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When Worlds Collide

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

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The first part of this article discussed the collision of the bankruptcy and public finance worlds, and the damage caused to bondholders and their respective professionals in the case of *In re Las Vegas Monorail Company,* 429 B.R. 317 (Bankr. D. Nev. 2010) (*Las Vegas Monorail*). This month, the authors analyze and discuss two other cases and share what bankruptcy and public finance lawyers need to know when navigating the mostly uncharted waters of municipal bankruptcy.

In re Jefferson County, Alabama

In *In Re Jefferson County, Alabama,* Jefferson County, AL, (the County) filed its Chapter 9 bankruptcy case on Nov. 9, 2011, after attempts to reach agreement with its creditors, particularly the holders of approximately $3.2 billion of special obligation warrants issued to finance rehabilitation and improvements to the sewer system in the County, had failed. Over a year before the commencement of the Chapter 9 case, a receiver had been appointed for the sewer system, managing it in place of the county commissioners and employees, many of whom had been convicted of, or pled guilty to, federal bribery and related charges. The proceedings were commenced by a new slate of county commissioners not subject to the taint of the misdeeds of their predecessors.

Despite the objections of the state court receiver and the trustees for the warrants, the bankruptcy court returned control of the system to the county commissioners, restoring their authority to manage a system whose revenues were and continue to be inadequate to maintain it properly and pay the substantial debt service with which it was burdened.

The bankruptcy court rejected the requests of the receiver and the trustees to lift the stay, and let the receiver continue to operate the system. While it was clear that the receiver had been operating the system with some success, the bankruptcy court found that the new county commissioners were capable of performing their responsibilities and essentially terminated the receiver's interest in the system.

Scope of the Pledge of Net Revenues

Like many special revenue bonds (and the *Monorail* bonds discussed last month), the warrants are payable from, and secured by, the revenues of the system after payment of the operating and maintenance costs of the system (the *Pledged Revenues,* also known as *Net Revenues*). Initially, the County argued that the lien on the Pledged Revenues was limited to the Net Revenues that were in the trustee's possession at the time of filing.

The bankruptcy court rejected this reading as inconsistent with the purpose of Sections 922(d) and 928 of the Bankruptcy Code. Specifically, the court found that the Pledged Revenues from the system were special revenues referred to in Section 928(a) to which the lien under the indentures would continue to apply notwithstanding the normal termination of such a lien on after-acquired property under Section 552(a) of the Bankruptcy Code.

The court also reserved the question of whether the lien was subject to the necessary operating expenses of the system as provided in Section 928(b), which limits a lien on special revenues to the "necessary operating expenses" of the system. The court found that the pledge was limited to the amount provided in the indentures, which already provided for payment of operating expenses to exclude depreciation and amortization.

Expenses Chargeable Against Revenues Before Debt Service

The County then sought to increase substantially the amounts charged as operating expenses. It doubled those of the receiver during the prior year — some 92% higher than had been incurred in the two years before the receivership — while correspondingly reducing the amounts available as Net Revenues for debt service on the warrants. Under the indenture, sewer revenues were chargeable first to operating expenses, then to debt service, and then to a series of additional accounts for debt service reserves, rate stabilization, depreciation, surplus and redemption. Even without the County's increases in operating expenses, the sewer revenues were not sufficient to pay the debt service in full, and so no amounts were currently, nor would be expected to be, available for any allocations beyond debt service.

Under the indenture, operating expenses were defined to include certain items, specifically excluding depreciation, "that by generally accepted accounting principles are properly chargeable to expenses of

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administration and operation and are not characterized as extraordinary items."

One of the disputed items the County sought to include in operating expenses was amounts for depreciation and amortization. While the parties agreed that depreciation and amortization were operating expenses under generally accepted accounting principles, the structure of the cash flows in the indenture confirmed that the parties intended only the cash expenses to be included in operating expenses for the purpose of the calculation of operating expenses.

Furthermore, the bankruptcy court concluded that in the years leading up to the bankruptcy, depreciation and amortization had not been included in operating expenses, which further supported the interpretation of the indenture's meaning of operating expenses.

The other disputed expense that the County sought to include in operating expenses was a reserve for professional fees and expenses, but the trustee and the County also disagreed on what current legal expenses could be properly chargeable as operating expenses. The trustee did not dispute that legal fees directly related to the operation of the system — such as legal fees incurred in a dispute over the termination of a sewer system employee — were proper operating expenses.

