors, so a recalcitrant creditor cannot hold up the process by unreasonably demanding more than what other similarly situated creditors are receiving; and the contract clause of the United States Constitution and various state constitutions prevent a nonjudicial mandatory involuntary settlement of claim by all creditors.

MYTH VI:

ANY MUNICIPALITY CAN GO INTO A CHAPTER 9 PROCEEDING.

REALITY

In order to institute a Chapter 9 proceeding, the municipality must be duly authorized by state law or home rule power. There is no grant to creditors of a municipality to institute an involuntary bankruptcy proceeding as such is available for creditors of corporate debtors. A municipality is a "political subdivision or public agency or instrumentality of the state". Before a municipality is able to institute a proceeding under the Bankruptcy Code, it must be generally authorized to be a debtor under such chapter by state law or by a government officer or organization empowered by state law to authorize such an entity to be a debtor under such chapter. Sixteen states have specifically authorized a municipality to so proceed. Some states have specifically prohibited municipalities from filing under the Bankruptcy Code. Other statutes govern the conditions under which municipal bankruptcy can be instituted. [See, e.g., Texas House Bill No. 2621, effective August 31, 1987, which modifies the ability of water districts to utilize the general authorization to avail themselves of Chapter 9.] However, one bankruptcy court has found no such authorization in the typical statutes authorizing an entity "to sue or be sued" without any specific statutory authorization to file a Bankruptcy case. With regard to an unincorporated tax or special assessment district which does not have its own officials, an action is commenced under Chapter 9 by filing a petition under that chapter by the district's governing authority or board or body which has authority to levy taxes or assessments to meet obligations for such a district. If it can be shown to the Bankruptcy Court that a petition was filed not in good faith or not meeting the requirements of Chapter 9, the petition may be dismissed.

MYTH VII:

IN A CHAPTER 9 PROCEEDING, THE BANKRUPTCY COURT CAN ORDER THE PAYMENT OF DEBTS AND THE SALE OF MUNICIPAL ASSETS.

REALITY

Given the prohibitions placed upon Congress by the U.S. Constitution, Chapter 9 does not grant the Bankruptcy Court the power to interfere with the governmental affairs of the municipal body. The Bankruptcy Code specifically provides that the court may not, unless the municipality consents or its plan so provides, interfere with: (1) any governmental or political powers of the municipality; (2) any property or revenues of a municipality; and (3) the municipality's use or enjoyment of any income producing property.

MYTH VIII:

A CHAPTER 9 PROCEEDING PREVENTS FILING OF LAWSUITS AGAINST A MUNICIPALITY.

REALITY

The filing of a petition under Chapter 9 operates as an automatic stay of any actions to collect debt from the debtor, create a lien on the debtor's property, or take possession of the debtor's property. For municipalities, the automatic stay includes: (1) the commencement or continuation, including the issuance or employment of process, or judicial, administrative, or other proceedings against an officer or inhabitant of a debtor that seeks to enforce a claim against a debtor; and (2) the enforcement of a lien on or arising out of taxes or assessments owed to the debtor. However a bondholder or creditor may apply to the court to lift that stay and proceed with the remedies explained above.

MYTH IX:

A MUNICIPALITY MAY FILE A CHAPTER 9 PROCEEDING WITHOUT NOTICE BEING GIVEN TO THE BONDHOLDERS OF THE INSTITUTION OF THAT PROCEEDING.

REALITY

A notice must be given of the commencement and dismissal of a case under Chapter 9. Such notice must be published once a week for three successive weeks in at least one newspaper of general circulation published in the district in which the case is commenced and in such newspapers having a general circulation among bond dealers and bondholders as the court designates.

MYTH X:

IN A CHAPTER 9 PROCEEDING, ANY BONDHOLDER OR CREDITOR OF THE MUNICIPALITY MAY APPEAR AND VOTE ON THE PLAN OF ADJUSTMENT.

REALITY

In order to vote on a plan of adjustment in a Chapter 9 proceeding and to be counted as a creditor, a party who has a claim against the debtor municipality must either file a proof of claim or be listed as a creditor in the list of creditors filed by the municipality. Pursuant to the Bankruptcy Code, any claim that appears in the list of creditors filed by the municipality in the Chapter 9 proceeding will be deemed to be a filed proof of claim except a claim that is listed as disputed, contingent or unliquidated.

MYTH XI:

DURING A CHAPTER 9 PROCEEDING, THE MUNICIPALITY CANNOT OBTAIN FURTHER CREDIT.

REALITY

Unless the court orders otherwise, a municipality in a Chapter 9 proceeding may obtain unsecured credit and incur unsecured debt in the ordinary course of its business allowable as an administrative expense with a priority superior in payment to other unsecured debt. If the debtor municipality is unable to obtain unsecured credit, the court after notice and hearing may authorize the obtaining of credit or the incurring of debt: (1) with priority superior to all other administrative expenses, (2) secured by a pledge or lien from the property of the municipality which is not otherwise subject to a pledge or lien, (3) a junior pledge or lien on property of the municipality which is subject to a prepetition lien or, (4) in certain circumstances, secured by a lien equal to or senior to a prior pledge or lien of property of the municipality.

MYTH XII:

DURING A CHAPTER 9 PROCEEDING, A MUNICIPALITY MAY REJECT ANY EXECUTORY CONTRACTS (SUCH AS LABOR UNION CONTRACTS AND UNEXPIRED MUNICIPAL LEASES) WHICH IT DESIRES.

REALITY

On February 22, 1984, in The Matter of National Labor Relations Board v. Bildisco and Bildisco, 465 U.S. 513 (1984), the Supreme Court held that §365(a) of the Bankruptcy Code provides that, with certain exceptions, the trustee (or presumably a municipality in a Chapter 9 proceeding) may assume or reject "any executory contract" of the debtor, including a collective-bargaining agreement.

According to the Court, a bankruptcy court should permit rejection of a collective bargaining agreement subject to §365(a) but only if the debtor can show both that the agreement burdens the estate and that the equities balance in favor of rejection. This would include a consideration of the likelihood and consequences of:

(A) liquidation for the debtor absent rejection;

(B) the reduced value of the creditors' claims that would follow from affirmance and the hardship that would be imposed on them; and

(C) the impact of rejection on the employees.

In striking the balance, the bankruptcy court must consider not only the degree of hardship faced by each party, but also any qualitative difference between the types of hardship each may face. Nevertheless, the Supreme Court rejected the test espoused by the Union that Bildisco should not be permitted to reject the collective bargaining agreement unless it could demonstrate that its reorganization would fail unless rejection was permitted.

The Bankruptcy Amendments and Federal Judgeship Act of 1984 modified Bildisco's holding regarding the standard to be applied and other aspects of the holding. Under 11 U.S.C. §1113(c), a court shall approve an application for rejection of a collective bargaining agreement only if the Court finds that:

1) the Trustee (or Debtor) has prior to the hearing made a proposal that fulfills the requirements of subsection (b)(1) [proposal regarding modification which is fair and equitable];

2) the authorized representative of the employees has refused to accept such proposal without good cause ("good cause" is an undefined term); and

3) the balance of the equities clearly favors rejection of such agreement.

The thrust of the present legislation is to allow a court-supervised balancing of interests between the collective bargaining agreement and the rehabilitation of the corporation. The legislation appears directed at ad hoc determinations by a court without detailed and defined guidelines. The success of §1113 will depend upon the future decisions of the courts. There is no reference or amendment contained in the 1984 Act or §901 of the Bankruptcy Code that would indicate that §1113 would be applicable to a Chapter 9 proceeding. As a result, Bildisco may be applicable and still valid as to a Chapter 9 to the extent it is not inconsistent with §904 of the Bankruptcy Code or the Tenth Amendment.

Given the fact that labor obligations are among the most burdensome problems faced by municipalities as evidenced by the San Jose School District bankruptcy, the Bildisco result obviously could be attractive to some local governments. However, municipal workers generally perform a governmental function. It is not clear then whether the Bildisco holding would govern a municipal bankruptcy. Absent a resolution by the debtor municipality's legislative body approving or disapproving rejection, the provisions of §904 of the Code require that the Bankruptcy Court cannot interfere with the political or governmental powers of the debtor. Accordingly, the jurisdiction of the Bankruptcy Court is limited, and the termination of a labor contract contrary to the wishes of the municipality's elected officials may be subject to attack as beyond the court's power. Further, if Bildisco is to be applicable to a Chapter 9, a clearer standard for review by the Bankruptcy Court should be promulgated to ensure no violation of S904 or Tenth Amendment.

MYTH XIII:

THE MUNICIPALITY AND CREDITORS MUST AGREE ON A PLAN OF ADJUSTMENT PRIOR TO THE INSTITUTION OF THE CHAPTER 9 PROCEEDING.

REALITY

The municipality, without prior approval of creditors, may file a plan of adjustment for the municipality. If such plan is not filed with the petition, the municipality shall file such plan at such later date as the court may fix. The municipality may modify the plan at any time prior to confirmation provided such modification is consistent with the requirements of Chapter 9. The plan need not be agreed to by all creditors prior to filing and the Bankruptcy Code provides a mechanism for seeking the approval of an appropriate percentage of creditors including bondholders.

MYTH XIV:

ALL CREDITORS MUST APPROVE A MUNICIPAL PLAN OF ADJUSTMENT BEFORE THE PLAN CAN BECOME EFFECTIVE.

REALITY

The plan of adjustment must have the consent of two-thirds of the allowed amount of each class and more than one-half in number of the creditors of each class. The approval of all creditors is not necessary. If the plan does not discriminate unfairly and is fair and equitable with respect to each of the claims that is impaired (receiving less than is owed) thereunder and which has not accepted the plan, the court may still confirm the plan. After notice to all parties and interests, the court shall hold a hearing on confirmation. The court shall confirm a plan only if it meets with the specific requirements of Chapter 9 including being proposed in good faith and not by any means forbidden by the law and at least one class of the claims has accepted the plan or the court determines the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under the plan and has not accepted the plan. For a discussion of several recent plans see, In the Matter of Jersey City Medical Center, 817 F.2d 1055 (3d Cir. 1987) and In the Matter of Sanitary and Improvement District 65 of Sarpy County, Nebraska, 73 B.R. 205 (Bankr. Nebraska 1986).

MYTH XV:

A PAYMENT TO BONDHOLDERS DURING 90 DAYS PRIOR TO THE FILING OF THE PETITION BY THE MUNICIPALITY IS A VOIDABLE PREFERENCE AND MUST BE RETURNED TO THE MUNICIPALITY.

REALITY

The payment to defease a bond issue may be deemed to be a preference depending upon the source and timing of payment: (1) If the proceeds of the new bond issue (i.e., a "refunding issue") acquired during the preference period (90 days prior to the date of filing the petition) are specifically designated by the terms of the issue to be used to defease a prior indenture (predating the preference period), then probably there is no preference problem. Generally, new unsecured loans or payments to creditors by a third party are not transfers of debtor's property if the property is never in the debtor's estate but goes directly from the third party to creditors since the estate of the municipality is not diminished. If the debtor gives new security for the refunding bond issue, then it may be argued there is a diminution and there is a preferential transfer to the extent of the collateral value. (2) Similarly, use of funds deposited in a debt service reserve fund or with an indenture trustee prior to the preference period and paid to the bondholders during the preference period probably is not a voidable preference. Also payment into a debt service reserve fund during such preference period may be argued not to be a preference if funds were previously pledged and collected prior to the preference period. (3) By reason of the Code, the use of other previously accumulated revenues to retire bonds to defease the indenture during the preference period probably constitutes a preference to the extent the funds were received during the preference period. (4) Any other payment to defease the indenture, retire bonds or to pay interest during the preference period probably constitutes a preference.

MYTH XVI:

FILING OF A CHAPTER 9 PROCEEDING TERMINATES THE LIENS OR PLEDGES GRANTED BY MUNICIPALITIES TO BONDHOLDERS.

REALITY

The Bankruptcy Code provides that property acquired by the municipality after commencement of the case is not subject to any lien or pledge resulting from any agreement entered into by the municipality prior to the commencement of the case. Revenue bonds are secured by pledges of revenues owing from tax levies or assessments to be received from the respective taxpayers. Some may argue that upon the filing of the petition under Chapter 9, such a "security interest" ceases since the taxes paid after the filing of the petition are property acquired by the municipality after the commencement of the case. It may be argued that just like the case of the security interest created by a security agreement which extends "to property of a debtor acquired before the commencement of the case and to the proceeds, product, off-spring, rents or profits of such property", the pledge of municipal revenue creates a security interest under the Bankruptcy Code which continues after the commencement of the case. However, a Pledge of Revenue under Municipal law cannot be equated to a questionable security interest under Corporate and Bankruptcy laws. A pledge of the revenue created by resolution or ordinance should continue after commencement of the case under applicable state law and policy. It can be argued that the right to receive revenues is "property. If the trust indenture or bond resolution specifies that it extends to "proceeds" of such property, it can be argued that the revenues are proceeds of that property. Perhaps one should distinguish those revenues which are collected after the filing but which are proceeds of tax assessments made before the filing from those which are pledged, assessed and collected after the filing. The right to collect and assess tax where the only matter remaining outstanding is the collection of the revenues would seem to be "property" and the subsequent revenue would be "proceeds" thereof. By analogy to accounts receivable, checks received by the debtor in collection of accounts receivable generated before bankruptcy are considered to be proceeds of pre-existing accounts receivable even though the checks are received, cashed and paid post petition.

MYTH XVII:

IN A CHAPTER 9 PROCEEDING, THE COURT WILL REQUIRE THE MUNICIPALITY TO PAY ALL PLEDGED REVENUES TO THE BONDHOLDERS FOR PRINCIPAL AND INTEREST PAYMENTS EVEN THOUGH THERE MAY NOT BE ENOUGH FUNDS AVAILABLE TO PAY FOR THE COSTS OF OPERATING THE MUNICIPALITY.

REALITY

A municipality while in a Chapter 9 proceeding will still have to function as a municipality. There are certain necessary basic municipal services which must be provided such as police, fire and, under certain circumstances, sewer, water and electric services. The bankruptcy court and creditors will not be able to successfully interfere with such service. Accordingly, certain revenues and activities of the municipal body which may be the cause of the insolvency may not be able to be effectively restrained, curtailed or modified without an impelling reason for such action. As a practical matter, courts may order that funds pledged to bondholders by the municipality may have to be used on an emergency basis to pay municipal operating costs with the promise to repay through assessments and levies of additional taxes.

MYTH XVIII:

INSOLVENCY OF A MUNICIPALITY CAN BE EASILY DETERMINED.

REALITY

A municipality is presumed to be solvent during the period of ninety days prior to the commencement of a case under Chapter 9. However, the test of insolvency is questionable if insolvency means that debts that exceed assets and assets are defined to exclude those which are exempt from attachment by state law. Since in most states the bulk of a municipality's assets would be exempt from attachment by state law, most municipalities under the terms of the Bankruptcy Code would be "insolvent" even though they are capable of meeting their debt obligations as they become due and have sufficient assets which are exempt from state law.

MYTH XIX:

A LETTER OF CREDIT WHICH SERVES AS BACKING FOR A MUNICIPAL OBLIGATION BECOMES PART OF THE ESTATE IN THE EVENT OF A MUNICIPAL BANKRUPTCY.

REALITY

Letters of credit are not guarantees, and are not considered to be guarantees so as to be ultra vires for national banks. A letter of credit is considered to be the full faith and credit of a financial institution in the amount set forth therein. In drafting any letter of credit transaction it is important that all documents clearly indicate that the letter of credit is not a guarantee. A letter of credit upon presentment of specified documents and fulfillment of certain conditions is an unqualified obligation to pay.

