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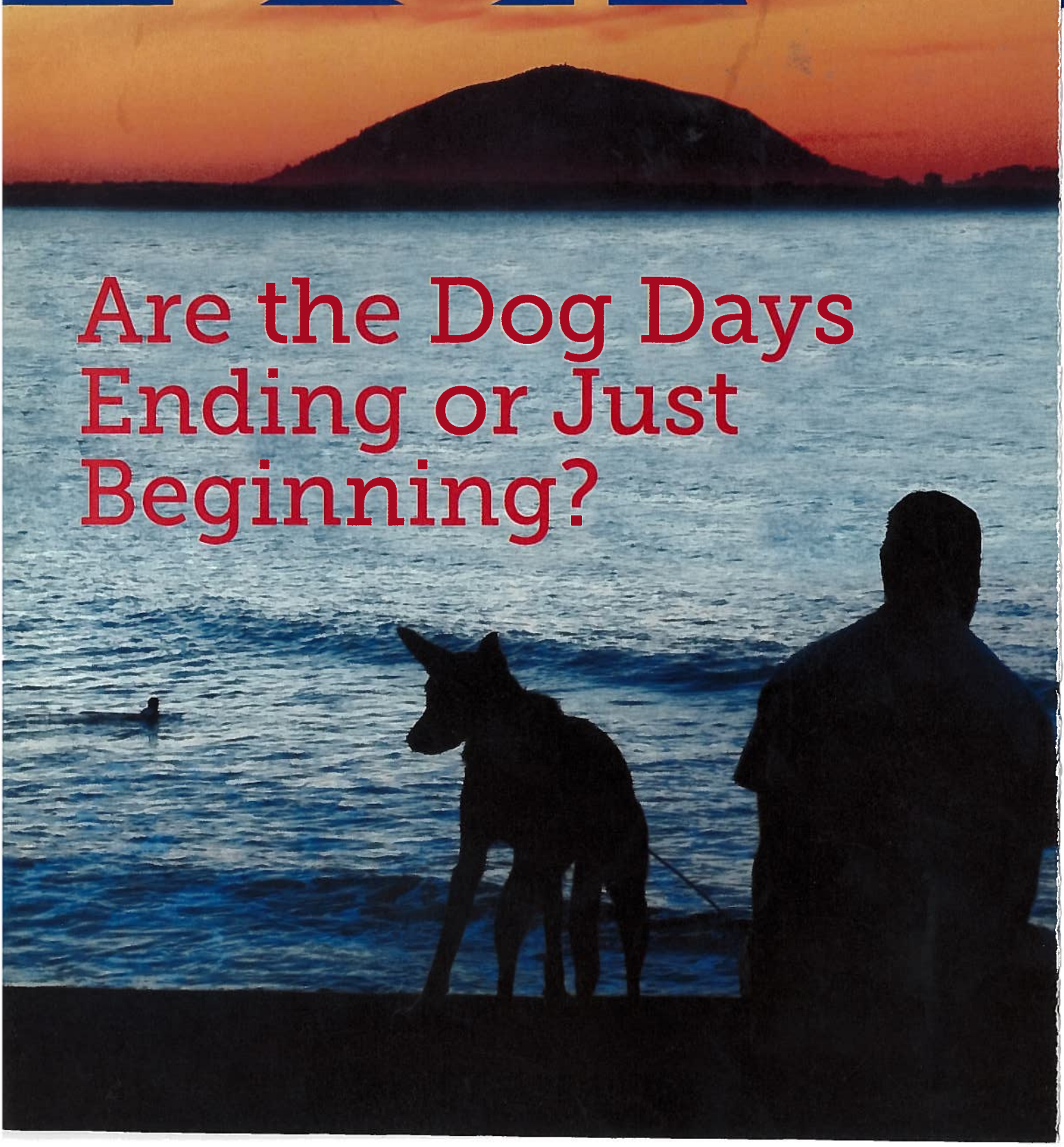

Using Chapter 9 as an Out-of-Court Restructuring Tool

BY MICHAEL H. GOLDSTEIN, ALLEN G. KADISH & HOWARD J. BERMAN, SHAREHOLDERS, GREENBERG TRAURIG, LLP

With more than three decades of experience with modern bankruptcy law, restructuring professionals have witnessed the power of the Chapter 11 "Sword of Damocles" to motivate creditors, interest holders, and other parties to negotiate a consensual out-of-court restructuring. Although less well-developed in practice, Chapter 9 provides a similarly powerful restructuring model.

