MUNICIPAL DEBTORS: “CRAM DOWN” OF SPECIAL REVENUE DEBT

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Municipal financing differs in a number of significant ways from traditional commercial financing. Therefore, while chapter 9 of title 11 of the United States Code (the “Bankruptcy Code”) incorporates many provisions applicable in cases under chapter 11 of the Bankruptcy Code, including section 1129(b), a/k/a the “cram down” section, it also contains its own provisions with respect to the confirmation of a plan of adjustment – i.e., sections 943 and 944 of the Bankruptcy Code. See 11 U.S.C. § 901(a) (incorporating sections of the Bankruptcy Code). When considering the differences between cram down scenarios in cases under chapter 11 of the Bankruptcy Code and cases under chapter 9 of the Bankruptcy Code, one must consider the prevalence of special revenue financing by municipal debtors and the protections that are built into chapter 9 of the Bankruptcy Code.

I. Can Special Revenue Debt Be Impaired?

A. Special Revenue Financing

Our system of federalism grants state governments the independence and the freedom (with the consent of their citizens) to authorize local governmental bodies to finance various governmental functions and necessary improvements through the issuance of municipal bonds. Municipalities issue their own debt obligations either based on their full faith and credit (general obligation bonds) or based upon the revenues to be collected by the municipality from the financed improvement (revenue bonds). Local government borrowing differs in a fundamental way from either individual or corporate borrowing. The municipal borrower is an entity having special characteristics that differ from those of private actors. See Joel A. Mintz et al., Fundamentals of Municipal Finance 45 (2010). The local government exists solely to provide governmental services; it does not exist for profit-making purposes. Id. Due to the public benefit of financed projects, like water and sewer systems, municipalities are limited in the actions they can take with these assets, including certain restrictions on the right to mortgage or transfer the property, or to allow foreclosure or possession of the property by a secured creditor in the event of default. Further, limitations exist due to the state’s interest in protecting the credit of the state and insuring that municipalities do not harm the state’s credit by undertaking obligations which cannot be repaid.

As municipalities have grown, so has their need for financing. Protecting the integrity of municipal financing is essential to the continued confidence of the municipal bond markets. Thus, municipalities have traditionally made every effort to honor their public debt obligations.

i. Protections for Special Revenue Creditors

Unlike general obligation bonds, which are backed by the full faith and credit of the issuer and, therefore, rely on the assessment and collection of taxes for repayment, revenue bonds do not increase the tax burden of the citizens. They are non-recourse obligations repaid solely from the revenues (and other specified pledged funds) generated by the project that is being financed, such as a sewer or water system, toll road, toll bridge, tunnel, or the like. Consequently, in many jurisdictions, revenue bonds may be issued

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without voter approval or other procedures often required for the issuance of general obligation bonds. *See Fundamentals of Municipal Finance*, at 3-4.

To entice the public to purchase revenue bonds in particular, states have enacted statutory provisions designed to promote this type of financing. Since repayment of the revenue bonds is limited to the stream of income from the financed public projects, states authorize the issuing municipality to irrevocably pledge (or set aside) the revenue stream (or net revenue stream) for the benefit of the revenue bondholders. Typically, the pledge includes the creation of a first lien on the revenue stream. Some states even provide that the pledged revenue streams are held in trust for the benefit of the special revenue creditors. For example, Alabama recognizes that pledged revenues "shall constitute a trust fund or funds which shall be impressed with a lien in favor of holders of the warrants to the payment of which such pledged funds are pledged" and that the pledged revenues are "irrevocably pledged for the payment of the principal and interest on such warrants as provided in Section 11-28-3." Ala. Code §§ 11-28-2, 11-28-3.

Other protections that are authorized by state law and that are often contained in revenue bond documents are covenants in which the issuer pledges: (a) to issue all bonds necessary to finance the project; (b) to complete project construction expeditiously; (c) to maintain specified amounts of reserve funds; (d) to fix, establish, and collect appropriate fees, rates, tolls, or user charges; and (e) to restrict the investment of bond proceeds. *Fundamentals of Municipal Finance*, at 3-4. In addition, where revenue bonds are issued to finance a series of projects undertaken by the same issuer, the municipality that issued them will usually pledge not to issue any additional bonds that are secured by the same revenue stream, unless current revenues are sufficient to cover a specified percentage of both current and future debt service on both outstanding bonds and the new bonds. *Id.* Once entered into, the revenue bond covenants may not be modified or abandoned by the municipality. *Id.*, 2

Since bondholders are unable to take ownership of certain public assets, municipalities will often transfer certain control rights to bondholders to provide the holders with a meaningful remedy in the event of nonpayment. One such remedy is the right to the appointment of a receiver to oversee the particular project in question, and, if appropriate, raise rates sufficient to pay the special revenue debt issued to finance the project.

The states and their municipalities have designed these financing structures to guaranty that the revenue stream relied upon by special revenue bondholders will be protected and not impaired. These statutory provisions protect not only bondholders but also protect the overall credit of the state and all of its municipalities. *See Fundamentals of Municipal Finance*, at 4. As will be discussed in more detail below, given the prevalence of this type of financing, and with it being particular to municipal debtors, Congress, in amending chapter 9 of the Bankruptcy Code in 1988, intended to protect and preserve the bargain made between the municipal debtors, as issuers, and the holders of special revenue debt.

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2 *See also* Spiotto Statements.
B. Chapter 9 And A Brief History Of Municipal Bankruptcy Legislation

Chapter 9 of the Bankruptcy Code is the sole chapter under which a municipality may seek bankruptcy relief. Chapter 9 has evolved since it was first enacted in 1934. Prior to 1988, chapter 9 lumped all of a municipality’s debt into one pot and did not distinguish between general obligation bonds and special revenue bonds. In 1988, Congress approved a series of amendments (the "1988 Amendments") aimed at distinguishing between the two types of bonds. The intent of Congress in enacting the 1988 Amendments was to ensure that state laws protecting special revenue financing were honored in a chapter 9 proceeding and the rights of special revenue creditors would receive additional protections not granted prior to the 1988 Amendments. See S. Rep. No. 100-506, at 13 (1988) (the "Senate Report"). Specifically, the 1988 Amendments sought to ensure that special revenue bondholders would have unimpaired rights to the project revenues pledged to them.

The ultimate intent of Congress in enacting the 1988 Amendments was to provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing. The Senate Report for the 1988 Amendments noted that "[r]easonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal financing." Id. at 21. The Senate Report further noted that:

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 provided in the amendment 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. . . .

Id. at 12 (emphasis added). For example, prior to the 1988 Amendments, special revenue bondholders were at risk that section 552(a) of the Bankruptcy Code would strip them of their liens on post-petition revenues. The Senate Report addressed that issue:

In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenue granted pursuant to state statutory or constitutional provisions to bondholders can be terminated by the filing of a chapter 9 case. 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.

Id. at 6 (emphasis added). The risk posed by section 552(a) was eliminated by the 1988 Amendments. See In re Cnty. of Orange, 179 B.R. 185, 191-92 (Bankr. C.D. Cal. 1995).

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3 For an excellent discussion of the history or chapter 9 and the 1988 Amendments, see Spiotto Statements.
While protecting the integrity of special revenue bonds in chapter 9, Congress was also determined to protect the integrity of the state laws that authorize special revenue municipal financing. With revenue bonds, “the general taxpayers are usually not committed to repaying the bonds or funding operational deficits through general tax revenues . . . [and] it would be quite problematic and contrary to state law if a bankruptcy filing resulted in revenue bonds being converted into general obligation bonds.” Senate Report, at 5. With regard to the 1988 Amendments, one court has noted:

The 1988 Amendments to the Bankruptcy Code added the definition of “special revenues” in § 902(2). The 1988 Amendments were intended to preserve a dichotomy between general obligation and special revenue bonds for the collective benefit of bondholders (to secure the benefit of their bargain), municipalities (to maintain the effectiveness of the revenue financing vehicle) and taxpayers (to ensure that revenue obligations were not transformed into general obligations).


