

BANKRUPTCY BASICS FOR MUNICIPAL BONDHOLDERS

Organizations that issue municipal bonds rarely file for bankruptcy. When they do, the rights of issuers and bondholders are subject to the federal bankruptcy code, state-specific insolvency laws, or both. Breckinridge remains very confident that the vast majority of municipal debt will be unimpaired despite today's turbulent fiscal waters, but prudent navigation of the market requires revisiting the basics of municipal bankruptcy. This primer summarizes the general rules for investors and highlights some important unresolved legal issues.

Municipal bond issuers fall into two broad categories for the purposes of bankruptcy law: organizations that are *independent* of government control and organizations that are *state-controlled*.¹ Independent organizations usually include private universities, hospitals, airports, community redevelopment corporations, or continuing care retirement centers. State-controlled organizations usually include counties, cities, school districts, state agencies, commissions, and bridge or highway authorities. U.S. states are ineligible to file for bankruptcy.

Both kinds of organizations file for bankruptcy very infrequently. A bankruptcy may follow when an issuer fails to comply with a covenant in its bond indenture or defaults on a principal or interest payment. Independent issuers (especially hospitals, community redevelopment organizations, and continuing care retirement centers) declare bankruptcy more often than state-controlled issuers. Small, special districts are the most common type of state-controlled filer.² Among state-controlled entities, there were only 208 bankruptcy filings between 1981 and 2008. This compares to 39,307 business filings under Chapters 7 and 11 in 2008, alone.³

Different Bankruptcy Rules Depend on the Type of Organization and State Laws

In all 50 states, municipal issuers that are *independent* of government control ordinarily file under Chapters 7 or 11 of the federal bankruptcy code. The overarching purpose of Chapters 7 and 11 is to maximize return for investors. Sometimes this results in the "liquidation" of the organization's assets (Chapter 7). In other instances it results in "reorganizing" the capital structure of the institution, including asking bondholders to exchange their rights as lenders for equity in the new entity (Chapter 11). Under both chapters, creditors may file for bankruptcy and force the debtor into bankruptcy.

In 26 states, *state-controlled* issuers may file under Chapter 9 of the bankruptcy code and, concurrently, may be subject to state insolvency laws (discussed below). Chapter 9 and state insolvency rules apply in the possible bankruptcy of Jefferson County, AL and the

¹ The legal term for a "state-controlled" entity is an "instrumentality of the state." An instrumentality of a state" is usually state-controlled, but it need not be. The term "state controlled" is presented here for the sake of simplicity. In fact, each state defines "instrumentality of the state" differently, and there is significant variation among the states.

² See McConnell and Picker, When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy, 713 Practising Law Institute (1995), p. 22.

³ Administrative office of U.S. courts, 1981 – 2008.

ongoing bankruptcy of Vallejo, CA. The goal of Chapter 9 is to provide debt relief to the state-controlled issuer; maximizing returns for investors is a secondary concern.⁴ Under Chapter 9, creditors can neither liquidate the assets of the state-controlled entity nor exchange their debt for equity in it. Chapter 9 also prohibits creditors from forcing a state-controlled entity into bankruptcy. Local sovereignty is unconstitutionally impaired when creditors “liquidate” such an entity, take an “equity stake” in it, or force bankruptcy on it.

In 24 states, *state-controlled* issuers are subject exclusively to state insolvency laws.⁵ These states have failed to make Chapter 9 expressly available to their state-controlled entities. State insolvency laws either mandate or provide options for the reorganization of an issuer’s debts. Reorganization strategies may include permitting a state takeover of an issuer’s operations, appointing a receiver to renegotiate an issuer’s contracts, or having the state assume the issuer’s debts.

Recovery Rates

State-controlled entities that have filed (or wish to file) for bankruptcy generally provide solid recovery rates for creditors. This is true for several reasons. First, state-controlled issuers cannot be liquidated or reorganized; if these issuers also paid low recovery rates upon default or bankruptcy, their access to credit would decrease dramatically. Second, states wish to protect the credit reputation of *all* their state-controlled organizations; this fact often expedites a state “bailout” or some other out-of-court resolution before a bankruptcy is declared.⁶ Third, current law suggests that Chapter 9 is the only constitutional way state-controlled organizations can impair contracts with private parties.⁷ Bondholders are, therefore, in a strong negotiating position in states that deny Chapter 9 access to state-controlled entities. Fourth, bondholders remain in a relatively strong negotiating position even after Chapter 9 is filed. The main power of a Chapter 9 court is to prevent creditors from moving simultaneously on the issuer’s assets. Court powers available under Chapters 7 and 11, such as compelling creditors and issuers to accept a plan of reorganization, are circumscribed under Chapter 9.

Recovery rates against state-controlled entities vary depending on the type of debt issued and the financial capacity of the issuer. Standard & Poor’s has reported a 100% recovery rate on *rated* general obligation bonds over the past 30 years.⁸ Other types of debt

⁴ CRS Report: “Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy code,” Summary page, March 8, 2007.