As with Chapter 11, Chapter 9: (i) suspends creditor litigation and gives a municipality time to implement strategies to revitalize governmental operations; (ii) values principles of transparency and equality by following the absolute priority rule and respecting state law and contractual rights of priority among creditors; and (iii) creates an incentive for parties to negotiate a consensual restructuring instead of litigating the municipality's ability to force a restructuring. However, the constitutional limitations on a federal court interfering with states' rights limits the Bankruptcy Court's authority with respect to a municipality.[1] Consequently, a municipality has substantially greater latitude in a Chapter 9 case than does a debtor in a typical Chapter 11 case.

Chapter 9 is not currently available to all municipalities,[2] but in those jurisdictions in which it can be used, it provides a framework for the restructuring process. The ability to use Chapter 9 to implement a restructuring does not mean that a Chapter 9 filing is the inevitable, or the best, course of conduct for a distressed municipality. The time and cost of an in-court restructuring process, including the potential impact on a municipality's capital costs, can serve as mitigating factors to filing a Chapter 9 case. However, the potential for a Chapter 9 filing can be a catalyst for accomplishing an out-of-court restructuring.

Chapter 9 is only available to those municipalities where applicable state law authorizes such filings.[3] In many states and the District of Columbia, the enactment of specific legislation is required before a municipality can avail itself of Chapter 9. In contrast, Georgia specifically prohibits the filing of a Chapter 9 case. Even where Chapter 9 is an option, its availability is statutorily conditional in many instances,[4] and in all instances may be politically impracticable[5] or economically difficult.[6]

Were Chapter 9 made more available to municipalities,[7] it would have a pervasive influence in shaping the municipal restructuring landscape. More Chapter 9 cases would increase the body of case law, thus providing a greater degree of precedent, certainty, and predictability. As with Chapter 11, it is the prospect of a court-enforced restructuring that provides the critical leverage point for a municipality in negotiating an out-of-court restructuring.

Chapter 9 as a Template

Because of limited formal in-court mechanisms to implement restructuring, municipalities in many cases have no choice but to engage in out-of-court strategies to address looming financial extremis. Whether the result of declining revenues, such as income tax, capital gains tax, sales tax, project revenues, and real estate taxes; the loss of federal subsidies; or increasing labor, health, retiree, and operating costs, governors, legislatures, and municipalities throughout the United States are focused on closing budgetary deficits.

The challenge for any out-of-court restructuring process is to identify and implement a strategy that includes every stakeholder. That process can be difficult without legal leverage to force stakeholders to the bargaining table. A municipality's inability to compel a restructuring without 100 percent consent of stakeholders can adversely affect the municipality's ability to engage stakeholders in an out-of-court process.

Municipalities can effectively use the backdrop of Chapter 9 to effectuate an out-of-court workout. To do so, the municipality needs to focus on a message, be guided by fundamental principles, and effectively use the unique tools available.

Every successful restructuring has at its core a message that is told from the commencement of the restructuring to its implementation, a message that provides the context for particularized disputes and provides the narrative for consensus building. There is no substitute for a well-honed, well-publicized restructuring message. Winning the hearts and pockets of the stakeholders is essential for success. In addition, the electronic age demands that the message be disseminated not just through traditional public relations, but also through aggressive and proactive "new media."

In the out-of-court process, a comprehensive analysis is required to: (i) identify the financial, legal, operational, and political issues presented; (ii) model projected revenues and expenses with detailed line items and reasoned assumptions; (iii) describe relevant debt, contractual commitments, litigation, and other liabilities; (iv) set forth the proposed solutions to the identified issues; and (v) make the business case for those solutions.

In addition, the following guiding principles should be used for out-of-court restructurings.

No Piecemeal Problem Solving. An in-court restructuring requires a comprehensive resolution of a troubled enterprise. All claims must be classified and treated. Executory contracts must be assumed or rejected. The financial plan for the enterprise must be funded and feasible. And the proposed restructuring must respect legal priorities and be fair and equitable.