C. Sections 927, 928(a) And 1111(b) Protect Special Revenue Debt From Impairment During the Case and From a Cram Down.

The confluence of sections 927, 928(a) and 1111(b) of the Bankruptcy Code demonstrate Congress’ intent to protect the benefit of the bargain made by a municipal debtor, as issuer, and the holders of special revenue debt obligations under chapter 9 of the Bankruptcy Code both during the case and at confirmation.

i. Congress preserved the extent, validity and priority of liens on special revenues post-petition.

Through section 928(a) of the Bankruptcy Code, Congress preserved the extent of the creditors’ liens on special revenues of a municipal debtor. Section 902 defines special revenues as:

(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; or (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor[.]
In turn, section 928(a) of the Bankruptcy Code preserves the extent of a creditor’s lien on special revenues by granting such creditor a continuing post-petition lien on special revenues to the same extent as existed prepetition. Specifically, section 928(a) of the Bankruptcy Code provides:

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 shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.

Whereas, in a chapter 11 case a secured creditor with a consensual lien will not maintain its liens on collateral of the same type generated post-petition, in a chapter 9 case a consensual lien secured by special revenues continues to attach to post petition revenues to the same extent it existed prepetition.

ii. Congress similarly preserved the value of liens on special revenues.

Through the combination of sections 1111(b) and 927 of the Bankruptcy Code, Congress also preserved the value of liens against special revenues. Section 1111(b) of the Bankruptcy Code provides:

(1)(A) A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse, unless – (i) the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection; or (ii) such holder does not have such recourse and such property is sold under section 363 of this title or is to be sold under the plan.

(2) If such an election is made, then notwithstanding section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.

Congress enacted Section 1111(b) in an attempt to prevent the harsh results faced by non-recourse lenders in a cram-down scenario. See, e.g., Great Nat’l Life Ins. Co. v. Pine Gate Assocs., Ltd., 2 B.C.D. 1478 (Bankr. N.D. Ga. 1976). In Pine Gate, the court exercised its cram-down powers under Chapter XII to cash out a nonrecourse undersecured mortgagee at the appraised value of the property, rather than the amount of debt, at a time of depressed prices. In opposition to the debtor’s proposed plan, the lenders argued that their negotiated “benefit of the bargain” under the non-recourse financing arrangement was either (i) full payment or (ii) the right to foreclose on the property, and that their interests would not be adequately protected unless they were paid in full or allowed to foreclose. The Pine Gate court disagreed, holding that the proposed treatment of the secured claim through a cash payment equal to the appraised value of the collateral was sufficient. In reaching its decision, the court relied upon authority for the proposition that a secured creditor was entitled to receive no more than the appraised value of secured
property as just compensation for the loss of the property and satisfaction of its security interest.” Pine Gate, 2 B.C.D. at 1478. Accordingly, while the debtor retained ownership of the property, the mortgagee was not paid in full, did not retain its lien, and was deprived of its right to sue for a deficiency. See In re S. Vill., Inc., 25 B.R. 987 (Bankr. D. Utah 1982) (discussing the Pine Gate decision).

As a result of Pine Gate, it became clear that a debtor could seek relief through bankruptcy during a period when property values were depressed, propose to repay secured indebtedness only to the extent of the then-appraised value, cram-down a non-recourse secured lender, and preserve all potential future appreciation for the debtor alone.” See In re DRW Prop. Co., 57 B.R. 987, 990 (Bankr. N.D. Tex. 1986). In addition, “[t]he undersecured nonrecourse lender would not be entitled to vote in the unsecured class, thereby making confirmation of the plan much easier.” Id. (citing In re S. Vill., 25 B.R. 987 (Bankr. D. Utah 1982); Jeffrey A. Stein, Section 1111(b): Providing the Undersecured Creditors with Post-Confirmation Appreciation in the Value of the Collateral, 56 Am. Bankr. L.J. 195 (1982)). Secured creditors were shocked by this result and sought relief from Congress when the Bankruptcy Code was proposed and debated. See Richard F. Broude, Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Prerogative, 39 Bus. Lawyer 441 (1984).

As a result of the concern communicated to Congress, the final version of the Bankruptcy Code included section 1111(b) for purposes of alleviating the problem recognized under Pine Gate and restoring the “benefit of the bargain” expected by non-recourse lenders. Kenneth N. Klee, All you Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L.J. 133 (1979); Michael J. Kaplan, Nonrecourse Undersecured Creditors Under New Chapter 11 – The Section 1111(b) Election: Already a Need for Change, 53 Am. Bankr. L.J. 269 (1979). Accordingly, as codified in the Bankruptcy Code, section 1111(b) now represents Congress’ attempt “to create a balance between the debtor’s need for protection and a creditor’s right to receive equitable treatment.” See In re Trenton Ridge Investors, LLC, 461 B.R. 440, 505 (Bankr. S.D. Ohio 2011) (quoting In re Union Meeting Partners, 160 B.R. 757, 769 (Bankr. E.D. Pa. 1993)).

Section 1111(b) balances those interests in two ways. First, if a nonrecourse mortgagee is substantially undersecured, the mortgagee may retain the recourse status conferred by section 1111(b)(1)(A) and cause that class of claims to vote to reject the plan. Id. In such a circumstance, the undersecured creditor can make it impossible to confirm a plan absent a cramdown in accordance with section 1129(b)(2)(B), which would require that the unsecured claims be paid in full or that junior interests receive nothing under the plan. Id. In this way, the undersecured creditor can force the debtor into a situation where the debtor must propose a plan satisfying the unsecured debt or eliminate the debtor’s interest in the property. Id. (citations omitted).

Second, a secured creditor is permitted to make an election pursuant to section 1111(b)(2). Upon making such an election, the secured creditor forfeits its right to recourse against the debtor (i.e., the right to pursue an unsecured claim), but is instead granted an allowed secured claim in the amount of the debt rather than in a judicially determined amount. Id. Hence, the creditor may benefit from any future increase in the value of the property. Id.; see also Tuma v. Firstmark Leasing Corp., 916 F.2d 488 (9th Cir. 1990) (with section 1111(b), Congress sought to give creditors the opportunity to capture future appreciation in the value of their collateral); In re Bloomingdale Partners, 155 B.R. 961, 974 n.7 (Bankr. N.D. Ill. 1993) (“Congress [arguably] enacted
section 1111(b) to prohibit debtors from cashing-out creditors at judicially determined values."); In re Weinstein, 227 B.R. 284, 295 n.12 (B.A.P. 9th Cir. 1998) ("The real benefit of the [section 1111(b)] election is that it protects the creditor against a quick sale of its collateral. . . . By making the election, the creditor guards against an opportunistic sale . . . .")

In 1988, Congress amended chapter 9 of the Bankruptcy Code, proposing "to clarify the provisions of the Bankruptcy Code applicable to municipalities and to correct unintended conflicts that currently may exist between municipal law and bankruptcy law." Senate Report, at 1. Congress approved the 1988 Amendments to chapter 9 because it wanted to ensure that the market for municipal debts remained stable. Id. at 21 (Senate Judiciary Committee recognizing that "[r]easonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal financing."). In approving the 1988 Amendments, Congress recognized that the pledges common to municipal finance must not be adversely affected, even where a bankruptcy filing has occurred, in order to ensure stability in the special revenue financing market. Id. at 3. Congress also recognized that there were restraints on the treatment of special revenue financing imposed by state constitutions. Accordingly, Congress included limitations on both the: (i) conversion of non-recourse obligations into recourse obligations; and (ii) the ability to impair the holders of special revenue debt obligations.