A letter of credit is an "independent" contract between the issuing bank and the beneficiary. As such, if the stated conditions are satisfied, it survives the bankruptcy of the debtor for whom it was issued, including a municipality. Neither the letter of credit nor its proceeds are property of the estate of the municipality. In issuing the letter of credit, the bank agrees to pay out of its own assets. Moreover, most courts agree that payment pursuant to a letter of credit is not a preference voidable in bankruptcy.

MYTH XX:

A LEASE IN CONDUIT TAX EXEMPT FINANCING IS TREATED LIKE AN ORDINARY REAL ESTATE LEASE UPON THE BANKRUPTCY OF THE OBLIGOR AND DAMAGES FOR TERMINATION ARE LIMITED.

REALITY

In certain conduit tax exempt financing the obligation to pay principal and interest on the Bonds is defined by a lease obligation from the company obtaining the benefit of the financing to the municipal body. This lease obligation is then normally assigned to the Indenture Trustee for the benefit of the Bondholders. Some corporate debtors have taken the position that the lease of the relevant facility which was financed by the conduit tax exempt Bonds has the claim on that lease reduced from the total amount of principal, interest and expenses due under the terms of the documents to a claim for the termination of a lease of real estate under the Bankruptcy Code. Under Section 502(b)(6) of the Bankruptcy Code, a claim arising out of the termination of a lease of real estate is limited to the rent reserved by such lease, without acceleration, for the greater of one year or 15% not to exceed 3 years of the remaining term of such lease following the earlier of (i) the date the petition was filed instituting the action or (ii) the date on which such lessor repossessed or the lessee surrendered the leased property plus any unpaid rent due under such lease without acceleration as of the earlier of such dates. This position taken by certain corporate debtors is wrong because the lease in conduit tax exempt financing as was noted in the legislative history surrounding Chapter 9 of the Bankruptcy Code was a "financing lease" and not a lease of real estate. Courts, when faced with this situation, have generally held that "financing leases" with regard to conduit tax exempt financing are not subject to the provisions of Section 502(b)(6). It is therefore important from a Bondholder's position to have not only the lease obligation from the corporate debtor in a form where it is clear that it is a financing lease but also a guarantee of the corporate debtor of all obligations to pay principal and interest on the Bonds, thereby demonstrating the financing nature of the lease.

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MYTH XXI:

THERE ARE NO CHANGES WHICH NEED TO BE MADE TO THE EXISTING LEGISLATION GOVERNING MUNICIPAL BANKRUPTCY.

REALITY

I. THERE IS NEED FOR LEGISLATIVE CHANGE.

A. Present Requirement for Change.

1. Chapter 9 May be Needed by Municipalities.

The proposed amendments are limited but necessary. As we all know, Municipal Bond financing is part of the foundation upon which our present municipalities have been built and will be necessary for the future survival of our municipalities. There will be a number of cities, especially small and medium cities, which will face serious budgetary problems during the remainder of the 1980's. These are the cities which most likely will need continued municipal finance, especially for necessary improvements or maintenance to infrastructure.

2. Chapter 9 Interferes With Continued Ability to Finance.

If financially troubled cities seek any relief under Chapter 9 of the Bankruptcy Code, there will be increasing concern relating to termination of the pledge of revenues from such municipal improvements under §552(a) of the Bankruptcy Code. Further, a financially troubled municipality will be questioned about the extension of any credit during the 90 day period prior to a Chapter 9 proceeding since any pledge or payment on the Bonds could be deemed a "voidable preference" under §547 of the Bankruptcy Code. Likewise, Bondholders of Revenue Bonds who find the municipality using the pledge revenues in bankruptcy to pay necessary municipal expenditures may elect to transform that revenue bond into a "recourse debt" under §1111(b), contrary to statutory or constitutional debt limitations.

3. Amendments Are Necessary if Chapter 9 is to be of any Benefit to Municipalities.

Amendments to the Bankruptcy Code which are set forth below seek to provide assurances to Investors that in providing the necessary financing for municipalities which are experiencing a temporary cash flow crisis, the pledge of revenues for payments made on such obligations will not be terminated or any payment received by the Bondholders forced to be repaid. It should be noted there would be significant difficulty in requiring municipal bondholders who may number in the thousands to tens of thousands to repay an interest payment which was made during the 90 day period since most of those bondholders live outside the regional area, the cost and expense of retrieving such "preference payments" is prohibitive, and the ability to retrieve all such payments virtually impossible since the bonds are publicly traded and the holders, pre and post Chapter 9, may change.

B. The Difficulties Encountered by a Municipality in a Chapter 9 Proceeding Due to Section 547, 552(a) and 1111(b).

1. Operation of Section 547 in a Chapter 9 Proceeding.

a. As referred to above, given the present state of the Bankruptcy Code, it may be argued that a pledge of revenues or a collection of such revenues by a municipality or the payment of such revenues to the bondholders during ninety days prior to the filing of a Petition is a "voidable preference" because §547(e)(3) provides that a transfer (including the transfer of a security interest) is not made until the Debtor has rights in the property.

b. Further, payments to defease a bond issue, by an advanced refunding or new bond issue, may be deemed to be a preference under §547 depending upon the source and timing of the payments. Troubled municipalities which desperately need additional financing may experience the reluctance of the Market to purchase securities because under the Bankruptcy Code a "refunding issue" might be termed a preference or the payments of pledged revenues within the 90 day period would be deemed under §547 to be a preference. The above-cited application of §547 in a Chapter 9 proceeding appears to violate the provisions of §904 of the Bankruptcy Code since the Bankruptcy Court and the Bankruptcy Code are not intended to affect the municipality's use of its revenues and for that matter the use of its revenues as payment to bondholders pursuant to their claims and rights under State law.

c. As briefly referred to above, there are a number of arguments which municipalities and their bondholders may offer to a court to alter the undesired effect of §547 yet it is questionable whether a Court, without modification of the language of §547 as applicable to a Chapter 9, will accept these arguments. Municipalities may argue that:

(1) Pledged revenues may fall within the exception relating to exchanges for new values as provided for in §9-306 of the Uniform Commercial Code and accordingly the security interest which is pledged to the bondholders in a new revenue bond issue which is consummated within ninety days of the date of the municipality's instituting a Chapter 9 proceeding should not be held voidable.

(2) Pledged revenues constitute receivables and hence only a partial preference results to the extent of any

net reduction in the excess of the secured claim over the value of the securities. Section 547(a) defines a receivable as a "right to payment whether or not such right has been earned by performance". (Note the definition is broader than the Uniform Commercial Code definition for "accounts").

(3) The U.S. Constitution (Tenth Amendment and Impairment of Contracts Clause) and State Statutes (granting unconditional pledges of revenues to bondholders) mandate a different result. If the lien on future revenues is voidable as a "preference" this would be contrary to public policy and State enabling legislation which almost invariably provides that the pledges of such revenues are effective when made and good against other creditors.

There is no assurance that these arguments will be universally persuasive with all Courts; thus legislative change to prevent the ill effects of §547 is warranted.

2. **The Operation of Section 552(a) in a Chapter 9 Proceeding.**

a. In connection with current municipal defaults and threats of municipal bankruptcy, there has been concern on the part of the Municipal Bond Market as to whether a municipality's pledge of revenues to bondholders terminates upon the filing of bankruptcy similar to the termination of the lien of creditors of a corporation on its accounts receivable, inventory and income. This issue has not been directly decided by the Courts. Some Bankruptcy Courts in non-Chapter 9 proceedings have held that they are without power to terminate statutory tax liens. Further, there are numerous legal arguments that can be made to a Court such as:

(1) The right to receive revenues so pledged to the bondholders is a State granted property right and such a constitutional and statutory property right cannot be interfered with by a Bankruptcy Court;

(2) A trust indenture or bond resolution that specifies that it extends to the "proceeds of such property" covers the revenues as proceeds of that property when such are collected by the taxing entity even after the institution of a Chapter 9;

b. It would be contrary to the Tenth Amendment and the very principles upon which the Municipal Bankruptcy Act of 1937 was predicated and declared constitutional, for a Bankruptcy Court to state, pursuant to §552(a) of the Bankruptcy Code, that a pledge of revenues made by a municipal body pursuant to a state statute or a properly enacted bond resolution can be terminated upon the institution of a Chapter 9 proceeding. In further support of this practical approach to whether or not the pledge of revenue to bondholders is terminated by the institution of a municipal bankruptcy, one need only look to §904 of the Bankruptcy Code which specifically provides that "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. . . any of the property or revenues of the debtor . . .".

c. It can be argued that the Tenth Amendment and §904 prohibit the interpretation that pledges of revenues granted pursuant to state statute or constitutional provisions to bondholders can be terminated by the filing of a Chapter 9 proceeding. State law prescribing a method of composition of indebtedness may not bind any creditor that does not consent as recognized by §903(1) of the Bankruptcy Code. Likewise, under the Contract Clause of the Constitution, Article I, Section 10, a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a Chapter 9 proceeding.

3. **The Operation of Section 1111(b) in a Chapter 9 Proceeding**

a. A municipality in a Chapter 9 proceeding will need sufficient cash flow to pay ongoing necessary municipal expenditures such as Police, Fire, Sanitation, Water and Electricity. The municipality may attempt to use revenue generated by a profitable municipal operation even though such is pledged to revenue bondholders. Under §362, the revenue bondholders are stayed from commencing an action against the municipality for diversion of revenues. The Bondholders could bring an action under §362(d) for adequate protection or lifting the stay. The Bondholders could under §1111(b) transform their "non recourse" Revenue Bond Issue into a "recourse" (general obligation) of the municipality.

b. Even though the legislative history and §904 of Chapter 9 recognizes that the Bankruptcy Court should not interfere with the revenues, government and affairs of the municipality and the application of §1111(b) may cause the municipality to exceed its constitutional or statutory debt limitation. There is no social redeeming purpose for §1111(b) to be applicable to a Chapter 9 proceeding.

NOTE: This is an outline prepared for discussion purposes and is not intended and should not be construed as a statement of substantive law.

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CHAPTER III

CHAPTER NINE CASES FILED

June, 1988

YEAR	DEBTOR	COURT DISTRICT	DOCKET NUMBER
1980	Grimes County Municipal Utility District #1	Southern Texas	80-010948
1981	The Management Institute of San Leandro	N. California	81-02265
1981	North & South Shenango Joint Municipal Authority	W. Penn.	81-00408
1982	Wapanucka, Oklahoma	E. Oklahoma	82-00231
1982	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139
1982	Sanitary & Improvement District #5 of Cass County, Nebraska	Nebraska	82-01671
1983	Sanitary & Improvement District #4 of Lancaster County, Nebraska	Nebraska	83-01456
1983	Sanitary & Improvement District #42 of Sarpy County, Nebraska	Nebraska	83-00956
1983	Jersey City Medical Center	N. Jersey	83-00829
1983	South Tucson, Arizona	Arizona	83-00866
1983	San Jose School District	N. California	83-02387
1984	Whitley County Water District	E. Kentucky	84-00089
1984	Sanitary & Improvement District #63 of Sarpy County, Nebraska	Nebraska	84-01263
1984	Pulaski Memorial Hospital	Mo.	84-00082

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1984	Wellston, Missouri	Mo.	84-01492(3)
1985	Sanitary & Improvement District #7 of Lancaster County, Nebraska	Nebraska	85-0039
1985	Monterey County Special Health Care Authority	N. California	85-00649
1985	Sanitary and Improvement District No. 265 of Douglas County, Nebraska	Nebraska	85-2384
1985	Badger Mountain Irrigation District	Washington	03136-299
1985	Bell County Garbage and Refuse Disposal District	Kentucky	85-143
1986	Lassen Community College District	California	2-86-01379
1986	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798
1986	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885
1986	Cooper River School District	Alaska	3-86-00820
1987	Northwest Harris County Municipal Utility District No. 19	Southern Texas	87-02498-H-2-9
1987	Village of Merrill, Michigan	Michigan	87-09455
1987	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590
1987	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218
1987	Eagles Nest Metropolitan District	Colorado	87B1512E
1987	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1

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1988	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	18810005
1988	Borough of Shenandoah	Pennsylvania	88-20603

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CHAPTER IV

SELECTED PUBLICATIONS BY JAMES E. SPIOTTO

National Law Journal, "Municipal Bonds: Is There Life After Default", May 18, 1984.

New York Law Journal, "Municipal Finance and Bankruptcy, Chapter 9 Reforems Needed", June 28, 1984.

Resources in Review, "Municipal Bonds: Defaults and Remedies", March, 1983.

Bond Buyer, "Chapter 9 Reforms Are Needed", May 28, 1985.

"Municipal Insolvency: Bankruptcy, Receivership, Workouts and Alternative Remedies in 2 State and Local Government Debt Financing (D. Gelfand ed. 1985).

Bonds: Defaults and Remedies (PLI 1982).

Defaulted Bonds: Remedies and Related Litigation (PLI 1982).

Current Municipal Defaults and Bankruptcy (PLI 1983).

Defaulted Bonds and Bankruptcy: Problems of Indenture Trustees and Bondholders (PLI 1984).

Defaulted Bonds and Bankruptcy 1985 (PLI 1985).

Troubled Public Debt Financing: Litigation, Bankruptcy, Defaults, and Workouts (PLI 1986).

The Problems of Indenture Trustees and Bondholders: Defaulted Bonds and Bankruptcy (PLI 1987).

Troubled Debt Financing: Litigation, Bankruptcy, Defaults and Workouts (PLI 1987).

Municipal Bond Disclosure (with Joseph C. Daley) (Prentice-Hall Law & Business 1987).

The Problems of Indenture Trustees and Bondholders 1988, Defaulted Bonds and Bankruptcy (PLI 1988).

Senator HEFLIN. We will submit the statement into the record of Senator Strom Thurmond. The record will stay open for questions, statements, answers, and extensions of remarks.

[The prepared statement of Senator Strom Thurmond, and material subsequently submitted by panel members, follows:]

STATEMENT BY SENATOR STROM THURMOND (R-S.C.) BEFORE THE SUBCOMMITTEE ON COURTS AND ADMINISTRATIVE PRACTICE. REFERENCE, OVERSIGHT HEARING ON SELECTED BANKRUPTCY ISSUES. ROOM SD-226, FRIDAY, JUNE 10, 10:00 A.M.

MR. CHAIRMAN:

Today we are assembled to conduct an oversight hearing on a survey administered by the American Bankruptcy Institute and on selected bankruptcy bills before the Subcommittee on Courts and Administrative Practice.

The American Bankruptcy Institute recently completed a national survey which examined the operation and impact of particular 1984 amendments to the United States Bankruptcy Code. The results of the survey indicate that some believe the 1984 amendments have not had the impact intended by Congress. I am most interested in hearing the specific problems uncovered by the survey and any proposed solutions.

S.1626, S.1358, and S.1863 are all bills introduced by Senator DeConcini. S.1626 would protect the rights of intellectual property licensors and licensees which could be adversely affected if either party files bankruptcy. In the past, courts have determined that intellectual property contracts, such as software licensing contracts, are executory contracts. As such, a trustee in bankruptcy may reject contracts under section 365 of the Bankruptcy Code. S.1626 would amend section 365 to deny a trustee the ability to reject these contracts.

S.1358 is a bill aimed at clarifying the Bankruptcy Code's fraudulent transfer provisions. The 5th Circuit Court of Appeals in Durrett v. Washington National Insurance Company held that a non-collusive, regularly conducted foreclosure sale could be a fraudulent transfer without regard to the intent of the parties if the buyer fails to give what the court deems as "fair consideration". The Court in Durrett determined that a sale price of less than 70% of the judicially determined value would be treated as less than fair consideration. As a result, a trustee in bankruptcy can seek to set aside a foreclosure sale. Senator DeConcini's bill would amend the Bankruptcy Code so that a person who acquires the interest of a debtor through a non-collusive foreclosure proceeding has by definition given fair consideration.

