

Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress

SECOND EDITION



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Introduction

In May 2008, the City of Vallejo, California, filed for protection under chapter 9 of the United States Bankruptcy Code, followed in 2011 by Jefferson County, Alabama, in 2012 by the City of Stockton and the City of San Bernardino, California, and by Detroit, Michigan in 2013. No significant city or county filings have occurred since then, but municipalities¹ have been increasingly squeezed between the cost of providing basic services and flat or declining revenues, exacerbated by the COVID-19 pandemic and the loss of sales and other taxes and other types of revenues. In the face of these pressures, the possibility that some may want or need to seek chapter 9² protection has increased.

We intend this pamphlet to provide an overview of chapter 9 for those who manage and govern municipalities. We offer some thoughts on how to avoid filing as well as how to successfully navigate a bankruptcy case and emerge in stronger financial health. It does not attempt to provide an exhaustive technical exposition of the law; due to its size and format, this pamphlet only briefly summarizes, and in some cases omits entirely, areas that in particular cases might be very significant, but which we feel would not be of interest to the majority of our audience.

Accordingly, this pamphlet does not purport to provide legal advice or serve as a template for a practitioner seeking to advise a client considering a chapter 9 filing or to prosecute the case once there. Rather, what we hope to provide is a basic framework for those considering the chapter 9 alternative and enough background to enable decision makers and managers to ask informed questions of their advisors and appropriately consider the alternatives. Bankruptcy is a complex area of the law, and the adage “don’t try this at home” should be heeded. Any municipality seriously considering a chapter 9 filing should obtain expert legal counsel as well as financial advisory help.

¹ Throughout, we use the term “municipality” to refer to a local government entity that may file a chapter 9 case. The term covers a wide variety of local governments that may or may not be considered “municipalities” under state law.

² The observant reader will note that “chapter” is not capitalized when referring to the chapters of the Bankruptcy Code. This is the standard convention.

CHAPTER 1

Avoiding Chapter 9

If the reader takes away only one thing from this pamphlet, it should be that filing for bankruptcy protection should be considered a last resort, to be used only after every effort has been made to avoid it. As we discuss below, there are several significant downsides to a filing, and in the end, the problems that brought the municipality to the point of filing will have to be solved anyway, so it is far better to resolve them, if possible, outside of bankruptcy.

ASSESSING THE PROBLEM(S)

The initial step in trying to avoid bankruptcy is to clearly and dispassionately assess the underlying problem or problems that are pushing the municipality in that direction. The degree of self awareness and transparency among municipalities can vary widely, and for some, one of the main problems may be simply getting a good handle on the real drivers of financial stability and solvency. Not being financial managers, we will leave it to those more qualified to get into the technical details, but suffice it to say that if a municipality cannot identify in clear terms the specific factors that are driving revenues down and/or expenses up, it has some serious homework to do before venturing into a workout, let alone into bankruptcy court.

Municipalities that have been pushed to the brink of, or into, bankruptcy, generally experienced one or both of two types of fiscal problems. The first is a large and extraordinary one-time financial hit that cannot be absorbed by the budget or covered out of reserves. This could be a sudden and catastrophic investment loss (such as that experienced by Orange County, California, leading to its chapter 9 filing in 1994) or a large judgment rendered against the municipality (such as that experienced by Desert Hot Springs, California, leading to its chapter 9 filing in 2001). In each case, these significant one-time liabilities forced the municipality into seeking bankruptcy protection.

The second kind of fiscal problem is a structural operating deficit that continues long enough to burn through reserves and is not resolved by

revenue increases or spending cuts quickly enough for the municipality to avoid running out of cash as it attempts to meet necessary and fixed expenses such as debt service and payroll. Such was the case with Vallejo, Stockton, Detroit and San Bernardino. A municipality with this type of problem could be pushed over the edge by a relatively small one-time expense or drop in revenues, as it may have little or no cushion available to absorb even a modest setback. For example, the City of Vallejo, which had spent down its reserves in order to meet its obligations over a period of several years, became insolvent as a result of California's economic slowdown and the concomitant drop in real estate and sales tax revenues, combined with significant employee salary and benefit cost increases dictated by collective bargaining agreements. The City of Stockton suffered even greater losses due to the burst of the housing bubble, and in addition to unsustainable labor and legacy costs, faced public debt with payment obligations structured to escalate in the future. Unfortunately, the COVID-19 pandemic has the potential to be the straw that breaks the back of a municipality already struggling with a structural operating deficit. Indeed, the consequences of the pandemic may turn out to be a unique, third such driver of municipal bankruptcy, combining elements of both an extraordinary one-time financial hit with the potential for longer-term structural deficits should revenue losses as a result of associated economic and social dislocations be prolonged while needs, and associated costs, escalate.