As part of the amendments in 1988, Congress addressed the non-recourse nature of special revenue financing. One of the main concerns that the 1988 Amendments sought to address was that "[s]ection 1111(b) provides that in some circumstances non-recourse debt may be treated as recourse debt." Senate Report, at 22. The problem presented was that "[m]any municipal obligations are, by reason of constitutional, statutory, or charter provisions, payable solely from special revenues and not the full faith and credit of the municipality." Id. Thus, to resolve this problem, the 1988 Amendments adopted section 927, prohibiting conversion of revenue bonds into general obligation bonds in a chapter 9 case. "[The 1988 Amendments] [therefore] avoid[] the potential conversion of revenue bonds into General Obligation bonds under Section 1111(b)." Senate Report, at 2; see also H.R. Rep. No. 100-1011 (1988), at 7 (new section 927 to be added to ensure that non-recourse revenue bonds cannot be converted under section 1111(b) into recourse, or general obligation, debt because allowing such may violate some state constitutions and statutes). The reasoning behind Section 927 has been summarized as follows:

The amendments protect the future effectiveness of revenue bond financing against the possibility of an adverse judicial determination in connection with a municipal bankruptcy. Specifically, the amendments insure that in the event of a municipal bankruptcy, taxpayers will not be required to pay bondholders for bankrupt municipal projects that were intended to be funded exclusively through project revenues. The amendments insure that state constitutional and statutory debt limits will not be preempted by the application of bankruptcy laws. Finally, the amendments insure that revenue bondholders receive the benefit of their bargain with the municipal issuer, namely, they will have unimpaired rights to the project revenues pledged to them.

Senate Report, at 12-13 (emphasis added).
Section 927 of the Bankruptcy Code reads as follows:

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.

11 U.S.C. § 927. While adding section 927 to chapter 9, Congress could also have elected to remove the incorporation of section 1111(b) into chapter 9. However, pursuant to section 901, Congress incorporated section 1111(b), but chose merely to limit it. Section 1111(b), subject to the limitations imposed by section 927, still stands. Thus, in the context of special revenue bonds, the section 1111(b) election is automatic, not requiring any affirmative act by the secured creditor. The ability to elect full recourse treatment for non-recourse debt has been statutorily removed by section 927.

Although Congress recognized that the existing chapter 11 choice for full recourse treatment of non-recourse debt would be unavailable to chapter 9 creditors due to state constitutional limitations on recourse financing, it did not intend for the result to be the continued impairment of special revenue financing by results such as that reached in Pine Gate. Indeed, the existing structure of the Bankruptcy Code prevents such an impairment. By incorporating section 1111(b) into chapter 9, but also limiting the conversion of non-recourse debt to recourse debt, Congress made the section 1111(b)(2) election automatic, providing that the debtor must pay the full value of the claim. Any other reading would render the incorporation of section 1111(b) and the limitation set forth in section 927 superfluous. Further, it makes no sense to read chapter 9 as taking both the recourse protection as well as the section 1111(b)(2) protection away from secured lenders when Congress could have achieved such a result by simply not including section 1111(b) in section 901. Accordingly, in a case under chapter 9, a special revenue finance creditor must be treated as having an allowed secured claim in the full amount of the outstanding debt.

D. In Addition To The Forgoing Provisions Of The Bankruptcy Code, Municipal Debtors Face Additional Constitutional Limitations.

In addition to Congress’s intent to protect the bargains made with respect to special revenue financing, municipal debtors, as governmental units, are also subject to certain limitations imposed by the United States Constitution (the “Constitution”) and the municipality’s applicable state constitution.

Limitations set forth in the Fifth Amendment to the Constitution may impose obstacles or otherwise prohibit a cramdown with respect to a creditor whose claim is secured by special revenues. The Fifth Amendment provides:

No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a grand jury, except in cases arising in the land or naval forces, or in the militia, when in actual service in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of
law; *nor shall private property be taken for public use, without just compensation.*

U.S. Const. amend. V. (emphasis added). The limitations of the Fifth Amendment also apply, through the Due Process Clause of the Fourteenth Amendment, to takings by state governments and their subdivisions. See, e.g., *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992). As a result, the Fifth Amendment is applicable to municipal debtors, and a municipal debtor may not take property without just compensation.

The protections afforded by the Fifth Amendment are not abrogated by the Bankruptcy Code. The legislative history of the Bankruptcy Code indicates that the drafters of the Bankruptcy Code considered the Fifth Amendment to be a limitation upon the impairment of property rights in bankruptcy, and current bankruptcy law gives great deference to property rights. Julia Patterson Forrester, *Bankruptcy Takings*, 51 Fla. L. Rev. 851, 863 (Dec. 1999). The Supreme Court of the United States has addressed the takings issue in the context of bankruptcy on several occasions, holding each time that the bankruptcy power is limited by the Fifth Amendment. See *United States v. Security Indus. Bank*, 459 U.S. 70, 75, 78 (1982); *Wright v. Vinton Branch of Mtn. Trust Bank*, 300 U.S. 440, 456–58 (1937); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589 (1935); see also *Continental Ill. Nat'l Bank & Trust Co. v. Chicago, Rock Island, & Pac. Ry.*, 294 U.S. 648, 669 (1935) (stating that the bankruptcy power is not unlimited); *Holt v. Henley*, 232 U.S. 637, 639 (1914) (holding that an amendment to bankruptcy law must be applied prospectively to avoid affecting existing property rights). In the context of a chapter 9 case, it is important to determine the scope of the property rights held by a creditor where the debt at issue is secured by special revenues, and the impact that may have on the debtor’s ability to effect a cramdown.

While most people think of property as a thing that is owned by someone, bankruptcy specialists understand property as a collection of rights with respect to things. Stephen J. Ware, *Security Interests, Repossessed Collateral, and Turnover of Property to the Bankruptcy Estate*, 2002 Utah L. Rev. 775, 776 (2002). A sophisticated understanding of property dissolves the unitary conception of ownership into a metaphorical “bundle” of rights reflecting the fact that more than one person can have rights with respect to a particular thing. *Id.* Consistent with this understanding, courts have held that contractual rights are cognizable property interests protected under the Takings Clause of the Fifth Amendment. *Century Exploration New Orleans, Inc. v. United States*, 103 Fed. Cl. 70, 76 (Fed. Cl. 2012) (citing *Lynch v. United States*, 292 U.S. 571, 579 (1934) (stating that valid contracts are property protected by the Fifth Amendment); *Lion Raisins, Inc. v. United States*, 416 F.3d 1356, 1370 (Fed. Cir. 2005)). Even further, courts have generally classified as property, or rights to property, transferable interests generating pecuniary value. *21 West Lancaster Corp. v. Main Line Restaurant, Inc.*, 790 F.2d 354, 357 (3d Cir. 1986) (citing *United States v. Bess*, 357 U.S. 51, 55 (1958) (for tax lien purposes, life insurance policies are property to the extent of their cash surrender value, since policy holder could compel payment of that amount); Note, *Property Subject to the Federal Tax Lien*, 77 Harv. L. Rev. 1485, 1486–87 (1964) (federal classifications have focused on transferability and leviability of interest)). In the words of one court, the question to be asked is, “[i]s the interest . . . bargainable, [i]s it transferable, [does] it have value?” *Randall v. Nakashima & Co., Ltd.*, 542 F.2d 270, 278 (5th Cir. 1976). Based upon the foregoing, the question then becomes, “Which parts of the contract – of the bargain – constitute property subject to the protections afforded by the Fifth Amendment?”
While it is clear that the Fifth Amendment provides certain protection, there is no set formula for determining when justice and fairness require that economic injuries caused by public action be compensated by the government, rather than remain disproportionately concentrated on a few persons. *Penn Central Transp. Co. v. City of N.Y.*, 438 U.S. 104, 124 (1978). Rather, a takings analysis depends on the facts of each case, as the Supreme Court of the United States has explained:

> The Court's decisions have identified several factors that have particular significance. The economic impact of the regulation on the claimant, and, particularly, the extent to which the regulation has interfered with distinct investment-backed expectations are, of course, relevant considerations. So, too, is the character of the governmental action. A “taking” may more readily be found when the interference with property can be characterized as a physical invasion by government than when interference arises from some public program adjusting the benefits and burdens of economic life to promote the public good.

*Id.* (citations omitted). Consistent with the *Penn Central* opinion, the Supreme Court of the United States has further explained that, when considering whether an impermissible taking has occurred, courts should consider: (i) the economic impact of the action; (ii) its interference with reasonable investment-backed expectations, and (iii) the character of the governmental action. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979).