The trustee did dispute that the substantial legal expenses being incurred by the County associated with the County's Chapter 9 case were proper operating expenses. However, the amounts in dispute initially just involved the reserve for future fees, and the court found that such a reserve was not a current operating expense that could be charged as part of the operating expenses. The court ultimately found that it had insufficient details on the fees being incurred currently to rule on what would be properly includable in operating expenses, leaving open the question of whether Chapter 9 fees could be charged against the Pledged Revenues.

The bankruptcy court then considered several other arguments of the County as to why the depreciation and amortization amounts or reserves for future professional fees should or should not be deducted before the balance of the Net Revenues was paid to the trustee. The court analyzed Section 928(b)'s limitation of liens on special revenues subject to the necessary operating expenses of the system, and concluded that this limitation was applicable to liens on gross revenues from a system and did not apply to the lien on the Pledged Revenues under the indenture because it was a lien on net revenues and not gross revenues.

The court was satisfied that the operating expenses provided for in the indenture were sufficient to allow the system to operate, and that all the expenses in the definition of operating expenses under the indenture would be included within the "necessary operating expenses" under Section 928(b). It therefore concluded that the restriction in Section 928(b) did not apply as a further limitation on the lien on the Pledged Revenues, and that the scope of that lien would be determined solely by the terms of the indenture.

Allocation of Payments Among Different Classes of Warrants

Even with the bankruptcy court's determination that the County was not authorized to withhold amounts for depreciation and amortization or for reserves for future professional fees, the trustees were still faced with a likely shortfall in amounts for debt service. This resulted in two sets of actions for relief. The trustee, joined by the bond insurers and certain warrant holders, filed a motion for relief from the stay, on the grounds that the rate increase of 5.9% proposed by the County was an insufficient response to the shortfall in revenues.

That motion was heard on Jan. 24, 2013 and is currently under advisement. Before Feb. 1, 2013, the trustee had reportedly received waivers from certain holders of warrants held by certain banks (the Bank Warrants) and bond insurers allowing payments not only of interest but also scheduled payments of principal on the warrants that matured as if there were no defaults, nor any principal due, on the Bank Warrants. However, as of that date, certain holders of the Bank Warrants refused to consent further.

The trustee determined that it did not have sufficient funds to make the scheduled payments of principal and sinking fund payments due on Feb. 1, 2013 and, as a result, gave notice to the warrant holders that it would not pay debt service payments due on that date, stating that it would file a complaint for permission to accelerate the warrants.

On Feb. 6, 2013, the trustee filed a complaint with the bankruptcy court seeking authority to accelerate the warrants not previously accelerated, except, in the case of certain insured warrants, it sought to defer any acceleration until the insurer approved of the acceleration. Upon the acceleration of the warrants, each payment would be allocated in proportion to the total outstanding principal and interest *pari passu*. If, as expected, there will be a deficiency in amounts ultimately payable on the warrants, after acceleration any losses would be shared ratably, rather than leaving the deficiency to fall disproportionately on the holders of warrants with later maturities. This matter has not yet been fully briefed or heard, and meanwhile, no principal payments are being distributed on the warrants.

Courthouse Lease Warrants Settlement

Separate from the disputes relating to the sewer warrants, the bankruptcy court was faced with a dispute over a separate financing from designated revenues. Prior to the bankruptcy, the County had financed a new courthouse and jail with lease revenue bonds in the form of lease revenue warrants (*see also* discussion of *Stockton Lease Revenue Bonds* below). The Jefferson County Public Building Authority (the Public Building Authority) had acquired land and built a new courthouse and jail facility in Bessemer, AL, financed with $86,745,000 of lease revenue warrants issued in 2006, which were insured by Ambac Assurance Corporation. The County entered into a lease with the Public Building Authority for the term of the lease revenue warrants to pay rent sufficient to make the debt service payments on the lease revenue warrants.

After filing for bankruptcy, and after the period for the assumption or rejection of leases under Section 365 of the Bankruptcy Code had passed, the County sought a determination that its obligations under the lease had terminated. Because lease termination damages are limited under Section 502(b)(6) of the Bankruptcy Code, a termination would leave the Public Building Authority with a claim that would clearly be insufficient to pay the balance owing on the lease revenue warrants.

The Public Building Authority and the bond insurer opposed the termination on a number of public policy grounds, but before the issue was decided, the County, the Public Building Authority and the insurer entered into a settlement by which the original lease was terminated and replaced with a new lease with lower monthly rent but a longer term. The holders of the lease revenue warrants would be timely paid, to the extent the new lease payments were insufficient, from payments by the insurer, and the extended term of the lease was calculated to be sufficient to repay the insurer for its payments to the lease revenue warrant holders. The lease revenue warrant holders were protected from the risk of non-payment or termination of the lease by the insurer, whose agreement to cover the payment shortfalls in exchange for payments for an extended term made the settlement feasible.