In general, fiscal stress related to one-time problems can be resolved by financing cure costs over a long enough period so that those costs can be absorbed in the budget over time. And while bankruptcy protection may be necessary to buy time to consummate such a financing and delay disruptive collections efforts or the forced liquidation of collateral, all efforts should be made to convince creditors to be patient and not to cause the municipality to incur the significant costs associated with a bankruptcy filing.

Fiscal stress related to ongoing structural deficits and lack of reserves is much more difficult to tackle because a financing will have little impact on solving the underlying structural problem. In fact, this tactic will likely make things worse by "kicking the can down the road" and increasing the overall costs to the municipality. In these circumstances, painful cuts in service levels, employee compensation and other expenses may be required, as well as increased revenues through higher taxes or fees. Bankruptcy protection may

be needed to avoid immediate sanctions for breaching contracts, including labor agreements, missing debt service payments or failing to provide required levels of service.

CASH POSITION AND SPECIAL FUNDS

Most municipalities (particularly general purpose entities such as cities and counties) maintain scores of separate funds within their treasuries, each having a particular function and source of revenues, and each burdened by legal or grantor restrictions as to the use of the funds. For example, in California, revenues from municipal utilities such as water and sewer systems may be used only to pay the costs of operating and maintaining those systems or for capital improvements (including debt service) to those systems. Many states require that special funds be held in trust and not diverted for unrelated uses. Similarly, moneys received in grants and state subventions may be restricted to particular uses by the terms of the grants, or by statutes or regulations. Careful analysis must be made of the various funds held by the municipality to determine what diversions can legally be made and, more importantly, how limitations on the uses of funds will affect the true available cash position of the municipality. While it is not uncommon for all these funds to be commingled for investment purposes into a pooled cash account, a significant positive balance in pooled cash can mask a serious problem in the municipality's underlying financial condition.

Typically, the only fund completely unrestricted as to its use is the municipality's general fund. It is common and accepted practice for municipalities to use their pooled cash accounts as a source of cash flow within a fiscal year to carry funds that have intra-year cash inflows that do not match their cash outflows; *provided*, that the budget and reserves are sufficient³ to ensure that at the end of the fiscal year, restricted funds are not in a position of having funded items not permitted within their restrictions. For example, the general fund may receive large infusions from property tax revenues twice a year but have a monthly cash outflow that is relatively even. Generally, it is not improper for the cash outflow deficits to be covered from pooled cash during the year so long as the general fund makes up the difference from cash inflows by the end of the fiscal year.

The trouble arises when the budgeted revenues for a general fund will not meet budgeted expenditures, and there are insufficient reserves to cover the shortfall. Often these imbalances are not apparent until the fiscal year is

well under way and it becomes increasingly clear that projections of revenue and expense will not be met. In such a case, use of restricted funds in pooled cash could be a violation of the restrictions imposed on the special funds and therefore illegal. It is important to note that while municipal financial officers generally have immunity from personal liability for official acts, that immunity does not necessarily extend to knowing violations of the law. Thus, a municipal finance officer should be very careful not to permit advances from restricted funds intra-year if he or she knows that the amounts cannot be restored from budgeted revenues or reserves by the end of the fiscal year.

It is very important for a municipality that appears to be headed for insolvency to closely monitor its cash position, particularly in the funds that are projected to go negative by the end of the fiscal year, so that it can determine when it will run out of funds to maintain operations. A municipal official who requires or even permits employees to come to work if the official knows that the municipality will not be able to pay them may be violating state labor laws or committing common law fraud. In some states, this even may constitute a criminal offense. For example, if an employee is paid from a municipality's general fund (and cannot be allocated to some other special restricted fund because the employee's duties do not support the special fund's activities), and the general fund budget position is such that, taking into account any available reserves, it will be unable to achieve at least a zero year-end balance without using legally restricted funds in pooled cash, the municipality could be faced with the choice of either breaking the law by using restricted funds for an impermissible purpose or by failing to pay contracted for wages after work has been performed. If either of these occurs with foreknowledge by the municipality's managers or governing body, normal governmental immunity for official acts may not protect them from personal liability. This issue becomes important with respect to the timing of a bankruptcy filing, as will be seen below.

ACKNOWLEDGEMENT BY STAKEHOLDERS

Once the municipality's management has identified and quantified the underlying fiscal problems, it must recognize that a key ingredient to solving them is to clearly and transparently communicate the nature and scope of the challenges to all potentially impacted stakeholders so that they are able to understand and acknowledge the problems. Managers and political leaders should insist on clear and open disclosure of the financial data and related

facts, and they should make sure that stakeholders both receive all relevant information and data, and that they have an opportunity to ask questions and offer solutions. All reasonable suggestions to solve the problems should be investigated and taken seriously.