Based upon the foregoing, many questions arise in the context of a chapter 9 debtor seeking to cramdown the holders of debt, particularly special revenue debt. Can a municipal debtor impair covenants, such as the covenant to control the value of the stream of special revenues – *i.e.*, covenants with respect to controlling the proverbial spigot – without violating the Fifth Amendment? Is a municipal debtor entitled to divert special revenues to pay additional obligations for the good of the municipality? To the extent certain provisions of the contractual relationship between a municipal debtor and a creditor secured by special revenues are deemed property, the Fifth Amendment arguably prohibits such actions or, at least, imposes obstacles to the debtor’s ability to do so.

### E. State Trust Law May Remove Special Revenues From A Municipal Debtor’s Control and Its Ability to Impair in a Case Under Chapter 9.

As mentioned above, some state laws provide that special revenues pledged to the repayment of special revenue obligations are pledged and held in trust. For example, the Supreme Court of Alabama has stressed, a pledge “meant set apart, appropriated, or charged with the payment of a specific obligation authorized by law. . . . That the pledge may, by appropriate remedy, require such revenues conserved and applied to the secured demand . . . needs no citation of authority.” *Heustess v. Hearin*, 104 So. 273, 274 (Ala. 1925). See also Sylvan G. Feldstein, et al., *The Handbook of Municipal Bonds* 1295 (John Wiley & Sons, Inc. eds., 2008) (defining “pledged revenues” as “revenues legally pledged to the repayment” of the warrants).

It is fundamental that a debtor can only restructure “claims” against it in accordance with the requirements of the Bankruptcy Code. “[A] debtor owes a ‘debt’ to [a] creditor, who has a ‘claim’ against the debtor.” *In re Threatt*, No. 04-82082C-13D, 2004 WL
Claims against a debtor” are defined as including “claims against the property of the debtor.” 11 U.S.C. § 102(2) (emphasis added). These fundamental principles of bankruptcy law were incorporated into chapter 9. When special revenues are by state law transferred to be held in trust for the benefit of the holders of the debt secured by the special revenues, the municipal debtor may not be able to impair the creditors’ property interests in the revenues.

A bankruptcy court must look to state law to determine the debtor’s interest in a particular piece of property. Under settled principles of state trust law, property held in trust by one for the benefit of another is deemed to be property belonging to the beneficiary, not the trustee. Because, under state law, trust assets belong to the beneficiaries, the trust assets are not debtor’s property or property of the debtor’s estate, and shall not be distributed to any other creditors or sold unless all trust beneficiaries have been paid. See, e.g., In re Monterey House, Inc., 71 B.R. 244 (Bankr. S.D. Tex. 1986) (“That the corpus of a trust is not property of the estate is so widely accepted as to be beyond dispute.”); Matter of Vacuum Corp., 215 B.R. 277, 280 (Bankr. N.D. Ga. 1997) (“Because the debtor does not own an equitable interest in property he holds in trust for another, that interest is not property of the estate’ and is also not property of the debtor’ for purposes of § 547(b).”); Matter of Quality Holstein Leasing, 752 F.2d 1009 (5th Cir. 1985) (“Congress did not mean to authorize a bankruptcy estate to benefit from property that the debtor did not own.”); United States v. Whiting Pools, Inc., 462 U.S. 198, 205 n. 10 (1983) (“Congress plainly excluded property of others held by the debtor in trust at the time of the filing of the petition.”); Pearlman v. Reliance Ins. Co., 371 U.S. 132, 135-36 (1962) (“[Bankruptcy law] simply does not authorize a trustee to distribute other people’s property among a bankrupt’s creditors.”).

Courts have treated numerous types of municipal debtors as “trustees” of funds held on behalf of municipal bondholders. See, e.g., State ex rel. Central Auxiliary Corp. v. Rorabeck, 108 P.2d 601, 603 (Mont. 1941) (officers of irrigation district responsible for levy and collection of tax sufficient to pay principal and interest on bonds of the district, as well as county treasurer who is custodian of those funds, are trustees for district bondholders); Blackford v. City of Libby, 62 P.2d 216, 217-18 (Mont. 1936) (city becomes trustee on behalf of warrantholders of special improvement district); Fidelity Trust Co. v. Vill. of Stickney, 129 F.2d 506 (7th Cir. 1942) (holding the money which municipality collects in payment of special assessments is trust fund). In those cases, the courts held that the municipality merely served as a custodian of the funds held for the bondholders, and could not apply the funds toward other purposes. See, e.g., In re City of Columbia Falls, Mont., 143 B.R. 750, 762 (D. Mont. 1992) (“A fund that is derived from a special levy or one created for a specific purpose is in the hands of municipal officials in trust. The municipality

4 11 U.S.C. § 101 also defines the term “claim” to mean—(A) right to payment, whether or not such right is reduced to judgment, liquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.”

is merely a custodian, and its duties relative to such funds are purely ministerial. . . .”; holding funds held in trust may not be applied to purchase of other property). In addition, courts have found a fiduciary relationship exists between the municipality and the bondholders. See, e.g., Vill. of Brookfield v. Prentis, 101 F.2d 516 (7th Cir. 1939) (municipality issuing special assessment bonds for local improvement is a trustee of the special assessment funds charged with all duties of such a fiduciary, including the obligation to spread the assessment, collect it, and make disbursement thereof in conformity with the statutory provisions to those holding bonds payable out of the assessments); Sampson v. Vill. of Stickney, 173 N.E.2d 557 (Ill. App. 1961) (holding special assessments bondholder entitled to accounting from municipality who acted as trustee; “[t]he rule is that when a municipality issues special assessment bonds it becomes a trustee of the funds resulting from the collection under the special assessments, and is charged with all attending fiduciary duties.”).

Based upon the foregoing, a bankruptcy court could find that, because the holders of debt secured by special revenues hold an ownership interest solely in the special revenues, and because the special revenues are held in trust and are not property of the debtor, such holders do not have a claim against the debtor or the debtor's property. See, e.g., Ni-Fuel Co. v. Jackson, 257 B.R. 600, 619 (N.D. Okla. 2000) (remanding to state court those claims which are not “property of the estate,” and involved “no claims” against the bankrupt debtors); In re Threet, 2004 WL 2905344, at *2 (holding the movant has “no claim” against the debtor or against any property of the debtor; hence, there is no debt owed to movant and movant is not a creditor in the case). Without a claim against the debtor or the property of the debtor, the holder of debt secured by special revenues is arguably not subject to the cram-down provisions contained in the Bankruptcy Code.

II. Municipal Debtors And Successful Plans Of Reorganization: Best Interests Of The Creditors, Fair And Equitable, Valuation, Indubitable Equivalent And Feasibility

Assuming a municipal debtor may impair special revenue debt, a municipal debtor must still satisfy the “best interest of creditors” test and, if a class of special revenue holders is a non-consenting class, it must also satisfy the “cram-down” requirements of Section 1129(b). In both instances, facts specific to special revenue financing and municipal debtors create issues not found in typical commercial bankruptcy cases, including: (a) a different standard for the best interest of creditors test; (b) the potential for “valuation circularity”; (c) different considerations regarding the provision of the “indubitable equivalent” to a holder of special revenue debt; and (d) feasibility considerations in light of a municipality’s ability (or inability) to generate additional revenue.

A. Satisfaction Of The Best Interest Of Creditors Test Under Section 943(b)(7) Of The Bankruptcy Code

A chapter 9 debtor bears the burden of demonstrating its plan satisfies section 943(b)’s “best interests” standard by a preponderance of the evidence. In re Pierce Cnty. Housing Auth., 414 B.R. 702, 715 (Bankr. W.D. Wash. 2009); In re Mount Carbon Metro. Dist., 242 B.R. 18, 31 (Bankr. D. Colo. 1999). This standard differs from that set forth in section 1129(a)(7) because, unlike a chapter 11 debtor, a municipality cannot be
liquidated. Chapter 9 case law on this point is not well developed. Therefore, the legislative history is an important resource.

i. **History of Section 943(b)(7)**

The history of section 943(b)(7) is insightful. The Bankruptcy Act of 1934 (the "**1934 Act**") included the first look behind the "best interests" language, stating "[t]he judge shall confirm the plan if satisfied that (1) it is fair, equitable, and for the best interests of the creditors, and does not discriminate unfairly in favor of any class of creditors..." H.R. Rep. No. 5950, § 80(e) (1934). The senate report regarding the 1934 Act similarly noted the 1934 Act required a plan to be "workable and equitable." S. Rep. No. 407 (1934).