S.1863 is a bill which would amend provisions of current law found in chapter 9 of the Bankruptcy Code relating to the treatment of bonds in a municipal bankruptcy. Chapter 9 could be interpreted to allow conversion of revenue bonds into general obligation bonds. If conversion is allowed, bond obligations which would be paid from special revenues could become the responsibility of the residents of a municipality. This conversion could lead to an increase in local taxes to cover these obligations. S.1863 would prohibit municipal revenue bonds from being converted into general obligation bonds.

In conclusion, the above bills and the American Bankruptcy Survey contain provisions and make recommendations which affect the rights and liabilities of parties in bankruptcy. For this reason each bill should be carefully considered.

I look forward to the testimony of our distinguished witnesses.

PALMER & DODGE
ONE BEACON STREET
BOSTON, MASSACHUSETTS 02108
TELEPHONE (617) 573-0100
TELECOPIER (617) 227-4420
TELEX 951104

June 24, 1988

The Honorable Dennis DeConcini
Subcommittee on Courts
and Administrative Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator DeConcini: Municipal Bankruptcy - S. 1863

Thank you for the opportunity to respond to your written questions. They will help to further focus the issues. I will answer them from my perspective as a bond lawyer. Mr. King will answer them from the perspective of the bankruptcy bar.

Q. ARE YOU SATISFIED THAT ENACTMENT OF THIS LEGISLATION WILL NOT VIOLATE THE 10TH AMENDMENT? I KNOW THAT THIS WAS A CONCERN IN 1976 WHEN THE MUNICIPAL BANKRUPTCY AMENDMENTS OF 1976 WERE CONSIDERED.

A. S. 1863 will honor and respect state law. It will preserve the revenue bondholder's lien on pledged revenues of a revenue-producing system in accordance with state law, subject to payment of the necessary operating expenses of the system. It will preserve state-law limitations on the source of payment of revenue bonds by preventing conversion of revenue bonds into general obligations. As now written, §§552 and 1111(b) would override state law by terminating the bondholder's lien on pledged revenues and by allowing the conversion of revenue bonds (payable solely from pledged revenues) into general obligations (payable by the municipal taxpayers). Thus it is the existing Code and <u>not</u> the proposed amendment that raises 10th Amendment questions.

Q. WHY HAS THE NEED FOR THIS LEGISLATION ARISEN? WHY DOESN'T PRESENT CHAPTER 9 SUFFICE?. WHAT COULD HAPPEN IF THIS LEGISLATION IS NOT PASSED AND A CITY FILES FOR CHAPTER 9?

A. Chapter 9 was written, unfortunately, without the participation of lawyers knowledgeable in municipal finance. The lack of fit between commercial concepts and municipal finance realities was not recognized. If the Code is not corrected, and a city files under Chapter 9 because its general operations are in trouble, it is likely that its utility revenue bonds will lose their security interest in pledged revenues, causing turmoil in the municipal markets. Conversely, if a city files under Chapter 9 because its utility operations are in trouble, it is likely that its revenue bonds may be converted into general obligations (payable by the municipal taxpayers), causing consternation in state houses and city halls where they thought they had protected the taxpayers from this burden.

Q. ARE SUFFICIENT EXCEPTIONS CONTAINED IN THE BILL TO PERMIT FUTURE INHABITANTS OF A CITY FROM BEING OVERLY BURDENED BY THE COMMITMENTS THAT THIS BILL WOULD REQUIRE FROM A POPULACE TO PAY ON ITS INDEBTEDNESS?

A. The bill carefully protects future inhabitants. It insures that <u>general</u> revenues will be available for general operating purposes. Bondholders' liens will be protected only in <u>special</u> revenues and, if the special revenues are derived from an operating plant or system (e.g. a municipal utility), the lien will be subject to the prior payment of necessary operating expenses.

In addition to municipal utility receipts, "special" revenues include special excises and fees, as well as taxes specifically levied to finance particular projects.

"General" revenues include receipts from property, sales or income taxes that are levied to finance the general purposes of the municipality.

* * *

I would be pleased to meet with you or your staff to try to answer any further questions. Your introduction and thoughtful consideration of the legislation are greatly appreciated.

I am enclosing copies of my responses to Senator Heflin's and Senator Thurmond's questions.

Sincerely yours,

James W Perkins

James W. Perkins
Direct Dial: (617) 573-0271

JWP/lm
Enclosures
cc: Hon. Howell Heflin
Hon. Strom Thurmond

PALMER & DODGE
ONE BEACON STREET
BOSTON, MASSACHUSETTS 02108
TELEPHONE (617) 573-0100
TELECOPIER (617) 227-4420
TELEX 951104

June 24, 1988

The Honorable Howell Heflin
Subcommittee on Courts
and Administrative Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Heflin: Municipal Bankruptcy - S. 1863

Thank you for the opportunity to testify before the Subcommittee. Your written questions will help to further focus the issues. I will answer them from my perspective as a bond lawyer. Mr. King will answer them from the perspective of the bankruptcy bar.

Q. WHAT IS THE IMPACT OF CURRENT PROVISIONS OF CHAPTER 9 ON A MUNICIPALITY'S ACCESS TO CREDIT MARKETS?

A. The infamous Twist Cap case illustrates the impact of bankruptcy law on municipal credit markets. In that case, in 1979, a bankruptcy judge ordered a bank not to honor its letters of credit where its right of reimbursement from the debtor was secured by collateral. The judge did so on the theory that honoring the letters of credit would cause a preference, by substituting secured obligations for unsecured, although the collateral had been provided more than 90 days before bankruptcy. This decision has been thoroughly repudiated and was only "interlocutory" - it was not final - but it caused a near total breakdown in the marketing of letter-of-credit backed bonds. Municipalities, as well as other issuers, were hard hit.

Senate 1863 is intended to prevent the breakdown that would occur if a bankruptcy judge were to decide that §552 terminated the revenue bondholder's lien on pledged municipal revenues or that §1111(b) allowed revenue bonds to be converted into general obligations.

The market found a way around the Twist Cap decision. Borrowers gave the beneficiary of the letter of credit the same security as the bank. But there would be no way around the lien termination, or the conversion of revenue bonds into GOs, short of amendment of the Bankruptcy Code. We are urging that step in advance - to avoid the breakdown before it happens.

Q. IF A MUNICIPALITY FILES BANKRUPTCY UNDER THE CURRENT PROVISIONS OF CHAPTER 9, AND IGNORES SOME OF THE STATUTORY MANDATES BECAUSE THEY CONFLICT WITH THE MUNICIPALITY'S OBLIGATION TO CONTINUE MEETING ITS FINANCIAL RESPONSIBILITIES, HOW DOES THIS AFFECT THE MUNICIPALITY'S ABILITY TO REORGANIZE?

A. A municipality could not ignore §§552 and 1111(b). If it tried to, a bankruptcy judge would enjoin its conduct on application of an adverse party. If §§552 and 1111(b) caused an insolvency in the general fund to spill over into a utility fund by diverting pledged utility revenues into general operations, or vice versa by converting revenue bonds into GOs, the eventual ability to reorganize might or might not be impaired but the triggering of unnecessary general fund or utility fund defaults in the meantime would be highly disruptive to municipal markets.

Q. THE TESTIMONY INDICATES THAT THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. HOW MANY OF THESE 32 CASES ACTUALLY FILED A PLAN OF REORGANIZATION?

ARE THE CONCERNS THAT YOU ARE RAISING TODAY A FACTOR IN HOW THE MUNICIPALITY PROCEEDED UNDER CHAPTER 9?

A. Being a bond lawyer and not a bankruptcy lawyer, I have not been involved in any of the 32 cases. To the best of my knowledge and belief, although general-purpose municipalities commonly issue revenue bonds for revenue-producing functions, none of these proceedings involved such a municipality. But future bankruptcies are likely to involve these municipalities. See the answer to the next question.

Q. A CRITICISM OF THIS LEGISLATION IS THAT IT IS A SOLUTION LOOKING FOR A PROBLEM, NOT A PROBLEM LOOKING FOR A SOLUTION. WOULD YOU RESPOND.

A. We are indeed fortunate that the bankruptcies to date under Chapter 9 have generally involved small, special-purpose municipal entities. To the best of my knowledge, none involved revenue bonds and only two involved substantial municipalities with taxing powers. These were South Tucson and the San Jose School District. In San Jose, there were outstanding bonds backed by taxes that, under state law, were specifically levied to pay the bonds and could not be used for any other purpose. Other creditors could have sought to destroy the security for these bonds under §552 but did not do so, presumably because no one's interests would have been served by default and the resulting non-access to financial markets.

As the enclosed Wall Street Journal article[1] shows, we are heading into a new era with more substantial municipalities in trouble. It is imperative that municipalities be able to utilize Chapter 9 without jeopardizing the lawful security for their revenue bonds or risking the imposition of the repayment obligation on the taxpayers in violation of state law.

Q. CURRENTLY THERE IS LITIGATION INVOLVING THE BONDHOLDERS OF PROJECTS 4 AND 5 OF THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM (WPPSS). THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM COMMENCED CONSTRUCTION OF FIVE GENERATING PROJECTS IN THE 1970's TO PROVIDE ELECTRICITY TO CONSUMERS IN THE PACIFIC NORTHWEST.

IN 1982, THE SYSTEM TERMINATED PROJECTS 4 AND 5 BECAUSE OF SUBSTANTIAL COST OVERRUNS AND LOWER ESTIMATES OF THE AMOUNT OF POWER NEEDED.

I UNDERSTAND THAT THE SUPPLY SYSTEM IS NOT IN BANKRUPTCY, BUT COULD YOU EXPLAIN HOW THESE PROPOSED AMENDMENTS TO CHAPTER 9 WOULD IMPACT ON THE SITUATION INVOLVING THE SUPPLY SYSTEM.

A. The principal problems addressed by S. 1863 surfaced before the WPPSS defaults. The legislation is not aimed at the WPPSS situation but it would have a beneficial effect on it.

WPPSS has no intention of filing under Chapter 9, either in its present form or as amended. But, until Chapter 9 is amended, it cannot reduce its burden on the Bonneville Power Authority, the ratepayers of the Pacific Northwest and the federal government,[2] by refinancing its high-interest debt issued to finance Projects 1, 2 and 3. The rating agencies have advised WPPSS that they will not give ratings to bonds issued in a refinancing because, <u>if</u> WPPSS did file under the present Chapter 9, Bonneville's payments to WPPSS for

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[1]<u>Urban Wasteland</u>, The Wall Street Journal, June 22, 1988, page 1.

[2]Bonneville, a federal agency, passes its expenditures through to the ratepayers of the Northwest. These expenditures include Project 1, 2 and 3 debt service and repayments of loans from the federal government, as well as operating expenses. Its repayments to the federal government are limited by its resources. A reduction in interest costs on Projects 1, 2 and 3 would increase its repayments to the federal government.

principal and interest on Project 1, 2 and 3 bonds could be diverted to Projects 4 and 5. This would follow from the termination of the bondholders' lien under §552. It would take away from the 1, 2 and 3 bondholders the source of payment they had bargained for and give to the 4 and 5 bondholders a source of payment they had not bargained for. How long would Bonneville continue to pay in these circumstances?

When the WPPSS financing was structured, there was no §552 to destroy the only source of payment of the 1, 2 and 3 bonds. It is the retroactive applicability of §552 to WPPSS that makes the spectre of a WPPSS bankruptcy a nightmare for the Northwest.

Q. SOME MUNICIPALITIES WHICH ARE IN FINANCIAL TROUBLE TURN TO ALTERNATIVES OUTSIDE OF CHAPTER 9. WOULD YOU BRIEFLY EXPLAIN SOME OF THOSE ALTERNATIVES AND THEIR BENEFIT OVER A CHAPTER 9 PETITION.

A. Fortunately we have not had a municipal breakdown in Massachusetts since the 1930s. In the 1930s, the State Legislature put Fall River and Mashpee under the control of a state commission, giving it veto power over both appropriations and tax levies. Under this restraining hand, the municipalities regained their solvency and their autonomy. In subsequent decades, financial stress led to state laws authorizing local bonds to fund deficits in Boston and Somerville. These laws contained restraints on future spending aimed at preventing recurrence of their financial problems.

These arrangements worked because the remedies were tailored to fit the problems. There were no revenue bonds in these towns. But revenue bonds are now much more prevalent. In any community with outstanding revenue bonds, Chapter 9 as written is not a workable alternative to a state-sponsored solution. With the proposed amendments, it would be.

Q. THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. IS THERE A PROJECTION OF HOW MANY MUNICIPALITIES ARE CURRENTLY IN TROUBLE THAT WOULD BENEFIT FROM THE PROPOSED AMENDMENTS?

A. I am not qualified to project the number of municipalities that might need the protection of an improved Chapter 9 in the future. The enclosed Wall Street Journal article gives us reason to fear it might be many. Twist Cap teaches us that only one adverse decision under the existing Chapter 9 would be enough to deny market access to many, if not most, municipal revenue bond issuers.

Q. THE TESTIMONY MENTIONS THAT SOME MUNICIPALITIES ARE EXPERIENCING FINANCIAL PROBLEMS BECAUSE OF LABOR CONTRACTS.

WHAT IS THE INTERACTION OF SECTION 1113, WHICH WAS A CONGRESSIONAL RESPONSE TO THE SUPREME COURT DECISION IN BILDISCO, AND CHAPTER 9?

A. As a bond lawyer, and not a bankruptcy or labor lawyer, I am not qualified to answer this question. I note, however, that §1113 is not among the sections made applicable to municipal bankruptcies by §901.

* * *

I would be pleased to meet with you or your staff to try to answer any further questions. Your thoughtful consideration of these bankruptcy issues is greatly appreciated.

I am enclosing copies of my responses to Senator DeConcini's and Senator Thurmond's questions.

Sincerely yours,

James W. Perkins

James W. Perkins
Direct Dial: (617) 573-0271

JWP/lm
Enclosures
cc: Hon. Dennis DeConcini
Hon. Strom Thurmond

PALMER & DODGE
ONE BEACON STREET
BOSTON, MASSACHUSETTS 02108
TELEPHONE (617) 573-0100
TELECOPIER (617) 227-4420
TELEX 951104

June 24, 1988

The Honorable Strom Thurmond
Subcommittee on Courts
and Administrative Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Thurmond: Municipal Bankruptcy - S. 1863

Thank you for the opportunity to respond to your written questions. They will help to further focus the issues. I will answer them from my perspective as a bond lawyer. Mr. King will answer from the perspective of the bankruptcy bar.

Q. ASSUMING THE BANKRUPTCY CODE WAS INTERPRETED TO ALLOW FOR THE CONVERSION OF MUNICIPAL REVENUE BONDS INTO GENERAL OBLIGATION BONDS, AND IF LEGISLATION SUCH AS S. 1863 WERE NOT ENACTED, WHAT EFFECT WOULD THIS HAVE ON THE FUTURE STABILITY OF MUNICIPAL FINANCE?

A. A municipality may issue revenue bonds instead of general obligation bonds for any of a variety of reasons. The reason may be state constitutional or statutory limitations on the issuance of general obligation bonds, limitations imposed by a "home-rule" charter, voter antipathy to taxpayer subsidization of a revenue-producing function, or a desire to subject the project to a feasibility test in the financial marketplace. If §1111(b) converted the revenue bonds into general obligations, there would be a wholly avoidable collision between, on the one hand, raw federal power and, on the other hand, state constitutional or statutory policy, or hard-won local financial protections, or local voting rights, or careful financial planning at the local level. This frustration of either state policy or local decision-making is likely, through cynicism and confusion, to deter the undertaking of necessary public works in other states and municipalities.

