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When Worlds Collide

A Closer Look at the Intersection of Public Finance and Bankruptcy Law
Part One of a Two-Part Article

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It is unlikely that when Philip Wylie and Edwin Balmer co-authored "When Worlds Collide" 80 years ago, they were envisioning the growing wave of distressed municipalities and publicly financed projects, and the resulting collision between two heretofore separate and distinct worlds: that of public finance (where collection was simply not much of a consideration) and the insolvency world (where collection is the primary consideration). Until recently, the public finance world simply did not experience significant defaults. In financings where a municipality had agreed to pay for a publicly financed facility from that municipality's general funds, although detailed default and remedies provisions were included, repayment was considered sacrosanct because a default would render the municipality virtually unfinanceable.

Where it was contemplated that repayment of a publicly financed revenue-generating project would come from revenues and/or the assets comprising the project, repayment was considered safe because the bond trustee would be assigned a lien on project revenues and/or the assets compromising the project to secure bondholders' investments. Indeed, it was taken for granted that governmental debtors "always" pay, or have paid, at least since the 1870s, when cities and towns defaulted on bonds issued to facilitate the construction of transcontinental railroads. According to Moody's Investors Service, the average default rate for all rated municipal bonds between 1970-2011 was 0.13%, while during the same period the default rate for rated corporate bonds was 11.17% (Moody's Investors Service, Special Comment, U.S. Municipal Board Defaults and Recoveries, 1970-2011, accessed on April 12, 2013, http://bit.ly/12OHNWi). The collision of these two worlds has given rise to a whole host of issues related to, among others, the drafting of pledges, the interplay between special revenue bonds and state law creditor remedies, and challenges to lease revenue bonds, each of which was on public display in the bankruptcy cases of *In re Las Vegas Monorail*, *In re City of Stockton, California*, and *In re Jefferson County, Alabama*. We will discuss each of these cases in turn.

Public Finance Terminology For the Bankruptcy Practitioner

For the bankruptcy lawyers reading this article, here is a bit of public finance terminology.

General Obligations

"General Obligations" are debt obligations secured by the full faith and credit and taxing power of a municipal issuer. They are payable from a municipality's general fund, but also are secured by a pledge of its taxing power. In the world of public finance outside of a Chapter 9, a General Obligation pledge is the highest, most secure pledge a municipal issuer can grant, as it permits a bondholder to get a court order requiring that the municipality levy and assess a tax to pay its General Obligation bonds. Inside a Chapter 9 bankruptcy, however, bond lawyers have learned that General Obligation bondholders have the status of unsecured creditors.

Appropriation Obligations

"Appropriation Obligations" are "non-debt" obligations payable subject to annual appropriation of funds by the local government. Like General Obligations, Appropriation Obligations are payable from general fund revenues. However, unlike General Obligations, Appropriation Obligations are not secured by a pledge of taxing power. They are special obligations, payable solely from appropriated funds in the current-year budget. Appropriation Obligations generally are not considered "indebtedness" for the purpose of state-law debt limitations. The appropriating authority has the absolute right each fiscal year to determine not to appropriate funds to pay the obligation, and such an "event of non-appropriation" is not legally an "event of default" — otherwise the obligation would be considered illegal debt. Furthermore, there are two types of Appropriation Obligations: secured and unsecured.

Secured Appropriation Obligations

Most secured Appropriation Obligations are issued as "Lease Revenue Bonds" or "Lease Certificates of Participation" (COPs). These Lease Revenue Bonds or COPs involve leases where the governmental borrower is the lessee and must pay the lessor rentals, subject to annual appropriation of funds, in an amount equal to debt service. If the Lessee fails to appropriate for rentals to pay debt service, the lessor (often a bond trustee) has the ability to evict, or otherwise deprive the municipal lessee of use of the property. The Lessor then sells or leases the property to obtain revenues to pay the bondholders or COP holders.

Unsecured Appropriation Obligations

The other type of Appropriation Obligation is an unsecured loan, the payment of which is subject to annual appropriation of funds. The government unit has no legal obligation to appropriate funds and can terminate the obligation in any year by simply failing to appropriate. While this type of unsecured financing arrangement — where the borrower does not have an unconditional enforceable obligation to pay for the full term of the loan — seems truly bizarre to bankruptcy lawyers, it is, in fact, a common

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public financing technique, particularly in states where it is difficult to obtain legal authority to issue General Obligation bonds.

In Re Las Vegas Monorail

The collision of the bankruptcy and public finance worlds, and the damage caused to bondholders and their respective professionals, was on public display in the case of *In re Las Vegas Monorail Company*, 429 B.R. 317 (Bankr. D. Nev. 2010) (*Las Vegas Monorail*). The Las Vegas Monorail Chapter 11 case involved an issuance of industrial revenue bonds to finance the extension of a monorail track along the Las Vegas Strip. Specifically, the Director of the Nevada Department of Business and Industry (the Director) sponsored the issuance of approximately $650 million of municipal revenue bonds, the proceeds of which were thereupon loaned to the Las Vegas Monorail Company (LVMC) in consideration of, among other things, a promissory note, and the grant of a security interest in: 1) certain deposit accounts established pursuant to the bond indenture; 2) certain contract rights under the LVMC's franchise agreement to operate the monorail service; and 3) "Net Project Revenues" (*i.e.*, gross revenues for reasonable operating expenses).