The 1934 Act was created:

[t]o provide a forum where distressed cities, counties, and minor political subdivisions. . . . of their own volition, free from all coercion, may meet with their creditors under the necessary judicial control and assistance in an effort to effect an adjustment of their financial matters upon a plan deemed mutually advantageous. If a plan is agreed upon by the taxing district and its creditors holding two thirds in amount of the claims of each class of indebtedness, and if the court is satisfied that the plan is workable and equitable, it may confirm the plan, and the minority creditors are bound thereby.

H.R. Rep. No. 207, at 1 (1934). The House Report further emphasized that before a judge could approve a plan, the judge should hear objections and determine if the plan is fair and equitable. H.R. Rep. No. 207, at 3 (1934).


In addition to the confirmation requirements incorporated from section 1129 by section 901, this Section specifies additional requirements... . [P]aragraph (6) requires that the plan be in the best interest of creditors and feasible. The best interest test was deleted in section

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7 The 1937 Act, like the 1934 Act, was challenged on constitutionality grounds, but, unlike the 1934 Act, was declared constitutional. *U.S. v. Bekins*, 304 U.S. 27 (1938).
94(b)(1) of current chapter IX from previous chapter IX, because it was redundant with the fair and equitable rule. However, this bill proposes a new confirmation standard generally for reorganization, one element of which is the best interest of creditors test; see section 1129(a)(7). In that section, the test is phrased in terms of liquidation of the debtor. Because that is not possible in a municipal case, the test here is phrased in its more traditional form, using the words of art “best interest of creditors.” The best interest of creditors test here is in addition to the financial standards imposed on the plan by sections 1129(a)(8) and 1129(b), just as those provisions are in addition to the comparable best interest test in chapter 11, 11 U.S.C. [§] 1129(a)(7). The feasibility requirement, added in the revision of Chapter IX last year, is retained.

1978 U.S.C.C.A.N. 5963, 6355-56. Thus, the House Report makes clear that section 943(b) is in addition to—not in place of—the standards set forth in section 1129 (as made applicable to chapter 9 proceedings by section 901). *Id.* at 6464. Therefore, a court should confirm a plan:

[i]f it complies with the “fair and equitable” test and is in the best interests of creditors. The best interests of creditors test does not mean liquidation value as under chapter XI of the Bankruptcy Act. In making such a determination, it is expected that the court will be guided by standards set forth in *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943), and *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940), as under present law, the bankruptcy court should make findings as detailed as possible to support a conclusion that this test has been met.

*Id.* at 6465. Accordingly, in addition to the fair and equitable test (discussed *infra*), the best interests test set forth above remains intact.8

ii. **Case Law Guidance on Section 943(b)(7)**

The legislative history behind section 943(b)(7) points to *Fano* and *Kelley* – two cases from the 1940s – as instructive. In *Fano*, the Ninth Circuit required a debtor to make a reasonable effort to honor its obligations to creditors in order to satisfy the best interests of creditors test. *Fano v. Newport Heights Irr. Dist.*, 114 F.2d 563 (9th Cir. 1940). In its reversal of the plan’s confirmation, the *Fano* court states:

[w]e are unable to find any reason why the tax rate should not have been increased sufficiently to meet the District’s obligations or why it can be said that the plan is “equitable” and “fair” and for the “best interest of the creditors” with no sufficient showing that the taxing power was inadequate to raise the taxes to pay them.

*Id.* at 565-66.

8 None of the amendments to the Bankruptcy Code in 1988, 1994, or 2005 altered section 943(b)(7).
In *Kelley*, the U.S. Supreme Court analyzed a debtor’s proposed plan under chapter 11’s “fair and equitable” requirement. *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943). Even though the fair and equitable requirement is now somewhat different from the best interests test, the legislative history points directly to *Kelley* as providing a proper interpretation of the best interests requirement. See 1978 U.S.C.C.A.N. 5963, 6465 (“[i]t is expected that the court will be guided by standards set forth in *Kelley*. . . .”). In *Kelley*, the debtor proposed a plan where the only asset was future tax revenues. To determine whether the plan was fair and equitable, the Court ruled that express findings of fact based on current and projected revenues and expenses were required to ascertain whether the debtor could meet its obligations. *Kelley*, 319 U.S. at 420.9

*Kelley* and *Fano* together indicate that a court should evaluate the debtor’s budget, and after doing so, deny the plan if it appears that the debtor is not making sufficient effort to repay its obligations or that it will be unable to meet its future debt obligations. This concept dovetails neatly with feasibility, discussed *infra*.

More recently, some courts have found the chapter 9 best interest test challenging to adjudicate. See, e.g., *Cnty. of Orange v. Merrill Lynch & Co. (In re Cnty. of Orange)*, 191 B.R. 1005, 1020 (Bankr. C.D. Cal. 1996) (stating that the best interests of creditors test is “an elusive standard” in chapter 9 proceedings) (citing 4 *Collier on Bankruptcy*, ¶ 943.07(7) (15th ed. 1995)). One court, however, does a good job delineating the best interests test, stating it requires:

> [t]hat a proposed plan provide a better alternative for creditors than what they already have. This is often easy to establish. Since creditors cannot propose a plan; cannot convert to Chapter 7; cannot have a trustee appointed; and cannot force a sale of municipal assets under state law, their only alternative to a debtor's plan is dismissal. Outside of bankruptcy, general unsecured creditors often have little possibility of being repaid, especially where the municipality's debt burden is too high to be retired by taxes. Therefore, any possibility of payment under a Chapter 9 plan is often perceived by creditors as a better alternative. With few options and little negotiation leverage, either inside or outside of bankruptcy, creditor may accept even a hopelessly infeasible Chapter 9 plan in preference to the non-bankruptcy status quo.

*In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999) (emphasis added). See also *Cnty. of Orange*, 191 B.R. at 1020 (holding that the best interests test in a chapter 9 proceeding means that the plan must be better than the alternative that creditors have, which in the chapter 9 context, is dismissal) (citing 4 *Collier on Bankruptcy*, ¶ 943.07 (7) (15th ed. 1995)).

It is clear that a plan must provide for better treatment than the creditors would receive if the case were dismissed and that the debtor must actually try to meet its obligations. *Cnty. of Orange*, 191 B.R. at 1020 (holding that the best interest test requires

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9 This has been understood by at least one court to indicate that a balanced budget within a reasonable period of time post-confirmation is required. *In re Mount Carbon Metro. Dist.*, 242 B.R. 18, 33-34 n.46 (Bankr. D. Colo. 1999) (noting the intent of Congress as indicated in H.R. Rep. No. 686, at 60 (1975)).
a reasonable effort by the municipal debtor to provide an alternative better than dismissal of the case (quoting 4 Collier on Bankruptcy, ¶ 943.07 (7) (15th ed. 1995)); Mount Carbon, 242 B.R. at 34; 6 Collier on Bankruptcy ¶ 943.03[7] (Lawrence P. King ed., 15th ed. 1999) (noting that courts must require a "reasonable effort by the municipal debtor ... ."). Beyond that, few bright lines exist regarding what the appropriate best interests standard is. Some courts, as noted above, simply require the plan to be better than the alternative, while others require the plan to give creditors the greatest potential economic return from the debtor's assets. Compare In the Matter of Sanitary & Improvement Dist. #7, 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (requiring only that the plan proposed be better than dismissal of the case) with In re Barnwell Cnty. Hosp., 471 B.R. 849, 869 (Bankr. D.S.C. 2012) (holding that where "/[t]he Plan affords all creditors the potential for the greatest economic return from Debtor's assets," the plan meets the best interest of creditors test). A few case studies better illustrate the lay of the land.

a. "Better than the Alternative"