The absence of a formal in-court mechanism bringing all stakeholders into one forum can result in a municipality avoiding a complete solution in favor of addressing issues one at a time. Thus, instead of tackling revenues, expenses, levels of services, and financing issues in an integrated way, a municipality may be forced to address the "easy issues," those that are less politically confrontational. Such an approach, however, can invite inconsistent treatment, dissension among stakeholders, and inefficiencies.

Without the alternative of an in-court restructuring process, a serial "one at a time" approach can emerge. Even if Chapter 9 is not available, a municipality should strive to implement comprehensive, long-term solutions to its financial difficulties.

Maximizing Value. A Chapter 9 plan of adjustment at its core must maximize value and distribute that value fairly. It is assumed by all parties at the table that restructuring is better than liquidating, that problem-solving is better than determining who is right or wrong,

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and that all stakeholders, including the public, are better off repositioning already deployed assets rather than taking them out of the system entirely. Accordingly, a successful restructuring must embrace a long-term view.

Similarly, the out-of-court municipal restructuring must be perceived and accepted as a value-maximizing plan. If stakeholders are to make concessions and compromises, the corresponding detriments must result in a larger total pie.[8]

Sharing the Pain. In an out-of-court process, generally no one stakeholder will compromise unless all stakeholders share the burden. Whether framed in terms of "most favored nation," or avoiding the "freeloader" problem, the burden of the process must be felt. Accordingly, a strategy to avoid holdouts becomes a critical component of the strategy in the out-of-court process.[9]

Equal Treatment. Invariably, stakeholders will not all have the same legal rights vis-à-vis the municipality. Chapter 9 teaches that differing legal rights of stakeholders are to be respected. Stakeholders are classified under a plan of adjustment based on their legal rights, and they vote in classes. The absolute priority rule is a bedrock restructuring principle embodied in the statutory provisions and case law governing the cram-down of a class of claims that rejects the plan. The application of the absolute priority rule in the case of a municipality requires a nuanced application, as opposed to Chapter 11, there is no class of equity holders.[10]

Transparency. Full disclosure is an uncompromising principle of in-court restructurings. Stakeholders cannot be expected to concede legal and economic rights without the reasoned belief that such sacrifices are absolutely necessary and are being felt by all other stakeholders. Knowledge is an equalizer, leaving stakeholders no choice but to confront a shared reality.

Carrots, Sticks

For an out-of-court municipal restructuring to be successful, each stakeholder should receive a benefit in exchange for giving up legal or economic rights. It is naïve to believe that stakeholders would be prepared to give up legal or economic rights simply as a matter of civic duty. As a result, municipalities should make use of both "carrots" and "sticks" to encourage stakeholders to work for an acceptable restructuring.

Several incentives, or carrots, are available. They include:

Exchange Offer. Broadly stated, an exchange offer mechanism refers to a transaction in which a stakeholder gives up X and receives Y in exchange. The ranges of economic and legal tradeoffs that can comprise the exchange are infinite and depend on the subject of the exchange (e.g., debt or contract). For example, a debt instrument can be exchanged for a new debt instrument with differing maturity, interest rate, amortization, covenants, or priority. A new contract can modify the term, pricing, benefits provided, and/or commitments made. The goal of an exchange offer is to create a new instrument that provides the stakeholder with a better recovery than if the stakeholder did not make the exchange.

Upside Participation/Rights Offering. The underlying premise of an out-of-court restructuring is that value is enhanced over time if a consensual, comprehensive restructuring can be implemented. Stakeholders rightfully are concerned that if they make concessions as part of the restructuring, they will create value. As a result, a mechanism that can provide an opportunity for stakeholders to recover additional value if the restructuring meets or exceeds expectations is a valuable tool to incentivize participation in the restructuring.

One structure to provide stakeholders with future upside protection is to provide for enhanced payments, tax credits, or other consideration if certain criteria are met, such as revenue targets, expense reduction targets, or other relevant financial metrics. Another structure is to offer stakeholders the opportunity to invest in a new debt instrument, contract, surplus asset sale, or other arrangement at attractive pricing.

Reposition/Sale/Privatization of Assets. A municipality may have assets that can be repositioned (e.g., rezoned) or sold (e.g., privatization of prisons, hospitals, or libraries), or it can carve out specific government assets, programs, or services for other revenue-producing opportunities.

