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Balancing Best Interests And Feasibility In Chapter 9

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There is little Chapter 9 precedent. What little there is often deals with the challenges a municipality faces getting into Chapter 9. Less is written about how a municipality gets out of Chapter 9. There are material differences between the confirmation standards for a Chapter 9 plan of adjustment and those of a Chapter 11 plan of reorganization. One of the primary ways these differences manifest themselves is in the distinct way the"best interests of creditors" and "feasibility" tests are interpreted in Chapter 9.

The best place to start is the statute itself. Bankruptcy Code Section 943(b) deals with confirmation standards for a Chapter 9 plan of adjustment. It provides, in relevant part, that the court shall confirm a plan if:

- (1) the plan complies with the provisions of this title made applicable by sections 103[f] and 901 of this title;
- (4) the debtor is not prohibited by law from taking any action necessary to carry out the plan;
- (6) any regulatory or electoral approval necessary under applicable non-bankruptcy law in order to carry out any provision of the plan has been obtained, or such plan is expressly conditioned on such approval; and
- (7) the plan is in the best interest of creditors and is feasible.

Bankruptcy Code Section 103(f) provides that only Chapters 1 and 9 apply in a Chapter 9 case. Although much of Section 1129, which sets forth the confirmation requirements for a Chapter 11 plan, appears to be incorporated into Chapter 9 through Bankruptcy Code Section 901, among those sections absent are Sections 1129(a)(7) and 1129(a)(11).

Section 1129(a)(7) requires that each holder of a claim or interest in an impaired class must accept the plan or, as is more often the case, that the plan be shown to provide more to any such holder than it would receive in a Chapter 7. This is often referred to as the "best interests of creditors" test. Section 1129(a)(11) provides that a plan cannot be confirmed unless the court finds that the plan is not likely to be followed by liquidation or the need for further financial reorganization. This is often referred to
as the "feasibility" test.

Although Chapter 9 does not incorporate either of those provisions, Section 943(b)(7) requires that

a Chapter 9 plan of adjustment be in the best interests of creditors and feasible. So those tests must mean something different in Chapter 9 than in Chapter 11.

The Chapter 11 best interests test, whether creditors are receiving more than they would in a Chapter 7, cannot apply in a Chapter 9. Because a municipality may not liquidate under Chapter 7, this test has most often been interpreted to mean that a Chapter 9 plan must provide a better result for creditors than any of the existing alternatives.

What are the alternatives to a municipal debtor's Chapter 9 plan of adjustment? A municipality cannot be liquidated. A trustee cannot be appointed to administer the assets of a municipality. Only the debtor can file a plan of adjustment in Chapter 9. Some states in which Chapter 9 is an option also have alternative financial oversight regimes to a Chapter 9. State law often prevents typical creditor remedies such as levying and executing on assets. Constitutional concerns and legislative limitations
(see the 10th Amendment and Bankruptcy Code Sections 903 and 904) limit the oversight a court or the U.S. trustee can have over a municipality. The major leverage a court or a creditor has over a municipality is to seek dismissal of the case. Measuring a creditor's hypothetical recovery outside of the Chapter 9 plan of adjustment before a court certainly becomes a challenging exercise.

The legislative history of the Chapter 9 best interests test makes it clear that a court is expected to be guided by the standards set forth in Kelley v. Everglades Drainage District, 319 U.S. 415 (1943) and Fano v. Newport Heights Irrigation District, 114 F. 2d 563 (9th Cir. 1940). 124 Cong. Rec. H 11,100 (Sept. 28, 1978); S. 17,417 (Oct. 6, 1978). Kelley holds that a court must enter sufficient findings to
support a conclusion that ties the revenue of the municipality to the payments of the various creditor classes so that a court may "determine the fairness of the total amount of the cash or securities offered to creditors by the plan." The Fano decision makes it clear that a Chapter 9 plan is not a basis for soaking the creditor body. In the case of an irrigation district that had filed a Chapter IX, the court found the costs of a plan that diverted tax monies to reconstruct the irrigation district could not be unjustly allocated to the bondholders. Under today's Chapter 9, the best interest test has been interpreted to set a floor that a Chapter 9 plan must exceed "requiring a reasonable effort at payment of creditors by the municipal debtor."

The feasibility test also plays differently in Chapter 9. First, there are significant limitations on a court's interference with a municipal debtor's operations. Section 904 prevents the court from interfering with 1) any of the political or governmental powers of the debtor; 2) any of the property or revenue of the debtor; or 3) the debtor's use or enjoyment of any income-producing property. Second, the goal of the plan of adjustment in a municipal case is not the restoration of a commercial business to profit, but the preservation of a municipality's ability to provide essential municipal services. If the best interest test has been interpreted to be a floor in requiring, the feasibility test has been interpreted to be a ceiling,
requiring that the plan offer a "reasonable prospect of success and be workable." Mount Carbon, 242 B.R. at 35. A debtor has to show it can perform under the terms of the plan and still remain viable as a municipality. Here, as in Chapter 11, the court has to make findings supported by the record that the plan is in fact "feasible".

But there is an added challenge courts and municipal debtors face. Sections 943(b)(4) and (b)(6)

require that state and local law must be met with respect to the capital structure of the debtor on emergence. State constitutional, statutory and regulatory rules relating to issuance of, types of, and relative priority of debt have to be followed with respect to the classes of new or restructured debt provided for in the plan. Nor can the plan restructure debt with speculative new debt if payment of the debt in full is not clearly feasible. In re Sanitary and Improvement District No. 7, 98 B.R. 970, 973 (Bankr. D. Neb. 1989). See also In re City of Colorado Springs, Spring Creek General Improvement District, 177 B.R. 684, 695-696 (Bankr. D. Colo. 1995).

In the end, what these two tests tell us is that a court, with limited supervisory powers over a municipal debtor, is explicitly required to get right the balance between creditors' rights and debtor viability—and do so with less statutory and precedential guidance than a court reviewing a Chapter 11 plan has. If that is the case, and if as some predict there is an increase in Chapter 9 filings, it behooves all of the constituent parties to communicate early, often and transparently, to help the court get it right.

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