⁵ Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo, P.C. (Bankruptcy Conference Handout), NFMA Bankruptcy Conference, October 2009.

⁶ See “Municipal Bankruptcy: State Authorization Under the Federal Bankruptcy Code,” Section III (Public Law Research Institute).

⁷ Under the Constitution, a state and “instrumentalities of a state” can abrogate contracts only when “reasonable and necessary.” Proof of “necessity” is hard to establish, as most public entities have unlimited authority to raise taxes or other revenue to meet financial obligations. Chapter 9 was created, in part, to permit “instrumentalities of a state” to make an end-run around this Constitutional rule and reduce their debts. The U.S. Supreme Court upheld the constitutionality of Chapter 9 and the authority of federal bankruptcy courts to reduce the debts of “instrumentalities of states” in *U.S. v. Bekins*, 304 U.S. 27 (1938).

⁸ Per comments by Geoff Buswick, Managing Director of Public Finance Ratings at Standard & Poor’s, NFMA Bankruptcy Conference, October 2009.

such as lease-appropriation bonds, tax-secured debt, or moral obligation bonds have lower recovery rates. The most common Chapter 9 resolution techniques are extending maturity schedules, reducing the amount of principal and interest, and refinancing debt with new loans.⁹

Independent organizations that file for bankruptcy typically repay bondholders only a fraction of their initial investment. This results from the ability of creditors to liquidate or reorganize independent entities in Chapter 7 or 11 and from creditors' ability to force independent organizations into bankruptcy. Analysis of a 2003 Moody's study suggests the recovery rate is approximately 50%.¹⁰

Uncharted Legal Waters

Federal courts have left unresolved at least two important issues with respect to Chapter 9. First, federal courts have failed to rule conclusively on whether states' insolvency procedures and decisions can bind unsatisfied bondholders. Present law suggests that creditors who do not consent to a state-imposed plan of reorganization can hold-out for something better.¹¹ Second, the courts have yet to determine whether Chapter 9 debtors can reject collective bargaining agreements. Unilateral abrogation of collective bargaining agreements is prohibited under Chapter 11, but it may be permitted under Chapter 9. If state-controlled organizations can reject bargained-for pension and post-employment healthcare contracts in a Chapter 9 proceeding, more capital may be available to senior creditors, including bondholders, upon bankruptcy. A case involving the City of Vallejo, California may help decide this issue.

Since its inception, Breckinridge has invested only in bonds that it believes are of the highest quality. While an increase in municipal bankruptcy filings is possible in 2010 and 2011, the overwhelming majority of municipal issuers, including distressed ones, will neither default nor declare bankruptcy. Breckinridge remains attentive to developments in municipal bankruptcy law, and continues to analyze its holdings so as to preserve value and generate reliable income over time.

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⁹ See Summary of Municipal Bankruptcy Law, U.S. Courts website, October 2009.

¹⁰ See Moody's U.S. Municipal bond Rating Scale, Special Comment, p. 9. Most of the bonds in the 75%-100% category are g.o.'s and other Chapter 9 debt. Excluding these bonds, the other categories suggest a recovery rate of over 50%.

¹¹ Congressional Research Service report: "Municipal Reorganization: Chapter 9 of the U.S. Bankruptcy code," March 8, 2007, footnote 19.

U.S. States Authorizing Chapter 9 Bankruptcy

Chapter 9 Eligible

Alabama
Arizona
Arkansas
California
Colorado
Connecticut
Florida
Idaho
Iowa
Kentucky
Louisiana
Michigan
Minnesota
Missouri
Montana
Nebraska
New Jersey
New York
North Carolina
Ohio
Oklahoma
Oregon
Pennsylvania
South Carolina
Texas
Washington

Chapter 9 Ineligible

Alaska
Delaware
Georgia
Hawaii
Illinois
Indiana
Kansas
Maine
Maryland
Massachusetts
Mississippi
Nevada
New Hampshire
New Mexico
North Dakota
Rhode Island
South Dakota
Tennessee
Utah
Vermont
Virginia
West Virginia
Wisconsin
Wyoming

Important note: The lists above present the general rule in each state. Variations in state law may prevent Chapter 9 filings for certain entities in “eligible” states or permit Chapter 9 filings for certain entities in “ineligible” states.

Source: Presented by Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo, P.C. at National Federation of Municipal Analysts Conference on Municipal Bankruptcy (Boston, MA), October 2009. Information accurate as of August 25, 2009.

Municipal Bankruptcy Filings (Chapter 9), 1981-2009

Calendar Year	# of Filings
2008	4
2007	6
2006	5
2005	11
2004	7
2003	4
2002	7
2001	8
2000	6
1999	4
1998	8
1997	7
1996	9
1995	13
1994	15
1993	10
1992	18
1991	21
1990	9
1989	6
1988	2
1987	12
1986	3
1985	3
1984	3
1983	4
1982	2
1981	1

Source: Administrative Office of U.S. Courts, October 2009.