As mentioned, a major disadvantage of an out-of-court restructuring process is that there is no formal mechanism to require stakeholders to participate or to bind stakeholders who do not participate. As a result, the out-of-court restructuring process may include a set of penalties or costs to be used as sticks and imposed on a noncompliant stakeholder. These include:

Exit Consents. In the context of a debt exchange offer, a tool for incentivizing stakeholders to agree to the proposed exchange is to require that those parties who agree to the exchange consent to strip the debt documents of protective covenants. In this manner, stakeholders who do not consent to the exchange will find themselves holding a devalued investment. In the municipal context, amendments that can be structured to alter the non-taxable structure of the debt can prove to be a powerful stick for obtaining requisite consents to an exchange offer.

Legislation. Unlike a private entity, a sovereign is in the unique position to cause legislation to be passed to both grant and take away rights, benefits, and entitlements. Subject to constitutional limitations on the impairment of contracts,[11] newly enacted legislation that infuses both the offered carrot and the imposed stick with the force of law can be a sobering reminder that saying no to the sovereign on behalf of the community is not without its downside.

Reputation. As noted earlier, a municipal restructuring must carry a message that wins the support of the stakeholders. By doing so, those who stand in the way of a successful municipal restructuring are left to suffer the consequences that come with opposing the will of the majority.

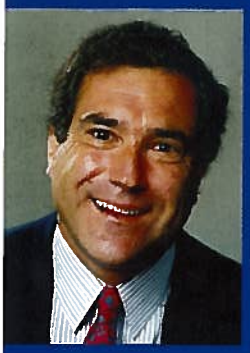
Composition Agreement. In the corporate context, a composition agreement (or other collective action agreement, such as a trust) among creditors has been employed to obtain the enforceable consent of creditors and to bind them to a proposed course of action. The negotiation of such an agreement can be an effective tool to persuade non-signing creditors to abide by the terms of the agreement, to isolate dissenting stakeholders, or to persuade a court that non-signing creditors should not obtain an advantage over other creditors and should be enjoined from interfering with the transaction. Such a composition agreement, for example, could take the form of a trust agreement in which the stakeholder beneficiaries collectively provide certain consideration to the municipality, such as economic or legal concessions, and the municipality in return provides certain benefits, such as granting liens to the extent available or priority rights of distribution.

No Remedy. The difficulty, and in some instances inability, for a stakeholder to effectively enforce remedies enables a municipality to just say no and leave the affected stakeholder at an impasse. While not a perfect solution, it does result in a self-imposed penalty on the stakeholder who has limited recourse while the rest of the restructuring takes place around it.

Dangle the Keys. When a creditor has an interest in a particular asset that has no utility, sometimes the best alternative is to simply offer to surrender the asset to the secured creditor. Many times, the creditor does not want or cannot operate the asset, and the credible threat to surrender the asset can drive a consensus.

A Powerful Incentive

Experience with Chapter 11 restructurings teaches that the availability of an in-court process dramatically improves the potential for success and efficiency of an out-of-court restructuring. There is every reason to assume that municipalities would experience the same benefits of the out-of-court restructuring process if Chapter 9 were a more widely available alternative to addressing financial distress.



Michael H. Golstein (not picutured) is a shareholder of Greenberg Traurig, LLP, in the firm's Los Angeles office, and **Allen G. Kadish** (top) and **Howard J. Berman** (bottom)are shareholders of the firm in its New York office. The three are affiliated with the firm's Business Reorganization and Financial Restructuring practice. The assistance of Whitney S. Baron, an associate of the firm, is gratefully acknowledged. Goldstein focuses his practice on representing debtors, sponsors, bondholders, creditors, committees, and purchasers of distressed assets across a variety of industries. Kadish's practice focuses on Chapter 11 restructurings, corporate crisis management, complex transactions, workouts, creditors' rights, and business litigation. Among his clients are debtors, debtors in possession, lenders, vendors and other creditors, fiduciaries, asset purchasers, investors, and committees in a wide range of industries. Berman has extensive experience in corporate restructuring and creditors' rights, including complex in- and out-of-court restructurings, loan restructurings, distressed asset sales and acquisitions, loan-to-own strategies, M&A, real estate restructurings, single-asset real estate cases, and bankruptcy litigation.