The monorail expansion project never met ridership expectations, and on Jan. 22, 2010, LVMC filed for relief under Chapter 11 of the Bankruptcy Code. Shortly after the bankruptcy filing, Ambac Assurance Corp., which had insured the bulk of the municipal revenue bonds, moved to dismiss the Chapter 11 case on the grounds that LVMC was a municipality and therefore ineligible for Chapter 11 relief. In its decision denying Ambac's motion to dismiss, the bankruptcy court found that LVMC was not a municipality under the Bankruptcy Code and, as a result, LVMC was: 1) eligible to file for Chapter 11; and 2) ineligible to file for Chapter 9.

Thereafter, LVMC sought authority from the bankruptcy court to use revenues earned post-petition in order to continue to operate the monorail business. The bond trustee objected to such use under Bankruptcy Code § 363, arguing that those revenues constituted the bond trustee's cash collateral, and that LVMC could not offer the bond trustee sufficient adequate protection for such use. The bankruptcy court explained that if it were to rule that post-petition revenues constituted cash collateral, then operation of the monorail system would have to terminate because LVMC did not have the financial wherewithal to offer sufficient adequate protection.

Net Revenue Pledge vs. Gross Revenue Pledge

At the time the bonds were issued, the bond trustee and the professionals who documented the transaction were still living in the public finance world in which the interplay of bankruptcy law and public finance law was largely untested. Bond underwriters, investors, and bond trustees took the position that in an event of default, operating expenses must be paid first in order to keep revenues flowing. The primary concern of the bond trustee was presumably that its lien on revenues not interfere with LVMC's ability to operate its business. Thus, as was (and is still) common for this type of industrial bond financing, the lien granted to the bond trustee was a "net revenue pledge" rather than a "gross revenue pledge."

This was a vortex at which the old public finance world and the new public finance world collided. Predictably — at least to bankruptcy lawyers — the bankruptcy court ruled that the bond trustee had no cash collateral interest in those revenues pledged for reasonable operating expenses. Unfortunately for the bond trustee and bondholders, the net revenues left over after operating expenses were merely sufficient to pay 10% of the LVMC's debt service.

To make matters worse for the bond trustee (and to the chagrin of public finance lawyers), the bankruptcy court ruled that the bond trustee's cash collateral interest in net revenues was cut off as "after-acquired property" under Bankruptcy Code Section 552(a). Finally, the Bankruptcy Court ruled that since the loan documents treated each payment of future revenues as a separate transaction independent of any previous payment, the bond trustee could not assert the "proceeds" of prepetition collateral exception embodied in Section 552(b). In today's brave new world, it is hoped that few bond issuers will repeat the mistakes that were made in *Las Vegas Monorail*. However, because many municipal bond issuances are issued as parity debt under old indentures providing for a net revenue pledge, and such bonds are outstanding for 20 or 30 years, there likely remain numerous outstanding revenue bond issues with insufficient or no collateral coverage in an event of default.

Potential Cures

There are many junctures at which the problem of no or insufficient collateral coverage of bond-financed facilities can be cured. First, and most obviously, with respect to new facilities, public finance professionals at the documentary stage can demand the same collateral coverage and default scheme as any non-public lender.

Second, municipalities may (or may not) decide as a matter of policy to pay unsecured bond obligations in order to preserve their ability to access the capital markets at reasonable rates of interest. Indeed, under Bankruptcy Code Section 904 and Tenth Amendment Sovereign Immunity limitations, in a Chapter 9 municipal bankruptcy case, a bankruptcy court cannot prohibit a municipality, outside of a plan of debt adjustment, from making a policy decision to pay one unsecured creditor to the detriment of other similarly situated creditors. This is the opposite of Chapter 7, 11 or 13 cases, where creditors of the same priority must be treated equally.

Third, states can pass legislation creating statutory liens in favor of all municipal bondholders secured by the general revenues of the municipality. States may be concerned that if one municipality defaults on its bonds, that default might have a so-called "contagion effect," making it more difficult or impossible for other distressed municipalities within that state to access the capital markets. The State of Rhode Island did exactly that in successfully passing such a lien statute in advance of the filing of the Central Falls Chapter 9 bankruptcy. As a result: 1) there were no observable negative effects in the capital markets for other distressed Rhode Island municipalities due to the Central Falls bankruptcy; and 2) shortly after Central Falls' plan of debt adjustment was confirmed and became effective, both Moody's and Standard & Poor's raised Central Falls' credit rating.

Finally, the 800-pound gorilla, Congress, currently sits quiet in Washington. If the wave of municipal bankruptcies surges into a tsunami, many believe that Congress will have no choice but to enact legislation to help guide the country's municipalities back to fiscal health. This could mean federal statutory protection for bondholders in order to be certain that capital markets continue to provide public financing to municipalities nationwide.

Conclusion

Next month, Part Two of this article will analyze and discuss the cases *In re City of Stockton, California*, and *In re Jefferson County, Alabama,* and discuss what bankruptcy and public finance lawyers need to know when navigating the mostly uncharted waters of municipal bankruptcy.

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