In District #7, the United States Bankruptcy Court for the District of Nebraska evaluated whether a plan had to provide post-petition interest on a bondholder's general unsecured claim. Dist. #7, 98 B.R. at 974. The court held that "a plan may be confirmed, over objection if it does not provide for post-petition interest, even if there is an asset base sufficient to provide such interest." Id. Section 943(b)(7) "simply requires the Court to make a determination of whether or not the plan as proposed is better than the alternatives." Id. In a chapter 9 proceeding, the only alternative is allowing the debtor to amend the plan or dismissing the case. Id. at 975. In District #7, dismissal would have resulted in the parties going back to state court and a state judge ordering the debtor to raise taxes sufficiently to pay the bonds in full (including accrued interest). Id. The court, however, ruled that convincing evidence had been presented that the taxes required "[w]ould create such a high level of taxes for the district that it is likely the revenues would not be made available to the district by taxpayers and the bondholders would still not be paid." Id. at 975-76 (relying on Nebraska state law, which required the bonds to be paid in full).

b. "Greatest Potential Economic Return"

In In re Pierce County Housing Authority, 414 B.R. 702 (Bankr. W.D. Wash. 2009), the bankruptcy court denied a plan because the plan restricted creditors' ability to reach funds potentially available to satisfy claims; specifically, because the debtor showed no reason why such limitations were necessary or helpful to the adjustment of its debts and, thus, the plan failed to meet section 943(b)(7)'s best interests requirements. Id. at 721. Moreover, when the debtor proposed the plan, it consciously omitted potential sources of income without stating any reason for doing so, raising the issue of whether the plan was proposed in good faith. Id. at 719.

In In re Connector 2000 Association, Inc., 447 B.R. 752 (Bankr. D.S.C. 2011), the debtor's proposed chapter 9 plan was deemed feasible and in the best interest of creditors where the plan afforded creditors the potential for the greatest economic return. The

10 The court also noted the confirmation requirement set forth in section 1129(a)(7), which requires holders of unsecured claims to receive the present value of those claims, is not applicable in chapter 9 proceedings. Dist. #7, 98 B.R. at 974.
Bankruptcy Court for the District of South Carolina evaluated the projected net revenues and held they were reasonable based upon evidence presented at the confirmation hearing. *Id.*; see also Barnwell Cnty. Hosp., 471 B.R. at 869 (holding that the plan afforded creditors “the potential for the greatest economic return from Debtor’s assets,” and, therefore, the plan satisfied the best interest of creditors test).

In *In re Corcoran Hospital District*, 233 B.R. 449 (Bankr. E.D. Cal. 1999), the bankruptcy court confirmed a plan over a creditor’s objection that the debtor should have raised taxes in order to generate sufficient revenue to pay its debts. The court analyzed the debtor’s ability to raise tax rates and found it simply was not possible. *Id.* The debtor could not raise property taxes unless two-thirds of the voting public supported the tax increase, and the city manager testified the measure would have received less than half the vote. Moreover: (a) only 2.3% of the debtor’s revenue came from tax assessment—the rest came from payment for services; (b) in the eight years prior to the petition date, there had been no successful efforts to raise property taxes; and (c) hard economic realities faced the hospital district as, at the time of the debtor’s chapter 9 petition, unemployment in Corcoran was 17.3%, and the median per capita income was half that of the rest of the state. *Id.* at 459. The court noted the Fano precedent but held it only required a debtor to raise taxes if it could actually do so. If the debtor lacked the ability, then failing to raise the tax rate would not defeat confirmation under the best interests test. *Id.*; see also Lorber v. Vista Irr. Dist., 127 F.2d 628, 638 (9th Cir. 1942) (requiring a trial court to make findings to “[s]upport a conclusion that the payments provided for in the plan of composition are all that the District is reasonably able to pay in the circumstances.”) (citing Consol. Rock Co. v. DuBois, 312 U.S. 510 (1941)).

B. Fair and Equitable; Valuation Issues for Special Revenue Stream Under Chapter 9

The Bankruptcy Code allows a plan to be “crammed down” if it is “fair and equitable with respect to a class.” In regards to secured claims, a plan is fair and equitable if the plan provides:

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder’s interest in the estate’s interest in such property; [or]

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(iii) for the realization by such holders of the indubitable equivalent of such claims.

i. **Impairment**

The first test in any “fair and equitable” analysis is ascertaining whether the secured creditor is actually impaired. If the plan “does not leave the creditor’s rights entirely ‘unaltered,’ the creditor’s claim will be labeled as impaired under § 1124(1) of the Bankruptcy Code.” *Solow v. PPI Enters. (In re PPI Enters.)*, 324 F.3d 197, 202 (3rd Cir. 2003). Impairment is presumed, and “[t]he burden is placed on the debtor to demonstrate the plan leaves the creditor’s rights unaltered.” *Id.* at 203. Note, however, that it is not possible to be impaired by statute—only by the actual plan. *Id.* at 204 (“Any alteration of legal rights is a consequence not of the plan but of the bankruptcy filing itself.”) (quoting *In re Am. Solar King Corp.*, 90 B.R. 808, 819-20 (Bankr. W.D. Tex. 1988)).

ii. **Valuation**

To ascertain whether a secured creditor is impaired, the creditor’s claim must be valued by the court. *Sandy Ridge Dev. Corp. v. La. Nat’l Bank (In the Matter of Sandy Ridge Dev. Corp.)*, 881 F.2d 1346, 1354 (5th Cir. 1989) (“It seems contemplated that this determination [(valuation)] is to be made by the court.”). Section 506 of the Bankruptcy Code does not specify the time or date a valuation is to be made, but rather states that “value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.” While some contrary authority exists, the majority rule is that “when valuation is for the purpose of plan confirmation, the value must be determined as of the date that plan is confirmed and not at some other date.” *Matter of Atlanta S. Bus. Park, Ltd.*, 173 B.R. 444, 450 (Bankr. N.D. Ga. 1994) (citing *In re Landing Assocs., Ltd.*, 122 B.R. 288, 292 (Bankr. W.D. Tex. 1990)); *Matter of Seip*, 116 B.R. 709, 711 (Bankr. D. Neb. 1990); *Ahlers v. Norwest Bank Worthington (In re Ahlers)*, 794 F.2d 388, 399 (8th Cir. 1986), *rev’d on other grounds* 485 U.S. 197 (1988); *In re Cason*, 190 B.R. 917, 926-27 (Bankr. N.D. Ala. 1995); *In re Kennedy*, 117 B.R. 967, 974 (S.D. Ala. 1995); see also *Green Tree Acceptance, Inc. v. Calvert (In re Calvert)*, 907 F.2d 1069 (11th Cir. 1990). But see *In re Beard*, 108 B.R. 322, 323-24 (Bankr. N.D. Ala. 1989) (holding that the value of collateral for purposes of allowing secured claims is established as of the date of the petition); *Orix Credit Alliance v. Delta Res., Inc. (In re Delta Res.)*, 54 F.3d 722, 729-30 (11th Cir. 1995) (supporting multiple valuation dates as opposed to a single date of determination of the petition date).

In *Seip*, the court held that “the collateral securing a creditor’s claim should be valued at a date in close proximity to the confirmation date.” *Seip*, 166 B.R. at 712. Citing *Seip* and other cases, the United States District Court for the Northern District of New York stated that “[c]ourts have been nearly universal in their statements that valuation hearings should be held in close proximity to the confirmation date.” *Beneficial Homeowner Serv. Corp. v. Moreau (In re Moreau)*, 135 B.R. 209, 213 (N.D.N.Y. 1992); see also *In re Stanley*, 185 B.R. 417, 423-24 (Bankr. D. Conn. 1995) (“where . . . the purpose of the valuation is to determine the treatment of a claim by a plan, the values determined at the § 506(a) hearing must be compatible with the values that will prevail on the confirmation date to avoid an inequitable result. For that reason, section 506(a) hearings should be timed so that they are in close proximity to confirmation hearings.”); *In re Mirant Corp.*, 334 B.R. 800, 829 (Bankr. N.D. Tex. 2005) (“It is incumbent upon this court in valuing [the debtor] to

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determine whether or not its value extends to equity to reach its decision using the best, most current information available.