Q. IN YOUR PREPARED STATEMENT YOU SPEAK OF AVOIDING THE COLLISION BETWEEN FEDERAL BANKRUPTCY LAW AND STATE CONSTITUTIONAL LAW AND STATUTORY LIMITATIONS ON THE ISSUANCE OF GENERAL OBLIGATION BONDS. COULD YOU EXPAND UPON THIS ISSUE AS IT RELATES TO CONVERSION OF REVENUE BONDS INTO GENERAL OBLIGATION BONDS?

A. Many states, by constitution or statute, limit the amount of debt that a municipality may incur. Bonds that are payable solely from the revenues of a revenue-producing function are generally exempt from these limits because they impose no burden on the municipal taxpayers. If the amendments are not enacted and revenue bonds are converted into general obligations, these debt limits will be exceeded.

In some states, the incurring of municipal debt requires voter approval. Here again, revenue bonds are often exempt because they do not burden the taxpayers. If the revenue bonds are converted into general obligations, they will become nonvoted general obligations in violation of state law.

In still other situations the law does not preclude the issuance of general obligations but a municipality may choose to issue revenue bonds instead of GOs in order to protect its general obligation credit, or to subject the project to a feasibility test in the financial market place, or for other reasons. If the bonds are converted to general obligations although by their terms they are payable solely from the pledged revenues, state contractual law is subverted.

These unintended federal preemptions of state law can be avoided by adopting the proposed amendments.

* * *

I would be pleased to meet with you or your staff to try to answer any further questions. Your thoughtful consideration of these bankruptcy issues is greatly appreciated.

I am enclosing copies of my responses to Senator Heflin's and Senator DeConcini's questions.

Sincerely yours,

James W. Perkins

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Law Offices of

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Theodore S. Chapman
1877-1943
Henry E. Cutler
1879-1959

111 West Monroe Street, Chicago, Illinois 60603
TWX 910-221-2103 Telex 206281
Telephone 312 845-3000

Salt Lake City Office
50 South Main Street
Salt Lake City, Utah 84144
Telephone 801 533-0066

James E. Spiotto
312 845-3763

July 26, 1988

The Honorable Howell Heflin
Subcommitte on Courts
and Administratial Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Re: Municipal Bankruptcy - S1863

Dear Senator Heflin:

I hope my answers to the following questions will be of assistance.

Q. WHAT IS THE IMPACT OF CURRENT PROVISIONS OF CHAPTER 9 ON A MUNICIPALITY'S ACCESS TO CREDIT MARKETS?

A. The uncertainty regarding the impact of Section 552(a) and Section 547 of the Bankruptcy Code clearly has not enhanced municipalities' access to credit markets. This uncertainty has not to date been a significant factor in the decisions made with respect to the issuance of municipal securities, including the interest rate charged. The municipal bond market has anticipated that the corrective measures, which have been sought in the nature of technical amendments since the passage of the Bankruptcy Code, will be enacted this year. If such a passage does not occur, there will be a reexamination of the effect of Sections 547, 552(a) and 1111(b), and one can expect an even greater concern on the part of the municipal bond market.

It is clear when municipalities are in trouble that they have and will feel the lack of clarity with respect to these Sections. The municipal bond market is reluctant to lend to financially troubled municipalities, and unanswered questions regarding the effect of pledges of revenue made within 90 days of the date of filing a petition may limit the ability of a financially strapped municipality to solve its problems. Likewise, the threat that Section 552(a) could interfere with a pledge of revenues strains the financially troubled municipality's access to the debt market.

The relevant data suggest that there will be a number of cities, especially small and medium cities, which will suffer significant budget deficits in the light of the anticipated interest rate increase in 1989. These are the cities which most likely will need continued municipal finance especially for necessary improvements or maintenance to infrastructure. At the same time, if such cities seek any relief under Chapter 9 of the Bankruptcy Code, and Senate Bill 1863 has not been enacted, there will be increasing concern in the municipal bond market relating to the termination of the pledge of revenues under Section 552(a) of the Bankruptcy Code. Further, a financially troubled municipality will be questioned about the extension of any credit by the municipal bond market during the 90-day period prior to a Chapter 9 since any pledge or payment on the bonds could be deemed a voidable preference under Section 547 of the Bankruptcy Code.

As the materials which have been submitted in support of the Municipal Bankruptcy Amendments indicate, the proposed Amendments are to clarify concerns regarding revenue bond issues. Revenue bond issues are bonds which are payable solely from the revenues of the project and are not general obligations of the municipal issuer. Some take the position that because of the concerns which presently exist regarding the Bankruptcy Code since 1968, revenue bonds are no longer judged by rating agencies or large investors solely upon the operations of the project without looking at the actual condition of the issuer itself. Previously, a small town could have a better credit position for its revenue bonds than for its GO bonds if the town's general credit was considered to be weak. Since the passage of the Bankruptcy Code, many who are familiar with this area contend that the rating agencies and large investors have started to question the continued viability of revenue bonds fearing that, although the revenue producing project may be solvent and capable of paying for its operation and debt service, the municipality itself may run into problems ultimately resulting in the filing of a bankruptcy petition. The fear is that revenues would be diverted to pay the operations of the town and that the bondholders would become general creditors. Because of this added danger to municipal revenue bonds, investors have sought more specific opinions from bond counsel which are reasoned rather than qualified, and there are those who contend that there has been an increase in the interest rates for such revenue bonds.

In fact, many municipalities have governed their actions based on a concern that positions taken in a Chapter 9 could forever bar their access to municipal bond markets. The San Jose School District filed bankruptcy at the same time that an interest payment was due its bondholders on June 30, 1983. From the beginning of the institution of that case, the San Jose School District made it clear that it did not intend to in any way impair the rights of the bondholders by the institution of the Chapter 9 procedure. Details as to the bankruptcy of the San Jose School District are set forth in the materials which I submitted in preparation for testimony. Similarly, when a financial emergency was declared by the State Auditor in 1980, the City of Cleveland did not consider a resort to municipal bankruptcy. Instead, Cleveland sought to solve its financial problems by borrowing $15 million from the State of Ohio to pay overdue debts and through the issuance and sale of $36.2 million in bonds to Cleveland banks. Cleveland apparently considered the resort to municipal bankruptcy too risky given the uncertainties which the pending legislation seeks to address. Also, certain advantageous bailout financing was not possible given the unresolved questions about the Bankruptcy Code.

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The Honorable Howell Heflin
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Q. IF A MUNICIPALITY FILES BANKRUPTCY UNDER THE CURRENT PROVISIONS OF CHAPTER 9, AND IGNORES SOME OF THE STATUTORY MANDATES BECAUSE THEY CONFLICT WITH THE MUNICIPALITY'S OBLIGATION TO CONTINUE MEETING ITS FINANCIAL RESPONSIBILITIES, HOW DOES THIS AFFECT THE MUNICIPALITY'S ABILITY TO REORGANIZE?

A. A municipality cannot ignore the statutory mandates of Chapter 9. Instead, cities which have utilized Chapter 9, such as San Jose, have bent over backward to leave bondholders unimpaired. I am unaware of any case, however, in which opposing creditor groups such as trade have attempted to force the issue of a preference or termination of a pledge of revenues other than as evidenced in the Badger Mountain case discussed below. Such could happen. Senate Bill 1863 is designed to relieve a municipality from the difficulty of being faced with other creditor groups attempting to force an unintended interpretation on Section 552(a) and 547(e)(3) by eliminating these concerns. Should a court at the insistence of such creditor groups decide upon the application of these sections some have feared, such would definitely affect a municipality's ability to reorganize since access to municipal finance in the future would be at serious risk.

Q. THE TESTIMONY INDICATES THAT THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. HOW MANY OF THESE 32 CASES ACTUALLY FILED A PLAN OF REORGANIZATION?

ARE THE CONCERNS THAT YOU ARE RAISING TODAY A FACTOR IN HOW THE MUNICIPALITY PROCEEDED UNDER CHAPTER 9?

A CRITICISM OF THIS LEGISLATION IS THAT IT IS A SOLUTION LOOKING FOR A PROBLEM, NOT A PROBLEM LOOKING FOR A SOLUTION.

WOULD YOU RESPOND.

A. Of the 32 cases, plans of reorganization were filed in 23 cases. In four cases, the matters were dismissed prior to the filing of plans. We are in the process of investigating the other cases and will supply additional information when available.

The concerns raised are very real as evidenced by the currently pending Badger Mountain litigation. In <u>In re Badger Mountain Irrigation District</u>, U.S. District Court, Eastern District of Washington, No. C87-161-RJM, the extent to which the bondholders were secured depended on an interpretation of state law regarding the extent of the bondholders' lien against the property owned by an irrigation district. The bondholders claimed a lien not only against the physical property owned by the District, but also against what they alleged is a property interest of the District, namely the power and obligation of the Badger Mountain Irrigation District to assess in the future lands within its boundaries for payment on the

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bonds. In upholding the Bankruptcy Court, the District Court declined to extend the bondholders' lien that far even though the bondholders contend such was contemplated by the documents. However, the Court held that the lien such as it existed would not be avoided in bankruptcy. The case currently is on appeal to the Ninth Circuit. The plan of reorganization filed in that case proposed that the bondholders would receive refunding bonds which would not be secured at any time by future assessments on real property within the District or property not received by the District prior to confirmation. The plan cannot be confirmed pending the resolution of the litigation. However it serves to illustrate that the issues presented by Senate Bill 1863 are alive and well.

Q. CURRENTLY THERE IS LITIGATION INVOLVING THE BONDHOLDERS OF PROJECTS 4 AND 5 OF THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM (WPPSS). THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM COMMENCED CONSTRUCTION OF FIVE GENERATING PROJECTS IN THE 1970S TO PROVIDE ELECTRICITY TO CONSUMERS IN THE PACIFIC NORTHWEST.

IN 1982, THE SYSTEM TERMINATED PROJECTS 4 AND 5 BECAUSE OF SUBSTANTIAL COST OVERRUNS AND LOWER ESTIMATES OF THE AMOUNT OF POWER NEEDED.

I UNDERSTAND THAT THE SUPPLY SYSTEM IS NOT IN BANKRUPTCY, BUT COULD YOU EXPLAIN HOW THESE PROPOSED AMENDMENTS TO CHAPTER 9 WOULD IMPACT ON THE SITUATION INVOLVING THE SUPPLY SYSTEM.

A. The Supply System and various parties connected directly or indirectly with the issuance of the Projects 4 and 5 bonds of the Supply System have been involved in lengthy litigation in MDL551. The court in that case has just approved partial settlements with certain parties, and it appears that that litigation will be resolved either through a global settlement or following a trial with non-settling defendants. S1863 is not directed at the WPPSS situation. However, the passage of the legislation would clarify once and for all that the pledge of revenues to Projects 1, 2 and 3 bonds cannot be diverted to solve other problems of the Supply System. However, while the passage of S1863 would reaffirm the respect to be accorded contractual provisions, it would not appear that the passage of S1863 would effect the pending cost-sharing litigation vis-a-vis the parties to that litigation.

Q. SOME MUNICIPALITIES WHICH ARE IN FINANCIAL TROUBLE TURN TO ALTERNATIVES OUTSIDE OF CHAPTER 9. WOULD YOU BRIEFLY EXPLAIN SOME OF THOSE ALTERNATIVES AND THEIR BENEFIT OVER A CHAPTER 9 PETITION.

A. As set forth in the materials previously submitted, Chapter 9 is not widely utilized and cities have attempted to seek alternatives outside of Chapter 9. This is not to say that those alternatives are necessarily better than a Chapter 9 if the

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uncertainties were clarified by Senate Bill 1863. However, given the uncertainties which now exist regarding the effect of a Chapter 9, many municipalities are loath to risk reliance upon Chapter 9 and instead pursue other alternatives.

Numerous states have provided for a state agency or other party to act as a receiver when a local governmental unit defaults on its financing obligations. State-created agencies have prevented a number of municipalities from having to seek relief under Chapter 9, and have allowed a number of troubled municipalities to work out their problems under state supervision while providing to the bondholders the assurance that the amounts still owing to them will be paid. This was done in New York City with the creation of the Municipal Assistance Corporation and also in Chicago in 1980 with the creation of the Chicago School Finance Authority. Frequently, states have enacted moratorium laws when faced with a municipal financial crisis. Such moratoria have received mixed treatment by the courts. To the degree they prevent bondholders from suing on past due interest and principal, such laws are unconstitutional.

Consultants, financial advisors or financing authorities cannot alter the bondholders' rights and remedies without the consent the bondholders and such consultants, advisors or authorities cannot properly exercise the power of a municipal body. Similarly, they cannot have an improper delegation by the municipal body of its municipal powers. If a municipal body finds that its function or purpose has been eliminated, another mechanism is to petition the legislature for revocation of its charter seeking an appropriate state court to supervise the liquidation of the municipal assets. This remedy is probably more appropriate for special tax districts and local governmental agencies which experience financial difficulties and have no current public purpose for their continued operation and existence.

The disadvantages of a workout outside of bankruptcy include the fact that lawsuits are not automatically stayed unless there is legislation or a court order staying such during the workout. Further, there is not necessarily an efficient and practical method whereby all creditors will be bound by the agreement of the majority except perhaps in a state receivership. Compositions are voluntary, and one holdout among creditor groups can create problems. Bankruptcy puts all creditors in one forum rather than a multitude of various forums staying litigation and providing a mechanism of binding all creditors so a recalcitrant creditor cannot hold up the process by unreasonably demanding more than what other similarly situated creditors are receiving. The Contract Clause of the United States Constitution and various state constitutions prevent a non-judicial mandatory involuntary settlement of claims by all creditors.

Q. THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. IS THERE A PROJECTION OF HOW MANY MUNICIPALITIES ARE CURRENTLY IN TROUBLE THAT WOULD BENEFIT FROM THE PROPOSED AMENDMENTS?

A. Such information is probably most readily available from organizations which collect this type of data. Via a copy of the answers to these questions, I am asking Frank Shafroth of the National League of Cities if he can assist in obtaining such information. Information recently released by the National League of Cities reveals that the proportion of cities reporting that their outlays exceeded revenues rose to 50% in 1988 from 33% in 1987, indicating possible future problem areas.

Q. THE TESTIMONY MENTIONS THAT SOME MUNICIPALITIES ARE EXPERIENCING FINANCIAL PROBLEMS BECAUSE OF LABOR CONTRACTS.

WHAT IS THE INTERACTION OF SECTION 1113, WHICH WAS A CONGRESSIONAL RESPONSE TO THE SUPREME COURT DECISION IN BILDISCO, AND CHAPTER 9?