In re City of Stockton, California

The Chapter 9 bankruptcy filed by the City of Stockton, CA, presents many of the same issues as other Chapter 9 cases, and although it is still fairly early in the proceedings, it appears that Stockton's contribution to the development of Chapter 9 is likely to be in the area of "Appropriation Obligations." Interestingly, Stockton has no outstanding General Obligation bonds or notes. According to the City's website (accessed on May 13, 2013, http://goo.gl/vPPRN), because California state law requires a supermajority of two-thirds voter approval for the issuance of General Obligation indebtedness, the City has instead issued Appropriation Obligations.

The City's "Proposal for Modification to Obligations Under AB 506 Process," dated May 7, 2012 (which presumably will serve as the basis for the City's plan of adjustment under Chapter 9), includes mostly secured Appropriation Obligations issued as lease revenue bonds and Lease Certificates of Participation (COPs), and two unsecured Appropriation Obligations, including $124,280,000 in pension obligation bonds that are not secured by any special source of funds.

In its proposal, the City describes its intended treatment of each of the Appropriation Obligations. The City has concluded that its debt is "not supportable given current economic realities without devastating current City services." The City's plan entails nonpayment of the unsecured Appropriation Obligations, and the suspension of payments on most of its secured Appropriation Obligations for five years. The City's goal is to stretch out debt service and make payments that it can afford while making further cutbacks in services to residents.

Stockton's 'Decision Tree'

The City's proposal analyzes each transaction applying two factors: Is the obligation secured or unsecured? If it is unsecured, then the City proposes to stop payment. If the obligation is secured by real estate or other assets, the City considers whether the assets are essential to its operations, or whether the City's residents will still have beneficial use of the facility even if the City should cease payment.

Employing that "decision tree," the City has, on the one hand, ceased paying its unsecured pension obligation bonds, while on the other hand, continuing to pay its lease revenue bonds secured by essential public facilities such as the library, the main police facility and fire stations. With regard to certain lease revenue bonds secured by three public parking garages, the City determined not to pay those bonds, but instead to permit the bond trustee to take possession of the parking structures and operate them with the assistance of a court-appointed receiver in order to generate revenues to pay debt service. This arrangement, in a way, permits the City to have its cake and eat it too. City residents continue to have use of the parking facilities, and yet the City is relieved of its bond obligation and its operating expenses for the garages.

So in this brave new world where public finance law and bankruptcy law interface, we are finding that contrary to the paradigm that municipal debtors "always" meet their debt service obligations, municipal debtors are not necessarily much different from other debtors. Stockton City officials are making value judgments regarding which obligations they will pay and which they will unload. The City is choosing to support only those Appropriation Obligations that are secured by essential facilities and is declining to fund Appropriation Obligations for facilities which City residents will be able to use notwithstanding nonpayment. Needless to say, bankruptcy lawyers and public finance lawyers are following Stockton's case with great interest.

The Brave New World of Public Finance

Post-*Vallejo*, post-*Central Falls*, post-*Jefferson County*, post-*Harrisburg*, post-*Pritchard*, post-*Stockton*, post-*San Bernardino*, post-*Detroit*, post-*Las Vegas Monorail* and on and on, a brave new world of public finance exists. Whereas 10 years ago, public finance professionals viewed bankruptcy professionals as somewhat ephemeral strangers, they now must become trusted friends. Today, bond lawyers and bankruptcy lawyers are navigating the mostly uncharted waters of municipal bankruptcy with increasing frequency and finding to their dismay that much of what they have learned in years of practice is not terribly useful in a Chapter 9 proceeding.

On the bankruptcy side, insolvency lawyers and bankruptcy judges are interpreting bond indentures in ways that capital market professionals never intended. At the same time, public finance lawyers representing bond trustees and capital market creditors are caught off-guard as fundamental tenants of municipal finance are being challenged. But professionals in the public capital markets have found when in severe financial straits, municipal debtors act much the same as private sector debtors. They try to keep their cash, and fight creditors' attempts to extract payment. Market participants seem surprised that a governmental unit would act other than in strict accordance with bond documents. In light of the foregoing, public finance professionals who close a bond financing without obtaining input as to drafting techniques (in particular, net vs. gross revenue pledges) and approval as to an exit strategy from bankruptcy professionals, do so at their peril. To do otherwise would be a recipe for malpractice.

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