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Would making Chapter 9 available to more municipalities mean that there would be more Chapter 9 filings? Not necessarily. Having Chapter 9 at a municipality's disposal does not mean it will be implemented more frequently. Chapter 9 is not a risk- or cost-free process.[12] However, with such an option, a municipality would have more alternatives and power with which to implement an out-of-court restructuring.

Would making Chapter 9 available to more municipalities mean that there would be more union contracts rejected, more debt defaults, or fewer government services? Not necessarily. Having Chapter 9 at a municipality's disposal, however, does prompt all stakeholders to share the burden of a restructuring in a manner that is fair, transparent, and respects traditional legal priorities and rights.

Would making Chapter 9 available to more municipalities mean that there would be more out-of-court restructurings? Not necessarily. Having Chapter 9 at a municipality's disposal does mean that to the extent that an out-of-court restructuring is required, the process should be more efficient and less burdensome than if the Chapter 9 alternative were not available.

Could a municipality benefit from an in-court restructuring process, even if Chapter 9 were not available? Yes. In such circumstances, the guiding principles of the in-court restructuring process provide a framework for an out-of-court restructuring process. An effective mechanism to create majority support and to bind or isolate holdouts would empower municipalities with an in-court restructuring process that can serve as the backdrop to an out-of-court restructuring process and incent all stakeholders to the negotiating table. ■

[1] The initial municipal debt relief act was held to be an unconstitutional infringement on state power. See *Ashton v. Cameron County Water District*, 298 U.S. 513 (1936). A revised act passed the following year was held to pass constitutional muster on the basis that the revised act required the state to consent

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to the relief requested by the municipality and the revised statute was intended to avoid interference by the Bankruptcy Court in the financial affairs of the municipality. See *United States v. Bekins*, 304 U.S. 27 (1938). The prospect that Congress can under federal law constitutionally craft a federal regime that limits state sovereignty itself—even if the state itself opts into such a system—squarely places the 10th Amendment in the crosshairs of the Bankruptcy Clause of the U.S. Constitution (Article I, Section 8, clause (iv)). The deference for state law that *Bekins* found critical to the constitutionality of the second municipal debt act is reflected in Chapter 9 in Sections 903 and 904 of the United States Bankruptcy Code (11 U.S.C. §§ 101, et seq.), which significantly limit the role of the Bankruptcy Court in a Chapter 9 case and require deference to applicable state law.

[2] "Municipalities" in this article should be taken to include other governmental and quasi-governmental units, including counties; public authorities, such as water and school districts and power, toll-road and air and water port authorities; and quasi-governmental commercial interests like off-track betting (OTB).

[3] Section 109(c) of the Bankruptcy Code specifies the requirements for eligibility to file a Chapter 9 case. The requirements include that the entity "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter." In a typical corporate setting, a Chapter 11 filing must be properly authorized by the board of directors. In a municipal context, a Chapter 9 filing similarly must be properly authorized by the requisite municipal or other authority, as may be legislated by the state. In the OTB matter, an executive order issued by the governor of New York served as the necessary authorization.

[4] Skillful representation by experienced counsel and/or financial advisors who can effectively work to achieve requisite legislative support is invaluable.

[5] The pressure brought to bear on municipal and other public officials to not have a Chapter 9 filing on their watch may permeate politicians' views on the advisability of a Chapter 9 filing. See, e.g., Philip J. LaVelle, "San Diego Straddling the Line on Bankruptcy," *The San Diego Union-Tribune*, Apr. 10, 2005, at www.signonsandiego.com/uniontrib/20050410/news_1n10bank.html; Jerry Sanders, "Debunking the Bankruptcy Myth," Jan. 31, 2010, at http://www.sandiego.gov/mayor/pdf/100131.pdf; Michelle Kaske, "Rendell Urges Harrisburg Against Bankruptcy," *The Bond Buyer*, June 10, 2010, at www.bondbuyer.com/issues/119_359/harrisburg-1013339-1.html.