A. The Bankruptcy Code provides that a municipality, after filing a bankruptcy petition, can reject executory contracts. In 1984, in National Labor Relations Board v. Bildisco and Bildisco, 465 U.S. 513 (1984) the Supreme Court held that Section 365(a) of the Bankruptcy Code provides that, with certain exceptions, a trustee may assume or reject collective bargaining agreements. The case attempted to set forth the standard by which such collective bargaining agreements could be rejected. The Court indicated that such could be rejected only if the debtor could show that the agreement both burdened the estate and that the equities balanced in favor of rejection. This would include a consideration of the likelihood and consequences of liquidation for the debtor absent rejection, the reduced value of the creditors claims that would follow from affirmance, and the hardship that would be imposed upon them, and the impact of rejection on the employees. The Court rejected the test espoused by the union that Bildisco could not be permitted to reject the agreement unless it could demonstrate that its reorganization would fail unless rejection was permitted. Section 1113 is Congress' attempt to modify the Bildisco' holding. Section 1113 substantially adopts the holding of Bildisco with respect to the balancing of equities. However, the Section overrules the portion of the opinion which held that unilateral rejection is not an unfair labor practice and therefore the debtor did not need to comply with the NLRB prior to seeking permission of the Bankruptcy Court to reject. It is true that Section 1113 is not incorporated in Section 901. As a result the Bildisco decision may be applicable, and still valid as to a Chapter 9 to the extent it is not inconsistent with Section 904 of the Bankruptcy Code or the 10th Amendment. (Section 904 of the Code, of course, requires that the Bankruptcy Court cannot interfere with the political or governmental powers of the debtor.) Accordingly, the jurisdiction of the Bankruptcy Court is limited and the termination of a labor contract contrary to

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The Honorable Howell Heflin
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the wishes of the municipality's elected officials may be subject to attack as beyond the Court's power. Neither Bildisco nor Section 1113 provides any standards for determining when a labor contract rejection by a municipality is justified. Standards that govern corporate bankruptcies cannot necessarily be applied to a municipality because the government cannot cease operation, and therefore all employees cannot lose their job. In any event, a clear standard should be promulgated to ensure that no violation of Section 904 or the 10th Amendment occurs.

The governmental considerations of keeping people employed in necessary governmental functions have lead to an attempt to manage and work out municipal labor problems. Interestingly, when securities were issued as part of the New York City financial crisis, the labor union pension funds were among the major purchasers of the securities issued by the Municipal Assistance Corporation.

I would be pleased to answer any other questions which you may have.

Sincerely,

James E. Spiotto

James E. Spiotto

JES/dlc

cc: Hon. Dennis De Concini
Hon. Strom Thurmond
Frank Shafroth

Law Offices of

CHAPMAN AND CUTLER
a partnership including professional corporations

Theodore S Chapman
1877-1943
Henry E Cutler
1879-1959

111 West Monroe Street, Chicago, Illinois 60603
TWX 910-221-2103 Telex 206281
FAX (312) 701-2361
Telephone (312) 845-3000

2 North Central Avenue
Phoenix, Arizona 85004
(602) 256-4060

100 Peachtree Street, N W
Atlanta, Georgia 30303
(404) 420-1420

50 South Main Street
Salt Lake City, Utah 84144
(801) 533-0066

July 26, 1988

The Honorable Strom Thurmond
Subcommitte on Courts
and Administratial Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Re: Municipal Bankruptcy - S1863

Dear Senator Thurmond:

I hope the following answer to your question will be of assistance.

Q. ASSUMING THE BANKRUPTCY CODE WAS INTERPRETED TO ALLOW FOR THE CONVERSION OF MUNICIPAL REVENUE BONDS INTO GENERAL OBLIGATION BONDS, AND IF LEGISLATION SUCH AS S.1863 WERE NOT ENACTED, WHAT EFFECT WOULD THIS HAVE ON THE FUTURE STABILITY OF MUNICIPAL FINANCE?

A. If Section 1111(b) converted the revenue bonds into general obligations it will be increasingly difficult to issue revenue bonds. The problem would be whether or not such revenue bonds violated the Constitutional Debt Limitations, and much more sophisticated and detailed credit checks would have to be performed by issuers. If such was not done, the risk of such conversion would be reflected in the interest rate for the bonds.

Please do not hesitate to contact me if you have any further questions.

Sincerely,

JES

James E. Spiotto

JES/dlc

cc: Hon. Dennis De Concini
Hon. Howell Heflin

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Law Offices of

CHAPMAN AND CUTLER
a partnership including professional corporations

Theodore S Chapman 1877-1943
Henry E Cutler 1879-1959

111 West Monroe Street, Chicago, Illinois 60603
TWX 910-221-2103 Telex 206281
FAX (312) 701-2361
Telephone (312) 845-3000

2 North Central Avenue
Phoenix, Arizona 85004
(602) 256-4060

100 Peachtree Street, N W
Atlanta, Georgia 30303
(404) 420-1420

50 South Main Street
Salt Lake City, Utah 84144
(801) 533-0066

July 26, 1988

The Honorable Dennis De Concini
Subcommitte on Courts
and Administratial Practice
223 Hart Senate Office Building
Washington, D.C. 20510

Re: Municipal Bankruptcy - S1863

Dear Senator De Concini:

I hope the answers to the following questions will be of assistance to you.

Q. **ARE YOU SATISFIED THAT ENACTMENT OF THIS LEGISLATION WILL NOT VIOLATE THE 10TH AMENDMENT? I KNOW THAT THIS WAS A CONCERN IN 1976 WHEN THE MUNICIPAL BANKRUPTCY AMENDMENTS OF 1976 WERE CONSIDERED.**

A. The 10th Amendment precludes the power of the federal government to supervise the bankruptcy of a state. Such was at issue in 1936 in the case of Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513 (1936) in which the Bankruptcy Act enacted in 1934 was held to be unconstitutional. The 1937 Municipal Bankruptcy legislation enacted in response to the Ashton decision required no interference with the fiscal or governmental affairs of political subdivisions, no involuntary proceedings, no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes and impairment of contractual obligations of states. This legislation was upheld by the Supreme Court in United States v. Bekins, 304 U.S. 27 (1938) which noted that statute was carefully drawn not to impinge upon the sovereignty of the states. The legislation set forth in S1863 in no way extends the control of the federal government over the government and affairs of municipalities. Rather it attempts to preserve the sovereign power of municipalities and the rights and interests of the holders of municipal debt. Therefore, the proposed legislation would not violate the 10th Amendment.

Q. **WHY HAS THE NEED FOR THIS LEGISLATION ARISEN? WHY DOESN'T PRESENT CHAPTER 9 SUFFICE? WHAT COULD HAPPEN IF THIS LEGISLATION IS NOT PASSED AND A CITY FILES FOR CHAPTER 9?**

A. As set forth in the materials submitted, given the concerns presented by the current Chapter 9, such either is not utilized or, if resorted to, no attempt is made to adjust the long-term debt of the municipality which at times would be

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The Honorable Dennis De Concini
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beneficial to the municipality. It is clear that municipalities and most specifically small and medium sized municipalities may very well wish to avail themselves of a Chapter 9 proceeding. However, given the uncertainties that Sections 552(a), 547 and 1111(b) place on bonded indebtedness, municipalities will continue to refrain from using Chapter 9 rather than risk their ability for future financing through the municipal bond market. It is up to Congress to decide whether or not Congress desires municipalities to be able to use Chapter 9 in a effective manner to help resolve their financing difficulties. If Congress desires effective use of a Chapter 9 proceeding, the only way to avoid the stigma of a Chapter 9 proceeding in the municipal bond market is to assure that the statutory and constitutional pledges and rights granted to bondholders remain in effect during the Chapter 9 proceeding. The proposed amendments would ensure that revenue bond obligations could not be transformed into general obligations in a bankruptcy proceeding which would then make such securities payable from the general revenue.

Q. **ARE SUFFICIENT EXCEPTIONS CONTAINED IN THE BILL TO PERMIT FUTURE INHABITANTS OF A CITY FROM BEING OVERLY BURDENED BY THE COMMITMENTS THAT THIS BILL WOULD REQUIRE FROM A POPULACE TO PAY ON ITS INDEBTEDNESS?**

A. The amendments do not in any way add additional commitments to future taxpayers. The whole notion of Chapter 9, as it currently exists, is debt adjustment not debt elimination. The amendments attempt to resolve issues of uncertainty with respect to revenue bonds which quite frankly are not payable by the general taxpayers in any event.

If you have any additional questions, do not hesitate to contact the undersigned.

Sincerely,

James E. Spiotto

JES/dlc

cc: Hon. Howell Heflin
Hon. Strom Thurmond

COPY

CHAPTER NINE CASES FILED

June, 1988

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1984	(A)	Whitley County Water District	E. Kentucky	84-00089	no plan filed	case dismissed 04/17/85
1984	(A)	Sanitary & Improvement District #83 of Sarpy County, Nebraska	Nebraska	84-01263	06/29/84	03/11/85
1987	(A)	Northwest Harris County Municipal Utility District No. 19	Southern Texas	87-02498-H-2-9	03/10/87	
1985	(A)	Sanitary and Improvement District No. 285 of Douglas County, Nebraska	Nebraska	85-2384	12/27/85 01/24/88 amendment 07/10/86 amendment	10/07/88
1985	(A)	Badger Mountain Irrigation District	Washington	03136-299	11/23/87	
1985	(A)	Bell County Garbage and Refuse Disposal District	Kentucky	85-143	05/08/88	no date; case dismissed 06/30/88
1985	(A)	Sanitary & Improvement District #7 of Lancaster County, Nebraska	Nebraska	85-0039	01/15/86 11/18/86 amendment 05/02/88 amendment	not yet confirmed

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

BY TYPE

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1981	(A)	North & South Shenango Joint Municipal Authority	W. Penn.	81-00408	case dismissed 05/26/82	no plan filed
1980	(A)	Grimes County Municipal Utility District #1	Southern Texas	80-010948	08/19/80	04/20/81
1982	(A)	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139	04/12/82 12/22/82 (refiled)	case dismissed 05/19/83
1982	(A)	Sanitary & Improvement District #5 of Cass County, Nebraska	Nebraska	82-01671	11/01/83 10/24/86 amendment 11/12/86 amendment 01/22/87 amendment	02/26/87
1983	(A)	Sanitary & Improvement District #4 of Lancaster County, Nebraska	Nebraska	83-01456	10/06/83 04/17/84 amendment 06/18/84 amendment	08/02/84
1983	(A)	Sanitary & Improvement District #42 of Sarpy County, Nebraska	Nebraska	83-00956	06/02/83 07/27/84 amendment	09/26/84
1987	(A)	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590	08/31/87	01/15/88
1987	(A)	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218	03/04/87	07/20/87
1987	(A)	Eagles Nest Metropolitan District	Colorado	87B1512E	written request for date; awaiting response	

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1986	(A)	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798	06/20/86	11/17/86
1986	(A)	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885	06/27/86 10/30/86 amendment	11/07/86
1987	(B)	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1	settled prior to filing plan	
1988	(B)	Borough of Shenandoah	Pennsylvania	88-20603	case dismissed prior to filing plan	
1983	(B)	South Tucson, Arizona	Arizona	83-00866	12/23/83 02/21/84 amendment 04/05/84 amendment	04/09/84 confirmation case closed 03/23/88
1982	(B)	Wapanucka, Oklahoma	E. Oklahoma	82-00231	no plan filed; case dismissed 10/14/83	
1984	(B)	Wellston, Missouri	Mo.	84-01492(3)	written request for more information	case closed 10/01/86
1987	(B)	Village of Merrill, Michigan	Michigan	87-09455	06/19/87	case dismissed 12/09/87
1984	(C)	Pulaski Memorial Hospital	Mo.	84-00082	08/14/85	10/10/85 confirmation case closed 01/08/88
1985	(C)	Monterey County Special Health Care Authority	N. California	85-00649	01/08/86	03/27/86

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1983	(C)	Jersey City Medical Center	N. Jersey	83-00829	written request for date	08/06/85
1988	(C)	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	18810005	07/07/88	disclosure hearing set for 08/09/88
1986	(D)	Cooper River School District	Alaska	3-86-00820	02/17/88	
1983	(D)	San Jose School District	N. California	83-02387	02/07/84	case dismissed 05/08/84
1981	(D)	The Management Institute of San Leandro	N. California	81-02265	written request for date; awaiting response	
1986	(D)	Lassen Community College District	California	2-86-01379	written request for date; awaiting response	

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

CHAPTER NINE CASES FILED

June, 1988

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1986	(D)	Cooper River School District	Alaska	3-86-00820	02/17/88	
1983	(B)	South Tucson, Arizona	Arizona	83-00866	12/23/83 02/21/84 amendment 04/05/84 amendment	04/09/84 confirmation case closed 03/23/88
1986	(D)	Lassen Community College District	California	2-86-01379	written request for date; awaiting response	
1987	(A)	Eagles Nest Metropolitan District	Colorado	87B1512E	written request for date; awaiting response	
1984	(A)	Whitley County Water District	E. Kentucky	84-00089	no plan filed	case dismissed 04/17/85
1982	(B)	Wapanucka, Oklahoma	E. Oklahoma	82-00231	no plan filed; case dismissed 10/14/83	
1987	(A)	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590	08/31/87	01/15/88

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

BY STATE

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1987	(A)	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218	03/04/87	07/20/87
1985	(A)	Bell County Garbage and Refuse Disposal District	Kentucky	85-143	05/08/88	no date; case dismissed 06/30/88
1982	(A)	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139	04/12/82 12/22/62 (refiled)	case dismissed 05/19/83
1987	(B)	Village of Merrill, Michigan	Michigan	87-09455	06/19/87	case dismissed 12/09/87
1987	(B)	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1	settled prior to filing plan	
1984	(C)	Pulaski Memorial Hospital	Mo.	84-00082	08/14/85	10/10/85 confirmation case closed 01/08/88
1984	(B)	Wellston, Missouri	Mo.	84-01492(3)	written request for more information	case closed 10/01/86
1985	(C)	Monterey County Special Health Care Authority	N. California	85-00649	01/08/86	03/27/86
1983	(D)	San Jose School District	N. California	83-02387	02/07/84	case dismissed 05/08/84
1981	(D)	The Management Institute of San Leandro	N. California	81-02265	written request for date; awaiting response	

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1983	(C)	Jersey City Medical Center	N. Jersey	83-00829	written request for date	08/06/85
1982	(A)	Sanitary & Improvement District #5 of Cass County, Nebraska	Nebraska	82-01671	11/01/83 10/24/86 amendment 11/12/86 amendment 01/22/87 amendment	02/26/87
1983	(A)	Sanitary & Improvement District #4 of Lancaster County, Nebraska	Nebraska	83-01456	10/06/83 04/17/84 amendment 06/18/84 amendment	08/02/84
1983	(A)	Sanitary & Improvement District #42 of Sarpy County, Nebraska	Nebraska	83-00956	06/02/83 07/27/84 amendment	09/26/84
1984	(A)	Sanitary & Improvement District #63 of Sarpy County, Nebraska	Nebraska	84-01263	06/29/84	03/11/85
1985	(A)	Sanitary and Improvement District No. 265 of Douglas County, Nebraska	Nebraska	85-2384	12/27/85 01/24/86 amendment 07/10/86 amendment	10/07/86
1985	(A)	Sanitary & Improvement District #7 of Lancaster County, Nebraska	Nebraska	85-0039	01/15/86 11/18/86 amendment 05/02/88 amendment	not yet confirmed
1986	(A)	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798	06/20/86	11/17/86

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

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YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1986	(A)	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885	06/27/88 10/30/86 amendment	11/07/86
1988	(B)	Borough of Shenandoah	Pennsylvania	88-20603	case dismissed prior to filing plan	
1967	(A)	Northwest Harris County Municipal Utility District No. 19	Southern Texas	87-02498-H-2-9	03/10/87	
1980	(A)	Grimes County Municipal Utility District #1	Southern Texas	80-010948	08/19/80	04/20/81
1988	(C)	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	18810005	07/07/88	disclosure hearing set for 08/09/88
1981	(A)	North & South Shenango Joint Municipal Authority	W. Penn.	81-00408	case dismissed 05/26/82	no plan filed
1985	(A)	Badger Mountain Irrigation District	Washington	03136-299	11/23/87	