TE-Two Real Estate Ltd. P’ship v. Creekstone Apartments Assoc., L.P. (In re Creekstone Apartments Assoc., L.P.), No. 3:94-0382, 1995 WL 588904, at *18 (M.D. Tenn. Sept. 18, 1995) (holding that the bankruptcy court must conduct the evidentiary hearing on valuation in close proximity in time to any hearing on confirmation of a Chapter 11 plan).

a. Forward Looking Valuation

The most oft cited valuation case is Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941). This Supreme Court decision laid the foundation for forward-looking valuations in the bankruptcy context, and stated that future earning capacity is the most important determination when valuing an entity in the bankruptcy process. As many other courts have subsequently noted, valuations that focus solely on past earnings or current market perception do not adequately take into consideration the benefits of the bankruptcy process. While Supreme Court decisions (and lower court decisions) after Consolidated Rock have allowed the use of a market-based approach or willing buyer-willing seller analysis, those cases generally involved situations where there were current bidders for the debtor or focused on the real estate context.

In Consolidated Rock, the Supreme Court found that the bankruptcy court must make a finding regarding the earning capacity of the debtor to approve a plan of reorganization. However, the Court further states that evidence of the earning capacity is fact dependent and the methodology to determine the forward looking value should be made practically rather than through a rigid formula. As a result, Chapter 9 debtors may seek to use past earnings as a major component of their valuation of future special revenues, while secured parties will prefer to weigh more heavily forward looking adjustments that could positively affect the stream of special revenues. The Supreme Court has emphasized forward-looking valuations in order to free the enterprise "from the heavy hand of past errors, miscalculations or disaster" that is "based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earnings record, and all circumstances which indicate whether or not that record is a reliable criterion of future performances." Id.

The extent and method of inquiry necessary for valuation based on earning capacity are necessarily dependent on the facts of each case and have varied widely. Valuation models that have been used by parties include a comparable company analysis, market based approach as if the debtor were going public, income based approach based upon a price between a willing buyer and seller, a valuation based upon future cost saving realization, and a load forecast and revenue requirements model. Support for these models come from various sources such as economists, consulting firms, the general manager of the debtor, finance professionals, and valuation firms. It should be noted that the courts and experts often use multiple valuation methods in their determinations. Often times, a single party will rely on multiple experts. Generally, courts do not accept one expert’s

12 Note that the Court in National Rural Utilities Cooperative Finance Corp. v. Wabash Valley Power Association, Inc. (In re Wabash Valley Power Association, Inc.), 111 B.R. 752 (Bankr. S.D. Ind. 1990) did consider – as one factor in its analysis – the willing buyer-willing seller analysis. However, in reversing the lower court, the district court criticized the lower court’s failure to consider the seller’s strengths and the possibility of rate increases. Stated otherwise, the lower court failed to consider the debtor’s future earning capacity post-bankruptcy. Although not explicitly stated by the district court, it appeared to reject a current market-based valuation.
valuation in its entirety over another expert’s valuation. Instead, the court will re-calculate the value on its own based on the elements of each experts’ reports with which the court agrees. The most common methodology is to determine value based on a comparable company analysis, a comparable transaction analysis and a discounted cash flow analysis, and then weigh each method according to the facts of the case. Ultimately, courts conduct valuation proceedings through the lens of the bankruptcy process, meaning that courts realize the special purpose of the valuation. See, e.g., In re Mirant Corp., 334 B.R. 800 (Bankr. N.D. Tex. 2005) (stating that “the purpose of a valuation in chapter 11 is to determine what returns may be produced in the future to satisfy claims and, if appropriate, equity interests” and to ensure fairness in satisfying claims).

b. Valuation Circularity

An issue of particular relevance in special revenue cases with a rate-setting component is the valuation circularity problem or rate-value conundrum. In the In re Public Service Company of New Hampshire, 88 B.R. 521, 530 (Bankr. D.N.H. 1988), a chapter 11 case of a regulated monopoly utility company, the bankruptcy court summarized the conundrum:

Valuation is based on revenues, which are derived from rates set by the [monopoly utility company]. Rates are based in part on capital structure, which is fixed under a plan approved by this Court. Capital structure is based in part on valuation, for value determines distributions under a plan. Id. at 531.

and

It is particularly important to note the unique problem of “valuation circularity” presented by a chapter 11 reorganization of a regulated monopoly utility company. A corporate reorganization under chapter 11 of the Bankruptcy Code has as its crux the restructuring of the corporate entity and a valuation of the assets of the entity as so reorganized. The regulation of an electric utility under New Hampshire Law has the NHPUC's primary function as setting rates to be charged by the utility company. However, the value of the assets of a public utility company in large measure is determined by the rates that can be charged for the power produced by those assets; and the rates to be set by regulators for a public utility company in large measure is determined by the structure of the company and the value of its assets. It is apparent then that such circularity could easily lead to a stalemate when a public utility company comes into a bankruptcy reorganization court unless an appropriate resolution can be accomplished in the chapter 11 proceedings.

In re Public Serv. Co. of N.H., 108 B.R. 854, 856 (Bankr. D.N.H. 1989). The bankruptcy court continued by noting that “these [valuation] issues are novel and complex, have no precedent, and must be fully analyzed from a financial, legal, practical, and strategic basis before meaningful negotiations toward a consensual plan can proceed.” As a result, the bankruptcy court asserted that courts should do what is necessary to push a debtor and its creditors from entrenched positions on rate increases and balance the federal interests of “maximization of values for all parties in interest in this reorganization proceeding – particularly through a consensual plan of reorganization, if possible – rather than having a litigated plan, with all the delays, costs, and expenses of going from consensual to litigated
reorganization” with the state’s rights to set rates. The court excluded the Public Utility
Commission from the plan negotiation process in order to achieve a consensual resolution.
Special revenue financing is at particular risk for valuation circularity.

C. “Indubitable Equivalent”

As defined by the Bankruptcy Court for the Eastern District of Michigan,
“[i]ndubitable means ‘too evident to be doubted.’” In re Walat Farms, Inc., 70 B.R. 330,
334 (Bankr. E.D. Mich. 1987) (Spector, Bankr. J.) (citation omitted); see also Atlanta S.
Bus. Park, 173 B.R. at 448 (“The generally accepted meaning of [indubitable equivalent] is
‘too evident to be doubted.’”) (citation omitted). “The phrase [indubitable equivalent],
however, does not imply that a creditor must receive the exact amount due and owing or
the exact amount measured by an exact valuation of the collateral. It cannot. No creditor
will ever receive such because courts . . . will be required to make fact findings of present
values of property.” In re Elm Creek Joint Venture, 93 B.R. 105, 111 (Bankr. W.D. Tex.
1988). But where there is doubt about whether a proposal provides the indubitable
equivalent of a claim, then the requirement has not been met. Walat Farms, 70 B.R. at
336.

The debtor bears the burden of proving, by a preponderance of the evidence, “that
the creditor will receive the indubitable equivalent of its claim.” Atlanta S. Bus. Park, 173
B.R. at 448 (citing Heartland Fed. Savings & Loan Ass’n v. Briscoe Enters., Ltd., II (In re
Briscoe Enters., Ltd., II), 994 F.2d 1160, 1165 n.26 (5th Cir. 1993)). Whether a plan meets
this standard is a determination made by the bankruptcy court on a case by case basis.
Walat Farms, 70 B.R. at 334. When determining whether the indubitable equivalent has
been provided, the court uses a valuation as of the date of plan confirmation. Atlanta S.