[6] The cost of a Chapter 9 process is routinely cited as a reason not to invoke Chapter 9. See, e.g., Benjamin Gonzalez, et al., "For All the Hype, Chapter 9 Filings Will Likely Stay Rare," *The Bond Buyer*, Aug. 29, 2011, at www.bondbuyer.com/issues/120_166/chapter-9-filings-1030486-1.html; Patrick Mcgee & Taylor Riggs, "Central Falls Aims to Protect GOs Chap. 9 Will Give Investors 1st Lien," *The Bond Buyer*, August 2, 2011, at Vol. 377, Issue 33558; Charles Oellermann & Mark G. Douglas, "The Year in Bankruptcy: 2010," Mondaq, Mar. 8, 2011, www.mondaq.com/unitedstates/article.asp?articleid=125250; James A. Chatz & Marc S. Zaslavsky, "Fear of Rejection," *The Daily Deal*, July 2, 2010. More significant, however, is the oft-heard refrain that if a municipality files Chapter 9, its ability to tap the municipal bond market will evaporate or become prohibitively expensive. See Mary Williams Walsh & Campbell Robertson, "Just Before Deadline, County in Alabama Delays Bankruptcy Move," *N.Y. Times*, July 29, 2011, at B1; Charles A. Jaffe, "Such Bonds of Trust May Prove Unwise," *Boston Globe*, Jan. 26, 1995, at Business; "Orange County Crisis Jolts Bond Market: From a Bankruptcy, Fears About Losses," *N.Y. Times*, Dec. 8, 1994. To the extent municipal bankruptcies increase in frequency, adjustments may be required to financial products and in credit markets. See, e.g., Benjamin Gonzalez, et al., "For All the Hype, Chapter 9 Filings Will Likely Stay Rare," supra.

[7] The political landscape varies as to whether the availability of Chapter 9 to a municipality is favored. See Cal. A.B. 506 (2011) (proposed California state bill that would alter the current unfettered rights of a municipality in California to file a Chapter 9 case, and require, *inter alia*, municipalities in California to participate in a neutral evaluation process with interested parties prior to filing a bankruptcy petition and to receive a certificate of good faith participation or certification in writing that continued neutral evaluation will not resolve the parties' dispute, and provides an alternative process to federal bankruptcy law involving submission of a petition to a local agency bankruptcy committee); see also Randall Jensen, California Legislation Seeks Pre-Bankruptcy Mediation, *The Bond Buyer*, May 9, 2011, at Vol. 376, Issue 33513.

[8] What comprises the "pie," of course is its own subset of issues attendant to the municipal restructuring. The pie may be measured in terms of: (i) revenues/taxes; (ii) return; (iii) services; (iv) quality of life principles (health, safety and welfare); and/or (v) other tangible and intangible measurements.

[9] The multifront attack on the lenders who refused to consent to the government-backed Section 363 sale of Chrysler and their subsequent isolation as un-American and opportunistic is an example of the hold-out problem. See, e.g., Jim Rutenberg & Bill Vlasic, "Chrysler Files to Seek Bankruptcy Protection," *N.Y. Times*, May 1, 2009, at A1.

[10] In a corporate context, old equity cannot retain any interest in a reorganized debtor unless the senior classes of creditors are paid in full, or consent. 11 U.S.C. §1129(b). In contrast, a municipality has no equity ownership, and thus the municipality can under a plan of adjustment remain in "control" of itself, notwithstanding the failure to pay senior classes in full or obtain their consent. However, at least one impaired class of creditors must consent to meet the separate requirement of Section 1129(a)(10) (incorporated into Chapter 9 by Section 901).

[11] The constitutional prohibition on a state impairing contracts (U.S. CONST. Art. I, §10) is not without exception. See generally, *General Motors Corp. v. Romein*, 503 U.S. 181 (1992).

[12] Chapter 9 did not solve the problems of OTB, as critical legislation did not pass and the Chapter 9 case was dismissed. *In re New York City Off-Track Betting Corp.*, No. 09-17121, 2011 WL 309594 (Bankr. S.D.N.Y. Jan. 25, 2011). And, while Chapter 9 can lead to confirmation of a plan of adjustment, it does not come without its costs. See Randall Jensen, "Vallejo's Bankruptcy Sojourn Sets Example Others May Want to Skip," *The Bond Buyer*, Oct. 12, 2010, at Vol. 374, Issue 33397 (citing legal costs in excess of $9 million). However, costs are to be considered in every transaction, and if the benefits are significant enough, the transaction costs will be just one predicate to the solution.