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

CHAPTER NINE CASES FILED

June, 1988

		COURT	DOCKET		PLAN OF	CONFIRMATION
YEAR		DEBTOR	DISTRICT	NUMBER	REORGANIZATION	OF PLAN
1980	(A)	Grimes County Municipal Utility District #1	Southern Texas	80-010948	08/19/80	04/20/81
1981	(D)	The Management Institute of San Leandro	N. California	81-02265	written request for date; awaiting response	
1981	(A)	North & South Shenango Joint Municipal Authority	W. Penn.	81-00408	case dismissed 05/26/82	no plan filed
1982	(B)	Wapanucka, Oklahoma	E. Oklahoma	82-00231	no plan filed; case dismissed 10/14/83	
1982	(A)	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139	04/12/82 12/22/82 (refiled)	case dismissed 05/19/83
1982	(A)	Sanitary & Improvement District #5 of Cass County, Nebraska	Nebraska	82-01671	11/01/83 10/24/86 amendment 11/12/86 amendment 01/22/87 amendment	02/26/87
1983	(A)	Sanitary & Improvement District #4 of Lancaster County, Nebraska	Nebraska	83-01456	10/06/83 04/17/84 amendment 06/18/84 amendment	08/02/84

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1983	(A)	Sanitary & Improvement District #42 of Sarpy County, Nebraska	Nebraska	83-00956	06/02/83 07/27/84 amendment	09/26/84
1983	(C)	Jersey City Medical Center	N. Jersey	83-00829	written request for date	08/06/85
1983	(B)	South Tucson, Arizona	Arizona	83-00866	12/23/83 02/21/84 amendment 04/05/84 amendment	04/09/84 confirmation case closed 03/23/88
1983	(D)	San Jose School District	N. California	83-02387	02/07/84	case dismissed 05/08/84
1984	(A)	Whitley County Water District	E. Kentucky	84-00089	no plan filed	case dismissed 04/17/85
1984	(A)	Sanitary & Improvement District #63 of Sarpy County, Nebraska	Nebraska	84-01263	06/29/84	03/11/85
1984	(C)	Pulaski Memorial Hospital	Mo.	84-00082	08/14/85	10/10/85 confirmation case closed 01/08/88
1984	(B)	Wellston, Missouri	Mo.	84-01492(3)	written request for more information	case closed 10/01/86
1985	(A)	Sanitary & Improvement District #7 of Lancaster County, Nebraska	Nebraska	85-0039	01/15/86 11/18/86 amendment 05/02/88 amendment	not yet confirmed

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YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1985	(C)	Monterey County Special Health Care Authority	N. California	85-00649	01/08/86	03/27/86
1985	(A)	Sanitary and Improvement District No. 265 of Douglas County, Nebraska	Nebraska	85-2384	12/27/85 01/24/86 amendment 07/10/86 amendment	10/07/86
1985	(A)	Badger Mountain Irrigation District	Washington	03136-299	11/23/87	
1985	(A)	Bell County Garbage and Refuse Disposal District	Kentucky	85-143	05/08/88	no date; case dismissed 06/30/88
1986	(D)	Lassen Community College District	California	2-86-01379	written request for date; awaiting response	
1986	(A)	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798	06/20/86	11/17/86
1986	(A)	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885	06/27/86 10/30/86 amendment	11/07/86
1986	(D)	Cooper River School District	Alaska	3-86-00820	02/17/88	
1987	(A)	Northwest Harris County Municipal Utility District No. 19	Southern Texas	87-02498-H-2-9	03/10/87	
1987	(B)	Village of Merrill, Michigan	Michigan	87-09455	06/19/87	case dismissed 12/09/87

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

YEAR		COURT DEBTOR	DOCKET DISTRICT	NUMBER	PLAN OF REORGANIZATION	CONFIRMATION OF PLAN
1987	(A)	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590	08/31/87	01/15/88
1987	(A)	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218	03/04/87	07/20/87
1987	(A)	Eagles Nest Metropolitan District	Colorado	87B1512E	written request for date; awaiting response	
1987	(B)	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1	settled prior to filing plan	
1988	(C)	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	18810005	07/07/88	disclosure hearing set for 08/09/88
1988	(B)	Borough of Shenandoah	Pennsylvania	88-20603	case dismissed prior to filing plan	

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education

NATIONAL BANKRUPTCY CONFERENCE

(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration.)

June 24, 1988

Honorable Dennis DeConcini
Subcommittee on Courts
and Administrative Practice
Senate Judiciary Committee
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator DeConcini:

Following are my responses to the questions concerning municipal bankruptcy that were attached to Senator Heflin's letter of June 16, 1988.

S.2279:

1. I HAVE A COUPLE QUESTIONS REGARDING S.2279, THE INTEREST RATE SWAPS BILL. S.2279 APPEARS TO BE A TECHNICAL AMENDMENT TO THE EXISTING PROVISIONS OF THE BANKRUPTCY CODE. I UNDERSTAND THAT SWAP AGREEMENTS ARE AN INCREASINGLY IMPORTANT FINANCIAL MANAGEMENT PROGRAM USED BY FINANCIAL AND COMMERCIAL INSTITUTIONS. DO YOU AGREE THAT THE LEGISLATION IS A REASONABLE EXTENSION OF CURRENT LAW THAT ALREADY SIMILARLY PROTECTS SECURITIES, COMMODITIES, AND REPURCHASE AGREEMENT CONTRACTS?

I agree that S.2279 is a reasonable extension of current law that protects securities, commodities and repurchase agreements. It is sound legislation to include in such protection new or developing financing instruments.

2. DO YOU AGREE THAT THERE ARE UNIQUE REASONS FOR SWAP PARTICIPANTS TO BE ABLE TO CLOSE OUT AND NET OUTSTANDING SWAP AGREEMENTS?

The same reasons apply for such agreements as are relevant to securities, commodities and repurchase agreements. Essentially the markets can continue and a domino effect avoided.

3. WOULD ENACTMENT OF THIS LEGISLATION HAVE ANY ADVERSE IMPACT ON INDIVIDUAL DEBTORS OR CONSUMERS?

I do not believe that individual debtors or consumers would suffer any impact from this legislation.

4. WOULD ENACTMENT OF THIS LEGISLATION SET A PRECEDENT THAT WOULD ADVERSELY IMPACT THE BANKRUPTCY CODE GENERALLY?

I do not believe that this legislation would have an impact on the Bankruptcy Code generally. It is transaction specific and, thus, would be of limited application.

S.1863:

1. ARE YOU SATISFIED THAT ENACTMENT OF THIS LEGISLATION WILL NOT VIOLATE THE 10TH AMENDMENT? I KNOW THAT THIS WAS A CONCERN IN 1976 WHEN THE MUNICIPAL BANKRUPTCY AMENDMENTS OF 1976 WERE CONSIDERED.

This legislation should not violate the 10th Amendment. If chapter 9 is not violative of the 10th Amendment, this legislation does not further impede on State powers, and should not have that adverse affect.

2. WHY HAS THE NEED FOR THIS LEGISLATION ARISEN? WHY DOESN'T PRESENT CHAPTER 9 SUFFICE? WHAT COULD HAPPEN IF THIS LEGISLATION IS NOT PASSED AND A CITY FILES FOR CHAPTER 9?

a. The term "insolvent" is used in various sections of the Code, e.g., sections 109(c), 547(b)(3), but it does not comport with the general nature of a municipality such as a village, town or city. Most of that entity's assets are public property out of the reach of creditors, under state law. The legislation proposes a more effective test of municipalities, one relating to the fact of currently paying its debts.

b. The need has not recently arisen. The need and why current chapter 9 does not suffice are specifically detailed in the written statements filed by Mr. Perkins and the National Bankruptcy Conference. In essence, the need is preventive; is it not more desirable to prevent a problem from arising than to try to cure one after it has arisen?

3. ARE SUFFICIENT EXCEPTIONS CONTAINED IN THE BILL TO PERMIT FUTURE INHABITANTS OF A CITY FROM BEING OVERLY BURDENED BY THE COMMITMENTS THAT THIS BILL WOULD REQUIRE FROM A POPULACE TO PAY ON ITS INDEBTEDNESS?

To the extent that bondholders' liens are on special revenues only, future inhabitants are protected by the unencumbered general revenues. If such liens exist on general revenues, this legislation contains no protection for future inhabitants. That protection should, probably, come from the overall supervision by the State and the political process.

Sincerely,

Lawrence P. King
Professor of Law
New York University
School of Law
40 Washington Square South
New York, NY 10012

LPK:ay

NATIONAL BANKRUPTCY CONFERENCE

(A voluntary organization composed of persons interested in the improvement of the Bankruptcy Code and its administration.)

June 24, 1988

Honorable Howell Heflin
Subcommittee on Courts
and Administrative Practice
Senate Judiciary Committee
223 Hart Senate Office Building
Washington, D.C. 20510

Dear Senator Heflin:

Following are my responses to the questions concerning municipal bankruptcy that were attached to your letter of June 16, 1988.

1. WHAT IS THE IMPACT OF CURRENT PROVISIONS OF CHAPTER 9 ON A MUNICIPALITY'S ACCESS TO CREDIT MARKETS?

S. 1863 intends to prevent a potential problem from arising which can have an impact on credit markets. Without the amendments to chapter 9 of the Bankruptcy Code, the potential exists for municipal bond investors to be concerned that if a petition is filed, their rights in the nature of liens on postpetition revenues would be lost. Whether the problem in fact exists in the minds of investors today, I do not know.

2. IF A MUNICIPALITY FILES BANKRUPTCY UNDER THE CURRENT PROVISIONS OF CHAPTER 9, AND IGNORES SOME OF THE STATUTORY MANDATES BECAUSE THEY CONFLICT WITH THE MUNICIPALITY'S OBLIGATION TO CONTINUE MEETING ITS FINANCIAL RESPONSIBILITIES, HOW DOES THIS AFFECT THE MUNICIPALITY'S ABILITY TO REORGANIZE?

I believe that the question is wrong. I would suppose the ability to reorganize would be affected by whatever political and governmental changes are made to make sure that the municipality's officers comply with, rather than ignore, statutory mandates.

3. (a) THE TESTIMONY INDICATES THAT THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. HOW MANY OF THESE 32 CASES ACTUALLY FILED A PLAN OF REORGANIZATION?

(b) ARE THE CONCERNS THAT YOU ARE RAISING TODAY A FACTOR IN HOW THE MUNICIPALITY PROCEEDED UNDER CHAPTER 9?

Honorable Howard Heflin
June 24, 1988
Page 2

(c) A CRITICISM OF THIS LEGISLATION IS THAT IT IS A SOLUTION LOOKING FOR A PROBLEM, NOT A PROBLEM LOOKING FOR A SOLUTION.

(a) I do not know.

(b) The few cases that have been filed have, I believe, involved various types of districts, such as a school district, rather than municipalities. Thus, I do not believe the concerns were a factor.

(c) The people who have been working on the legislation have better things to do. If the Subcommittee prefers to wait until a problem arises which would be incurable in the particular context, it certainly can do so.

I should like to point out that among the amendments in the legislation is one to define "insolvency" so that it makes more sense as concerns a municipality. As pointed out in the prepared statement of the National Bankruptcy Conference, the general definition contained in section 101(31) is not very effective with respect to a municipality whose assets are generally out of the reach of its creditors.

4. CURRENTLY THERE IS LITIGATION INVOLVING THE BONDHOLDERS OF PROJECTS 4 AND 5 OF THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM (WPPSS). THE WASHINGTON PUBLIC POWER SUPPLY SYSTEM COMMENCED CONSTRUCTION OF FIVE GENERATING PROJECTS IN THE 1970S TO PROVIDE ELECTRICITY TO CONSUMERS IN THE PACIFIC NORTHWEST.

   IN 1982, THE SYSTEM TERMINATED PROJECTS 4 AND 5 BECAUSE OF SUBSTANTIAL COST OVERRUNS AND LOWER ESTIMATES OF THE AMOUNT OF POWER NEEDED.

   I UNDERSTAND THAT THE SUPPLY SYSTEM IS NOT IN BANKRUPTCY, BUT COULD YOU EXPLAIN HOW THESE PROPOSED AMENDMENTS TO CHAPTER 9 WOULD IMPACT ON THE SITUATION INVOLVING THE SUPPLY SYSTEM.

Since the firm to which I am counsel is involved in some aspects of the WPPSS litigation, I prefer not to respond to this question.

5. SOME MUNICIPALITIES WHICH ARE IN FINANCIAL TROUBLE TURN TO ALTERNATIVES OUTSIDE OF CHAPTER 9. WOULD YOU BRIEFLY EXPLAIN SOME OF THOSE ALTERNATIVES AND THEIR BENEFIT OVER A CHAPTER 9 PETITION.

Honorable Howard Heflin
June 24, 1988
Page 3

An alternative, if the debtor entity is not too massive and there are known creditors to work with, is to attempt an out-of-court workout. Debt can be restructured if sufficient creditor consents can be obtained.

Another alternative is through close state supervision over spending and allocation of tax revenues together with the use of the state's taxing authority.

Each situation is sui generis and specifics are impossible to lay out.

However, the benefits over a chapter 9 filing can include savings of money and time, and absence of a "bankruptcy" stigma.

6. THERE HAVE BEEN 32 CHAPTER 9 PETITIONS FILED SINCE 1979. IS THERE A PROJECTION OF HOW MANY MUNICIPALITIES ARE CURRENTLY IN TROUBLE THAT WOULD BENEFIT FROM THE PROPOSED AMENDMENTS?

I do not know.

7. THE TESTIMONY MENTIONS THAT SOME MUNICIPALITIES ARE EXPERIENCING FINANCIAL PROBLEMS BECAUSE OF LABOR CONTRACTS.

WHAT IS THE INTERACTION OF SECTION 1113, WHICH WAS A CONGRESSIONAL RESPONSE TO THE SUPREME COURT DECISION IN BILDISCO, AND CHAPTER 9?

Section 1113, thus far, is not applicable in a chapter 9 case. As to any possible relationship, were it made applicable, the debtor municipality would be required to follow the procedures contained therein for modification or rejection of any collective bargaining agreement. Since at least 1976, Chapter IX of the former Bankruptcy Act and chapter 9 of the current Bankruptcy Code have permitted rejection of executory contracts. Such contracts have been deemed to include collective bargaining agreements. Thus, the purported safeguards of section 1113 could logically extend to chapter 9 cases.

Sincerely,

Lawrence P. King
Professor of Law
New York University
School of Law
40 Washington Square South
New York, NY 10012

LPK:ay

Public Securities Association
1000 Vermont Avenue, N.W.
Suite 800
Washington, D.C. 20005
(202) 898-9390

PSA

July 1, 1988

Senator Howell Heflin
Chairman, Subcommittee on Courts &
Administrative Practice
Committee on the Judiciary
223 Hart Office Building
Washington, DC 20510

Dear Mr. Chairman:

Enclosed is a statement by Richard F. Kezer, 1988 Chairman of the Public Securities Association (PSA), in support of S. 1863 and S. 2279, which would amend the federal bankruptcy code. These two bills were the subject of a hearing before your Subcommittee on June 10, 1988, and on behalf of the Public Securities Association, I ask that this statement be included in the formal written record of the June 10 hearing.

PSA appreciates this opportunity to submit testimony on the amendments to the bankruptcy code. If you have any questions about the statement or PSA's position, please do not hesitate to call Mark Moore here in Washington or Marianna Mafucci at the PSA New York Office. Thank you very much.