The facts underlying an indubitable equivalent determination are reviewed under the
clearly erroneous standard, but whether the actual legal standard has been met is reviewed
1415, 1421 (9th Cir. 1996); F.H. Partners, L.P. v. Inv. Co. of the Sw., Inc. (In re Inv.
Co. of the Sw., Inc.), 341 B.R. 298, 317 (B.A.P. 10th Cir. 2006) (same); see also Woods v. Pine
Mountain, Ltd., 80 B.R. 171, 172 (B.A.P. 9th Cir. 1987) (“Whether a plan provides a secured
creditor with the indubitable equivalent of a claim is, in our view, a mixed question of law
and fact.”). In each case, a determination on indubitable equivalence will be a fact-
tensive determination. For various determinations regarding indubitable equivalence, see:
to alter the collateral securing a creditor’s loan, providing the `indubitable equivalent’
requires that the substitute collateral not increase the creditor's risk exposure.”); In re
Bernard, 70 B.R. 181, 185-86 (Bankr. E.D. Ark. 1986) (finding that a new mortgage had to
be proposed with substantially all of the same provisions as the original mortgage, and a
new note had to be on substantially the same terms for the indubitable equivalence to be
provided); United States v. Arnold & Baker Farms, 177 B.R. 648, 653-63 (B.A.P. 9th Cir.
1994) (“to the extent a debtor seeks to alter the collateral securing a creditor’s loan,
providing the `indubitable equivalent’ requires that the substitute collateral not increase the
creditor’s risk exposure”) (citation and quotations omitted), aff’d 85 F.3d 1415 (9th Cir.
1996); In re Inv. Co. of the Sw., 341 B.R. 298, 319-26 (B.A.P. 10th Cir. 2006) (“Where
collateral is substituted, two attributions of the substituted collateral—its value and the
degree of risk that it imposes on the secured creditor—determine whether the new collateral is sufficiently ‘safe’ and ‘completely compensatory.’”

D. Feasibility Test Under Chapter 9

The feasibility requirement for confirmation is found with the best interests requirement in section 943(b)(7). Although Chapter 9 does not incorporate section §1129(a)(11) which bankruptcy courts generally use to determine whether a plan is feasible, legislative history indicates that Congress intended to incorporate the feasibility standards set forth in Kelley. As discussed above, Kelley requires a court evaluating a proposed plan of adjustment to engage in detailed fact-finding to determine the assets and liabilities—both current and projected—of the debtor. As stated by Representative Edwards during House deliberations, fact-finding is intended to enable the court “to evaluate the likelihood of performance and the availability of funds to meet the petitioner’s obligations under the plan.” Representative Edwards’ remarks, although helpful, are notably vague—for example, what he meant by “likelihood of performance” needs further explanation. Subsequent authorities have provided guidance on this issue.

The decision in Mount Carbon provides significant insight with respect to section 943(b)(7)’s “feasibility” requirement. See Mount Carbon, 242 B.R. 18 (Bankr. D. Colo. 1999). In Mount Carbon, it was uncontested that the debtor’s proposed plan met the “best interests” requirement—only “feasibility” was at issue. Before evaluating the proposed plan, the court grappled with the meaning of Section 943(b)(7)’s “feasibility” requirement. Citing Collier on Bankruptcy, the court found that the feasibility requirement sets a ceiling “which prevents the Chapter 9 debtor from promising more than it can deliver.” Id. at 34. The court further determined that, in order to be “feasible,” a plan must allow the debtor to repay its pre-petition debt and continue to provide essential governmental services. Id. at 34–35 (“The Court must, in the course of determining feasibility, evaluate whether it is probable that the debtor can both pay pre-petition debt and provide future public services at the level necessary to its viability as a municipality.”). The court concluded thusly because, “since insolvency is the foundation of Chapter 9 eligibility, it would make little sense to confirm a reorganization plan which does not remedy the problem.” Id. at 34.14

The chapter 9 feasibility standard, like that employed in chapter 11 cases, prevents debtors from confirming plans that promise creditors more than can possibly be attained. Mount Carbon, 242 B.R. at 35 (citing Travelers Ins. Co. v. Pikes Peak Water Co. (In re Pikes Peak Water Co., 779 F.2d 1456, 1460 (10th Cir. 1985)). Specifically:

A plan should offer a reasonable prospect of success and be workable.
In Chapter 9, this requires a practical analysis of whether the debtor can accomplish what the plan proposes and provide governmental services. Although success need not be certain or guaranteed, more is required than mere hopes, desires and speculation.

14 See also Moody v. James Irrigation Dist., 114 F.2d 685, 689 (9th Cir. 1940) (“To afford the plan of payment proposed the District must be in a position to proceed as a going District and for this reason its cash in hand cannot be too greatly depleted.”); Lorber v. Vista Irrigation Dist., 143 F.2d 282 (9th Cir. 1944) (affirming the court’s confirmation of a plan because the court’s fact finding indicated that the payments under the plan were as high as they possibly could be without jeopardizing the debtor’s viability as a municipality).
Mount Carbon, 242 B.R. at 35 (string citation omitted). Thus, there are two elements to feasibility: (1) the plan must allow the debtor to pay pre-petition debt and provide for public services “[a]t the level necessary to its viability as a municipality,” and (2) the plan must be attainable and not simply a “visionary scheme.” Id. at 34-35 (quoting Pikes Peak, 779 F.2d at 1460).

In regards to the first element, it would “make little sense” to confirm a plan that did not remedy the chapter 9 debtor’s insolvency. Id. at 34. See also Lorber, 127 F.2d at 638 (“To afford the plan of payment proposed the District must be in a position to proceed as a going District and for this reason its cash in hand cannot be too greatly depleted.”) (internal citations and quotations omitted). As to the second element, whether the debtor’s plan will be successful depends upon “reasonable income and expense projections.” Mount Carbon, 242 B.R. at 35. The debtor’s projections should take into account future expenses and should not “[r]epresent an ideal scenario and fail to anticipate any fluctuation [or] deviation. . . .” Id. 37-38.

Taken together, the best interests and “feasibility” tests require a debtor to make a reasonable effort to repay creditors in full and pursue any potential source of funds to meet those obligations, unless there are good reasons for not doing so. However, the debtor may not promise more to its creditors than it can deliver, and it may not jeopardize its ability to continue to function as a viable municipality. In this way, the best interest test is a “floor requiring a reasonable effort at payment of creditors by the municipal debtor” and the feasibility requirement is a ceiling that “prevents the Chapter 9 debtor from promising more than it can deliver.” Mount Carbon, 242 B.R. at 34; Pierce Cnty., 414 B.R. at 718. See also, Sanitary & Improvement, 98 B.R. at 974 (noting how the idea that chapter 9 would not allow a municipality to adjust its debts defeats the very purpose of chapter 9 and is non-sensical); Mount Carbon, 242 B.R. at 34, 41 (noting the purpose of chapter 9 is “[t]o allow an insolvent municipality to restructure its debts in order to continue to provide public services,” and “[t]here is no purpose in confirming a Chapter 9 plan if the municipality will be unable to provide future governmental services.”). Not raising taxes or rates will not necessarily mean denial of plan confirmation.15

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15 U.S. Const. Art. I, § 8, cl. 4, §10; In re Richmond Unified Sch. Dist., 133 B.R. 221, 224 (Bankr. N.D. Cal. 1991) (“any federal debt relief legislation affecting municipalities must be sufficiently narrow in scope to avoid intrusion by the federal courts on the sovereign power of the states”); see also, Barnwell Cnty., 459 B.R. at 910. “The United States Supreme Court has also repeatedly discussed the need for respect of state sovereignty and has found that Congress and the federal courts should not interfere with legitimate state interests even in the context of a municipal bankruptcy.” In re Sullivan Cnty. Reg’l Refuse Disposal Dist., 165 B.R. 60, 82 (Bankr. D.N.H. 1994) (observing that the jurisdiction of bankruptcy courts “should not be exercised lightly in chapter 9 cases, in light of the interplay between Congress’s bankruptcy power and the limitations on federal power under the Tenth Amendment”); see also Cnty. of Orange, 191 B.R. at 1018 (noting that section 903 was designed to ensure that states preserve their political and governmental powers in a chapter 9 proceeding and highlighting that section 903 could be deemed unconstitutional if it the court interfered with the county’s ability to continue its operations or dictated the type or level of service the municipality may provide) (citing 121 Cong. Rec. H39413, daily ed. Dec. 9, 1975).
III. Conclusion

Congress designed chapter 9 of the Bankruptcy Code in recognition of those differences. Indeed, the 1988 amendments to chapter 9 were enacted in large part due to Congress’ previous failure to give effect to the peculiarities of special revenue municipal financing. Chapter 9 of the Bankruptcy Code now provides unique protections to special revenue bondholders that limit, if not eliminate, the municipal debtor’s ability to impair or cram down special revenue debt.