Sincerely,

Marc E. Lackritz

Marc E. Lackritz
Executive Vice President

cc: Karen Kremer

Enclosure

0129M

Headquarters: 40 Broad Street, New York, N.Y. 10004 • (212) 809-7000

Public Securities Association
1000 Vermont Avenue, N.W.
Suite 800
Washington, D.C. 20005
(202) 898-9390

PSA

UNITED STATES SENATE

Committee on the Judiciary

Subcommittee on Courts & Administrative Practice

STATEMENT OF

THE PUBLIC SECURITIES ASSOCIATION

IN SUPPORT OF

S. 1863

AND

S. 2279

Richard F. Kezer

Chairman of the Public Securities Association

and

Division Executive at Citicorp Investment Bank

Headquarters: 40 Broad Street, New York, N.Y. 10004 • (212) 809-7000

On behalf of the Public Securities Association ("PSA"), I would like to express our support for two Senate bills pending before this Subcommittee: S. 1863, relating to municipal bankruptcies, and S. 2279, relating to swap agreements. PSA is a national trade association which represents approximately three hundred banks, dealers and brokers that underwrite, trade and distribute U.S. government and federal agency securities, mortgage-backed securities and state and local government securities. All of the primary dealers in U.S. government securities, as recognized by the Federal Reserve Bank of New York, are members of PSA.

I. SENATE BILL 1863

PSA supports S. 1863 which would amend Chapter 9 of Title 11 of the United States Code (the "Bankruptcy Code"). As currently in existence, Chapter 9 deals with municipal bankruptcies and incorporates by reference concepts applicable to general business bankruptcy. These concepts, however, do not work very well in a municipal finance setting. To understand the impact of Chapter 9 on municipal finance, it is perhaps useful to review the differences between revenue bonds and general obligation bonds. Whereas a revenue bond is a municipal obligation that is payable only from the revenues of a specific source or project, a general obligation bond is payable from any and all sources available to the municipality. The problem created by Chapter 9 is that it could be interpreted as terminating a lien on revenues dedicated to a revenue bond upon the filing of a municipal bankruptcy and converting bonds payable from a specific revenue source into general obligations of the municipality. Besides being inconsistent with municipal financing principles, this result would violate many States' constitutions and local statutory provisions which impose limits on the permissible amounts of general obligation bonds and generally require voters' approval before the issuance of any general obligations.

By retaining a lien on after-acquired property even when the property does not constitute proceeds of property previously subject to a lien and by removing questions of preferences, S. 1863 correctly recognizes the need to retain the lien created by a revenue bond even when the municipality is unable to meet its debts as they mature. S. 1863 recognizes, however, that operating expenses of a revenue producing system must be paid first. In addition, by making the provisions of the automatic stay inapplicable to the application of pledged revenues, the proposed amendments would eliminate the delay and expense attendant upon a request for relief from the automatic stay to achieve the results that were contemplated by the issuance of revenue bonds. Moreover, S. 1863 makes it clear that municipal revenue bonds will not be converted into general obligation bonds.

Revenue bonds are an extremely important and useful financing tool for states, municipalities, local agencies, and instrumentalities. We believe that it is crucial for the Bankruptcy Code to reflect the true operations of municipal finance and to avoid conflicts between it and States' constitutions and statutes. S. 1863 recognizes that it is in the best interest of taxpayers, municipalities and bondholders to retain the bargain made by the issuance of revenue bonds. PSA supports the objectives sought to be achieved by S. 1863 and urges quick and positive action to enact this bill.

II. SENATE BILL 2279

PSA would also like to express its support of S. 2279 introduced by Senator DeConcini and Senator Grassley. S. 2279 seeks to amend the Bankruptcy Code with regard to swap agreements. The bill would extend to swap agreements the protections afforded by the Bankruptcy Code to securities contracts and repurchase agreements and, consequently, minimize risks of disruption in the financial markets that may result by the bankruptcy of a swap market participant.

Interest rate and currency swaps are an essential and rapidly growing risk management tool. Swaps are used by a variety of institutions to minimize exposure to adverse changes in interest and currency exchange rates, and to convert a financial asset from fixed to floating rate and from one currency to another.

Congress has long recognized the volatile nature of financial markets and, as new financial instruments have been developed, it has acted to minimize the displacement caused by bankruptcies in such markets. The need for speed and certainty in this area was most recently recognized by Congress in 1982 and 1984 when Congress exempted the termination and set-off of mutual debts and claims arising under securities, forward and commodity contracts and repurchase agreements. S. 2279 would amend the Bankruptcy Code to provide for an exception to the automatic stay provisions, to clarify that netting and set-off provisions found in swaps agreements will be honored in bankruptcy, and to give assurance that the contractual right to terminate open transactions will be preserved. These amendments would provide a greater degree of certainty and speed in the swap market and would avoid inequitable decisions by a trustee in bankruptcy to assume favorable swap transactions while rejecting unfavorable transactions. If S. 2279 is enacted, a bankruptcy filing by a party to a swap of a forward foreign exchange agreement, for example, would not prevent a counterparty from exercising its contractual rights to terminate the agreement and to determine a single net termination value. In addition, it would eliminate the concern about potential preference exposure of the swap participants.

PSA believes that the objectives sought to be achieved by S. 2279 are essential for the efficient continuation and development of the swap market. We strongly urge you and your committee to act promptly and favorably on S. 2279.

Senator HEFLIN. The hearing is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[S. 2279 and additional material pertaining to S. 2279—interest swap legislation—follow:]

19-685.0 - 89 - 22

II

100TH CONGRESS
2D SESSION

S. 2279

To amend title 11 of the United States Code, the bankruptcy code, regarding swap agreements.

IN THE SENATE OF THE UNITED STATES

APRIL 13 (legislative day, APRIL 11), 1988

Mr. DECONCINI (for himself and Mr. GRASSLEY) introduced the following bill; which was read twice and referred to the Committee on the Judiciary

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A BILL

To amend title 11 of the United States Code, the bankruptcy code, regarding swap agreements.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 101 of title 11, United States Code, is amended by—

(1) redesignating paragraphs (49), (50), and (51) as paragraphs (51), (52), and (53) respectively; and

(2) inserting between paragraphs (48) and (51), as redesignated herein, the following:

"(49) 'swap agreement' means an agreement, including terms and conditions incorporated by reference therein, which is a rate swap agreement, basis swap, forward rate agreement, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option or any other similar agreement or combination thereof, and a master agreement for any of the foregoing together with all supplements shall be considered one swap agreement;

"(50) 'swap participant' means an entity that, on any day during the period beginning 90 days before the date of the filing of the petition, has an outstanding swap agreement with the debtor;".

SEC. 2. Section 362(b) of title 11, United States Code, is amended by—

(1) striking out "or" at the end of paragraph (12);

(2) striking out the period at the end of paragraph (13) and inserting in lieu thereof "; or"; and

(3) inserting at the end thereof the following:

"(14) under subsection (a) of this section, of the setoff by a swap participant, of any mutual debt and claim under or in connection with one or more swap agreements that constitutes the setoff of a claim against the debtor for any payment due from the debtor under or in connection with swap agreements against any payment due to the debtor from the swap participant under or in connection with the swap agreements or against cash, securities, or other property of the debtor held by or due from such swap participant to guarantee, secure or settle swap agreements.".

SEC. 3. Section 546 of title 11, United States Code, is amended by adding at the end thereof the following:

"(g) Notwithstanding sections 544, 545, 547, 548(a)(2) and 548(b) of this title, the trustee may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement and that is made before the commencement of the case, except under section 548(a)(1) of this title.".

SEC. 4. Section 548(d)(2) of title 11, United States Code, is amended by—

(1) striking out "and" at the end of subparagraph (B);

(2) striking out the period at the end of subparagraph (C) and inserting in lieu thereof "; and"; and

(3) adding at the end thereof the following:

"(D) a swap participant that receives a transfer in connection with a swap agreement, as defined in section 101(49) of this title, takes for value to the extent of such transfer.".

SEC. 5. Section 553(b)(1) of title 11, United States Code, is amended by inserting "362(b)(14)," after "362(b)(7),".

SEC. 6. Subchapter III of chapter 5 of title 11, United States Code, is amended by adding at the end thereof the following:

"§ 560. Contractual right to terminate a swap agreement

"The exercise of any contractual rights of a swap participant to cause the termination of a swap agreement because of a condition of the kind specified in section 365(e)(1) of this title or to set off or net out any termination values or payment amounts arising under or in connection with one or more swap agreements shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title. As used in this section, the term 'contractual right' includes a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.".

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STATEMENTS PERTAINING TO S. 2279

INTEREST SWAP LEGISLATION

STATEMENT OF
INTERNATIONAL SWAP DEALERS ASSOCIATION
IN SUPPORT OF S.2279

June 10, 1988

The International Swap Dealers Association, Inc. ("ISDA") supports S.2279, introduced by Senators DeConcini and Grassley, and urges Congress to amend the Bankruptcy Code to provide needed protections for interest rate and currency swap and forward foreign exchange agreements.

Interest rate and currency swap agreements are a rapidly growing and vital risk management tool in the world financial markets. Financial institutions and corporations use swaps to minimize exposure to adverse changes in interest and currency exchange rates. Swaps can also be used, in effect, to convert a particular financial asset from fixed to floating rate and from one currency to another. Currency swap and forward foreign exchange transactions also play an important role in international trade as a means of hedging against currency fluctuations. Swap dealers provide a critical source of liquidity to the entire swap market by often acting as principals in swap transactions.

As the swap market has grown, participants have become increasingly concerned about the possible impact of the federal Bankruptcy Code on certain of the critical provisions of swap agreements. One of the fundamental provisions of most swap agreements is that, upon termination of the agreement for default, including the commencement of a case under the Bankruptcy Code, all transactions encompassed by the agreement terminate. This prevents the counterparty from having to keep open transactions with a party that is unlikely to fulfill its obligations. At that time a single net settlement amount for all outstanding transactions is determined, and any settlement amount due the nondefaulting party is paid by the defaulting party.[1/]

Participants in the swap market are concerned that, if a counterparty files for bankruptcy, the automatic stay and other provisions of the Bankruptcy Code could be interpreted to bar the implementation of these contractual provisions. These bankruptcy-related issues create uncertainty among potential participants in swap and forward foreign exchange transactions,

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1/ Following more than a year of effort, the International Swap Dealers Association, Inc. ("ISDA"), an organization of leading commercial, merchant and investment banks, developed standard form swap agreements for use in both U.S. dollar and multicurrency swaps. The two standard form agreements operate substantively in the same manner with regard to default and termination. The standard form swap agreements developed by ISDA were published in early 1987 and are already being widely used throughout the commercial world. A brief description of ISDA is appended to this Statement.

creating a risk that, particularly in periods of volatility, the liquidity of the market will be restricted by concern over the applicability of Bankruptcy Code provisions.

Congress has for many years recognized the need for certainty and speed in the treatment of securities and other similar financial transactions in bankruptcy. Both the former Bankruptcy Act and the Bankruptcy Code have contained special stockbroker and commodity broker provisions. In 1982 and 1984 Congress further recognized the needs of the securities and commodities markets for certainty and speed by enacting broad protections for securities and commodities contracts and for repurchase agreements. These amendments have worked well in practice and have provided needed certainty about the treatment of these financial transactions in the event of the bankruptcy of a counterparty.

The protections proposed in S. 2279 closely parallel the 1982 and 1984 amendments.[2/] This legislation would ensure that a bankruptcy filing by a party to a swap or forward foreign

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2/ Indeed, it is widely believed that forward foreign exchange contracts are currently covered by the forward contract provisions of the Bankruptcy Code. The lack of clarity in certain definitional provisions has, however, given rise to a desire for certainty that currency swaps and forward foreign exchange contracts will be treated consistently. A forward foreign exchange contract is an agreement to exchange, at a future date, a certain amount in one currency for a certain amount of a second currency (*e.g.*, x dollars for y pounds). A currency swap covers a series of such exchanges on specified future dates.

exchange agreement would not prevent a counterparty from exercising its contractual rights to terminate the agreement and to determine a single net termination value. The amendments would also, like the earlier amendments, eliminate the concern about potential preference exposure of swap participants under the Bankruptcy Code. Finally, the amendments present no risk of abuse, in light of the financial sophistication of all parties to these transactions and the movement toward standard industry documentation based on the formats developed by ISDA and other groups of market participants.

I. THE INTEREST RATE AND CURRENCY SWAP MARKETS

A. Background

The swap market plays a vital role in providing a means for participants in the capital markets to reduce their exposure to currency and interest rate fluctuations. ISDA has compiled statistics showing that the dollar volume of outstanding U.S. dollar-denominated swap transactions alone exceeded $313 billion at the end of 1986, and that about $140 billion in new agreements were entered into in the first six months of 1987. Swap transactions are utilized by a wide range of financial and nonfinancial institutions. The participants include commercial banks, investment banks, thrift institutions, insurance companies, domestic and multi-national corporations, foreign governments, and U.S. and foreign government-sponsored entities.

A typical single-currency interest rate swap transaction involves an agreement where one party agrees to make periodic payments based on a fixed rate while the other agrees to make periodic payments based on a floating rate. Payments are calculated on the basis of a hypothetical principal (or "notional") amount and payment amounts are typically netted (even in the absence of any default) on common payment dates. The principal or notional amounts generally are not transferred. The term of swap transactions generally ranges from one to twelve years.

Swap transactions are widely used by institutions, including thrift institutions, to manage mismatches between their assets and liabilities. For example, an entity that has substantial short-term floating rate liabilities and long-term relatively fixed rate financial assets has substantial interest rate exposure. In a rising interest rate environment, the entity may suffer losses as the cost of its short-term floating rate liabilities rises above the fixed return on its assets. To hedge this risk and "lock in" a positive spread between the rate it receives on its assets and the rate it is required to pay on its liabilities, that entity can enter into an interest rate swap in which it will make fixed rate payments (which can be funded by its fixed rate assets) and will receive floating rate payments (which will rise or fall along with its floating rate liabilities).

An entity with a relatively low credit rating not only can reduce its market risk through a swap transaction but can also lower its borrowing costs by entering into swaps with an entity with a higher credit rating. Certain institutions, either because of better credit ratings or better market recognition, have a comparative advantage in borrowing in the fixed-rate markets. Other institutions may be unable to obtain long-term fixed rate financing at acceptable rates, but will be able to obtain short-term floating-rate funds. Through the use of swaps, however, that institution will often be able to obtain favorable long-term fixed rates. Because the credit exposure on a swap is relatively small compared to a traditional loan of principal, entities with higher credit ratings are often more willing to enter into long-term swaps than long-term loans with lower-rated entities.

A party to a swap transaction may enter into a swap directly with another principal end-user. More commonly, however, it enters into a swap with a commercial or investment bank that acts as a dealer in swaps. The dealer will often act as a principal, creating a "portfolio" of swaps. By standing ready to enter into swaps with any qualified party at any time, swap dealers provide important liquidity for the swap market.

B. The Master Agreement

The principal risk of loss under swap agreements arises if one party defaults and there has been a shift in interest or currency exchange rates. The primary means for the parties to a swap to minimize their exposure to each other is through the use of a single master agreement, with each individual transaction governed by that agreement. Thus, a swap dealer, such as a commercial or investment bank, which has a number of dealings with one party will have one master agreement with that party, with the particular notional amount and payment terms for each individual transaction reflected in a supplemental confirmation.

Upon termination of a swap agreement for default, the defaulting party will owe the market value of the agreement to the nondefaulting party. The standard form agreements developed by ISDA and used by the financial community provide in such case for the netting of termination values for all swap transactions under the agreement. In this way, any potential liability of a defaulting party is reduced by the value of any swap transactions that favored that party. Forward foreign exchange dealers similarly are developing arrangements expressly to provide for the netting of all exposures.

The protections of the netting provisions work only if, in the event of a bankruptcy, the nondefaulting party is able to terminate all transactions under the relevant agreement and net the positive and negative exposures to the defaulting party. The nondefaulting party could face substantial market exposure if the automatic stay barred it from terminating all outstanding transactions and forced it to hold open all transactions with the debtor, particularly in a volatile market. Moreover, the nondefaulting party could suffer unexpected and perhaps substantial losses if, contrary to the express agreement of the parties, the defaulting party (or its bankruptcy trustee) could selectively assume certain favorable transactions while rejecting those unfavorable to it (i.e., "cherrypick"). Imposing these potential losses on nondefaulting parties not only is contrary to the contractual provisions, but would materially increase the potential risk associated with all swap transactions.

Although ISDA believes that under existing statutory provisions and case law netting should be enforced under the Bankruptcy Code, the issue has never been expressly addressed by a court and, accordingly, cannot be entirely free from doubt. If netting is not allowed -- and the debtor is permitted to cherrypick -- the potential exposure for nondefaulting parties is materially increased, which could undermine the basic functioning of the swap market especially in periods of market volatility.

For these reasons, ISDA supports enactment of S.2279 to extend to swap and forward foreign exchange transactions the same protections enacted by Congress in the 1982 and 1984 securities, commodities, and repurchase agreement amendments.

II. PROPOSED CHANGES

The changes to the Bankruptcy Code contained in S.2279 address three specific problems. These are (a) the impact of the automatic stay on the enforcement of the contractual rights to terminate a defaulted contract, (b) the right to net positive and negative exposures with one counterparty, and (c) the impact of the Bankruptcy Code on normal prebankruptcy activities, such as the setoff of mutual claims and debts and the potential exposure of ordinary prebankruptcy transfers to later preference recovery. The changes contained in the bill to deal with these issues closely parallel those enacted in 1982 and 1984 by Congress for securities contracts, forward contracts, commodity contracts, and repurchase agreements. The same reasons that led Congress to enact those amendments support the proposals put forward in S.2279.

A. Automatic Stay Provisions

The automatic stay of Section 362 of the Bankruptcy Code bars a party from taking any action to interfere with property of the bankruptcy estate. It is possible that a bankruptcy court could interpret this provision to stay a nondefaulting party from taking action either to terminate a swap or forward foreign exchange agreement with a debtor or to net offsetting exposures, at least without first obtaining authority from the bankruptcy court.

Obtaining such authority necessarily takes some time, often many weeks or months. Any delay in obtaining authority to terminate outstanding transactions and to net offsetting exposures would create unreasonable risks for the nondefaulting party. The interest rate and currency exchange markets often move rapidly and, given the substantial volume of transactions, any type of delay following a bankruptcy filing would impose unreasonable risks of loss on the participants in the market. Following a default, and absent a stay, a prudent counterparty would immediately terminate all transactions with a debtor so as to fix its exposure and would simultaneously enter into separate transactions to hedge that exposure. The possibility that the automatic stay would prevent such termination -- possibly for weeks or months -- creates a threat of a substantial increase in the nondefaulting party's potential exposure to the debtor and generally complicates any effort to hedge that exposure.

The unfairness of this result can be shown by an example. First assume that two parties had entered into a single interest rate swap transaction under a master agreement. Assume also that the defaulting party receives fixed rate payments and makes floating rate payments based on a notional amount of

$50 million. If that party files for relief under the Bankruptcy Code, absent the potential application of the automatic stay the nondefaulting party could fix its exposure based on then-current interest rates and enter into a new transaction to hedge that exposure.

The situation is far more uncertain if the stay applies. If the nondefaulting party were certain that the debtor would default, it would hedge its exposure and lock in its position; if it were certain that the debtor would perform, it could do nothing. But the uncertainty as to whether the transaction will be assumed would likely force the nondefaulting party to hedge, thereby incurring the cost of a new transaction and depriving it of the benefits of its original bargain. Moreover, if the nondefaulting party had hedged the original transaction (as is often the case), it could be faced with an uncovered open position depending on the ultimate decision on assumption or rejection made by the debtor, a decision that the debtor may not make for a number of months.

The risks of cherry-picking can be shown by a second example. Assume that two parties had entered into two transactions under a single master agreement. As is often the case, the parties are on opposite sides in the two transactions, so that the defaulting party receives fixed rate payments under the first agreement and variable rate payments under the second. Assume further that each transaction has a current market value of $1 million. In such circumstances, the net position between the parties is zero and if both transactions were terminated simultaneously, no payment would be made by either party. Now assume that one of the parties becomes the subject of a case under the Bankruptcy Code. If the court failed to give effect to the termination and netting provisions of the master swap agreement, the debtor arguably could assume the favorable transaction, while rejecting the unfavorable transaction. The debtor's estate would then continue to receive payments from the nondebtor under the favorable transaction, while the nondebtor would be left with an unsecured claim for damages with respect to the rejected transaction, which is unlikely to be satisfied in full.

Congress has long recognized the need for certainty and speed in the volatile securities and financial markets. Section 60e of the former Bankruptcy Act (11 U.S.C. § 96e) provided special treatment for stockbroker bankruptcies, creating a separate fund for stockbroker customers with priority over general creditors. These provisions were carried forward into the stockbroker and commodity broker provisions of Chapter 7 when the Bankruptcy Code was enacted in 1978.

As new financial instruments have been developed, Congress has recognized the need to amend certain aspects of the Bankruptcy Code in order to continue to provide the necessary speed and certainty in complex financial transactions. In 1982 and again in 1984 Congress amended Section 362 to exempt the termination and setoff of mutual debts and claims arising under securities contracts, forward contracts, commodity contracts or repurchase agreements. The 1982 amendments were "intended to minimize the displacement caused in the commodities and securities markets in the event of a bankruptcy affecting these industries," recognizing the "potential volatile nature of the markets." 128 Cong. Rec. H 261 (daily ed. Feb. 9, 1982). The same rationale supported the 1984 amendments.

ISDA supports the proposal in S.2279 to extend these protections to swap and forward foreign exchange agreements for the same reasons that they were provided for securities contracts, forward contracts, commodity contracts and repurchase agreements. Permitting the prompt termination and exercise of netting rights reduces the potential market impact of a bankruptcy filing by allowing immediate action as contemplated by the standard agreements. This exception does not interfere with the basic operation of the Bankruptcy Code, since section 553 of the Code already preserves the right of setoff, although requiring a court hearing. The volatility of the interest rate and currency exchange markets makes the risk of delay pending such a court hearing unreasonable and detrimental both to the debtor, which could incur additional losses if open transactions turn unfavorable, as well as to the nondefaulting party.

B. Right to Terminate

Both the 1982 and the 1984 amendments provide that the contractual right of a nondefaulting party to terminate a securities contract, forward contract, commodity contract or repurchase agreement will not be stayed by any order of the bankruptcy court or otherwise under the Bankruptcy Code. This provision essentially assures counterparties that they will not be exposed to an effort by a bankruptcy trustee to assume these agreements under Section 365 of the Bankruptcy Code.

A similar assurance is needed for swap participants. In a volatile interest and currency exchange rate environment, a requirement that the counterparty keep open transactions awaiting such a decision risks imposing additional losses either on the nondefaulting party or on the debtor's estate at a time when the estate should be reducing its market exposure.

The right to terminate open transactions is particularly needed in light of the size of the swap market. As Congress recognized at the time of the 1982 and 1984 amendments, counterparties could be faced with substantial losses if forced to await a bankruptcy court decision on assumption or rejection of financial transaction agreements. Unlike ordinary leases or executory contracts, where the markets change only gradually, the financial markets can move significantly in a matter of minutes. The markets will not wait for a court decision on whether a debtor can cure, assume or provide adequate assurance of future performance of such agreements. There is a clear need for Congress to assure counterparties that they will be able to terminate these agreements and exercise contractual liquidation and netting rights if a party to the agreement files for bankruptcy relief.

C. Setoff and Preference Provisions

The 1982 and 1984 amendments provide that ordinary transfers made or setoffs effected under a securities or repurchase agreement immediately before a bankruptcy case cannot be set aside by a bankruptcy trustee. This is an exception to the preference provisions of Section 547 and to the preference provision of the setoff statute (section 553(b)(1)), which generally discourages setoffs before bankruptcy in ordinary commercial transactions.

The exception created by the 1982 and 1984 legislation recognizes that protections for payments made and setoffs effected under securities and other financial agreements are needed in order to preserve the functioning of the market. Similarly, in swap and foreign exchange transactions, it is important to eliminate any concern that Bankruptcy Code provisions could be read to preclude the exercise of contractual rights of prebankruptcy netting or setoff.[3/] This is particularly

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3/ As discussed above ISDA believes that under existing statutory provisions and case law, standard netting provisions

[Footnote continued next page]

important to swap participants since netting is the normal, intended course of dealing in swap transactions unlike ordinary commercial transactions, where setoff is an extraordinary remedy. While the setoff preference provision of section 553(b)(1) is designed to discourage bank account setoffs that may precipitate a bankruptcy filing, its operation in the swap market could materially interfere with the customary operation of that market. For these reasons, swap and forward foreign exchange transactions should be granted the same exception from ordinary preference rules and from the preference provisions of section 553(b)(1) as Congress has accorded securities contracts and other financial agreements.

[Footnote continued from preceding page]

ought to be given effect. The question, however, has never been expressly addressed by a Court and, accordingly, is not entirely free from doubt.

INTERNATIONAL SWAP DEALERS ASSOCIATION, INC.

The International Swap Dealers Association, Inc. ("ISDA") is an international organization of commercial, investment and merchant banks that act as dealers in interest rate and currency exchange ("swap") transactions. The purposes of ISDA include the promotion of practices conducive to the efficient conduct of the business of its members in rate swaps and related transactions; the creation of a forum for the discussion of issues of relevance to participants in the swap market; the representation of the common interests of its members before legislative and administrative bodies and international or quasi-public institutes, boards and other bodies; and the encouragement of the development and maintenance of an efficient and productive market for swaps.

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N Y 10271 · (212) 608-1500

EDWARD I. O'BRIEN
President

June 7, 1988

The Honorable Howell T. Heflin
Chairman, Subcommittee on Courts
and Administrative Practice
Committee on the Judiciary
United States Senate
Washington, D.C. 20510-0101

Re: <u>Senate Bill 2279</u>

Dear Senator Heflin:

On behalf of the Securities Industry Association ("SIA"),1/ I am writing to express our support for Senate bill 2279, introduced by Senators DeConcini and Grassley to amend Title 11 of the United States Code (the "Bankruptcy Code"). The bill would extend the protections afforded to securities contracts and repurchase agreements under the Bankruptcy Code to interest rate and currency swap agreements.

Many members of SIA are major participants in the market for interest rate and currency swaps, a relatively new but

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1/ The Securities Industry Association is the trade association representing over 550 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

rapidly growing financial management tool. Currently, there is outstanding in excess of $400 billion in U.S. dollar denominated swap transactions. Interest rate and currency swaps are an essential tool for U.S. and foreign financial institutions, corporations, municipalities, and thrift institutions to manage exposure to changes in interest and currency exchange rates in the highly volatile markets of recent years. For these institutions, swaps are an indispensable method of effectively hedging these exposures.

The amendments to the Bankruptcy Code contemplated by S. 2279 are substantially similar to those enacted by Congress in 1982 and 1984 for securities and commodity contracts and for repurchase agreements. Congress has recognized that the market participants for certain financial instruments require certainty with respect to their remedies when facing the insolvency of the counterparty. Those policies apply equally to interest rate and currency swaps.

SIA is particularly concerned that failure to rectify existing legal uncertainties under U.S. bankruptcy law could drive interest rate and currency swaps to jurisdictions in which there is a more hospitable legal environment, thereby prejudicing the role of the United States participants in these markets and limiting the ability of United States corporations, financial institutions, and municipalities to utilize these vital financial management tools. Accordingly, we strongly urge you and your committee to support S. 2279.

Very truly yours,

Edward O'Brien
President

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2313L

NEW YORK CLEARING HOUSE

100 BROAD STREET. NEW YORK. N. Y. 10004

JOHN F. LEE
EXECUTIVE VICE PRESIDENT

June 9, 1988

The Honorable Howell T. Heflin
Chairman, Subcommittee on Courts
and Administrative Practice
Committee on the Judiciary
United States Senate
Washington, DC 20510-0101

Re: S. 2279

Dear Senator Heflin:

The New York Clearing House Association (the "Clearing House") supports Senate bill 2279 to amend the Bankruptcy Code in regard to swap agreements. The Bill would add provisions addressing the contractual rights of swap agreement participants to terminate and liquidate their obligations on a timely basis should one participant become subject to a bankruptcy proceeding. This amendment would do much to insure that the failure of a significant participant will not unduly disrupt an extremely important financial market. The Bill follows an approach that was adopted as fair, reasonable and beneficial in 1982 for securities, futures and commodity contracts and in 1984 for repurchase agreements ("repos"). The approach in each case is based on similar concerns about minimizing risks and dislocation in financial markets when a bankruptcy proceeding occurs.

The Clearing House is an association of twelve leading commercial banks located in New York City.* Nine of our member banks are also members of the International Swap Dealers Association, Inc. ("ISDA"), an organization of leading commercial,

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* The members of the New York Clearing House Association are The Bank of New York, The Chase Manhattan Bank, N.A., Citibank, N.A., Chemical Bank, Morgan Guaranty Trust Company of New York, Manufacturers Hanover Trust Company, Irving Trust Company, Bankers Trust Company, Marine Midland Bank, N.A., United States Trust Company of New York, National Westminster Bank USA and European American Bank.

merchant and investment banks, which has developed standard form swap agreements and which has requested and supports this legislation. Each of our member banks makes substantial use of both interest rate swaps and foreign currency swaps to protect against undesired exposures to interest rate and foreign currency fluctuations. In addition, by engaging in swap transactions our banks perform traditional functions of providing credit and liquidity to their customers.

The bankruptcy of a swap market participant could cause significant market disruption. This arises from the risk that an outstanding swap transaction would be held open (despite contractual provisions for its termination) and the risk that a defaulting party in bankruptcy could assume favorable swap transactions and reject unfavorable ones (despite contractual provisions calling for liquidation of these obligations by netting). The exposure created by these risks becomes very significant to many participants in a volatile market, and the accompanying uncertainties can lead to restricted liquidity and other market dislocations -- at a time when liquidity and stability may be most important.

The Bill deals with these uncertainties by taking the same approach earlier used to provide for the fair resolution of open securities contracts, forward contracts, commodity contracts and repos. The automatic stay provision of section 362 is amended to permit the contractually agreed-upon setoff to occur without the need for a cumbersome and time-consuming legal proceeding to lift the automatic stay. A new section 560 is added to give assurance that the contractual right to terminate open transactions will be preserved and will not be subject to inequitable or delayed decisions to assume favorable transactions or reject unfavorable ones. In addition, the preference provisions of sections 547 and 553(b)(1) are limited to preserve contractual rights of pre-bankruptcy netting and setoff that are vital to the functioning of the marketplace for swaps.

Our member banks welcome the opportunity to support this legislation and urge that it receive prompt and favorable action.

Very truly yours,

John F. Lee

cc: Ms. Tara McMahon, Esq.
Chief Counsel
SubCommittee on Trademarks
and Patents
Senate Judiciary Committee
Hart Senate Building 327
Washington, DC 20510

Sam Gerdano, Esq.
Chief Minority Counsel
Subcommittee on Courts
and Administrative Practice
Senate Judiciary Committee
Hart Senate Building 325
Washington, DC 20510

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