The ins and outs of labor negotiations are far beyond the scope of this pamphlet, but if payroll costs or benefits are a key component of the municipality's fiscal stress, it will be necessary to engage labor law advisors to assist in resolving these problems. In most states, laws applicable to public employee labor agreements place numerous restrictions on revising such agreements, even if the impact thereof is pushing the municipality toward bankruptcy. However, if all parties realize that failure to modify extant agreements would likely land the municipality in bankruptcy court, they should be willing to work very hard to achieve consensual modification of burdensome agreements. Although bankruptcy may provide more flexibility in dealing with labor agreements by enabling the municipality to reject an agreement, bankruptcy is not necessarily a "silver bullet" with respect to such matters, so every effort should be made to reach an agreement that provides a workable arrangement for the municipality prior to the decision to file. Negotiations continue after the bankruptcy filing as well. For example, in the City of Vallejo case, agreement was reached with one safety union after the bankruptcy filing and with another safety union even after the ruling of the bankruptcy court authorizing rejection was affirmed on appeal.

Similarly, creditors such as banks, bondholders and credit enhancers may be willing to restructure long-term debt in order to avoid forcing a municipality into bankruptcy. Attempts should be made to approach these stakeholders with clear and transparent information in order to reach some accommodation. Often an intermediate step in such a restructuring is a forbearance agreement under which the creditors agree not to declare a default and/or take remedial action against the municipality for a specified period while the parties attempt to reach a negotiated settlement.

Finally, the officers and elected officials of the ailing municipality must make the hard decisions about ongoing projects and programs that may have to be postponed, scaled back or cancelled in order to free up cash. These are often painful political choices, but the looming possibility of a bankruptcy filing can serve as a catalyst to reach consensus on these difficult issues.

³ The Government Finance Officers Association (GFOA) recommends that agencies maintain general fund unrestricted reserves of at least five to fifteen percent of the annual general fund budget.

CHAPTER 2

Advantages and Disadvantages of a Chapter 9 Filing

There are many misconceptions about the utility of a bankruptcy filing in addressing extreme financial problems for municipalities. While chapter 9 clearly provides certain benefits for municipalities that cannot otherwise solve their fiscal problems, it is no panacea and comes with some significant downsides.

ADVANTAGES

Protection; the Automatic Stay. One of the most important and immediate advantages of a bankruptcy filing is the injunction prohibiting actions that might be taken by creditors or others against the municipality, its officers and its inhabitants. The automatic stay protects debtor against creditor lawsuits, foreclosures, attempts to terminate leases and even collection phone calls and emails. The benefit to a municipality with insufficient liquidity to pay its operating costs cannot be overstated. The injunction, known as the automatic stay, is triggered by the filing of the bankruptcy petition, and the protection in chapter 9 cases to officers and inhabitants goes beyond the protection afforded only to debtors in chapter 11 cases. This extended protection means that even if the municipality or other protected persons take or omit to take actions related to claims against the municipality that would otherwise subject them to sanctions or liability in court or before a regulatory body, those actions may not proceed without the permission of the bankruptcy court. The stay lasts during the pendency of the chapter 9 case, although the bankruptcy judge retains the right to modify or terminate the stay for cause shown.

Breathing Space. Bankruptcy provides the debtor breathing space, enabling it to provide ongoing service to its residents while it tries to work out its creditor and cash flow problems. Raising new revenues, renegotiating contracts and restructuring debt obligations takes time. If a municipality is forced to breach contracts or face other legal claims caused by fiscal stress outside of

bankruptcy, it may have to spend time fighting off creditors trying to seize assets or collateral, or be forced into regulatory or other state fora to answer for such actions and redress grievances before it is able to fashion a workable solution for the benefit of all creditors, employees and residents. The bankruptcy case serves as the vehicle for all these disputes to be addressed in one forum, and the automatic stay provides the municipality the opportunity to focus on a comprehensive solution rather than simultaneously fighting multiple brushfires.

Access to an Expert Arbiter. An often-underestimated advantage of a bankruptcy filing is the bankruptcy court bench. Bankruptcy judges are experts in financial restructuring, negotiations and arbitrating complex debtor/creditor and intercreditor disputes. While chapter 9 filings may be rare, bankruptcy judges see similar issues in the private sector day in and day out, and generally are very well equipped by dint of knowledge and temperament to help the parties arrive at workable compromises. Furthermore, because of the unique system of assigning bankruptcy judges to chapter 9 cases, it is very likely that a chapter 9 case will be assigned to one of the most qualified and experienced judges within the applicable federal circuit. The value of a highly qualified and experienced judge in helping the stakeholders get to a solution should not be underestimated.

Ability to Adjust Obligations. The prime benefit of a bankruptcy filing may well be the debtor's ability to adjust public debt and other obligations. A chapter 9 plan of adjustment may provide that unpaid claims of creditors be either reduced (paid in "tiny bankruptcy dollars") and/or extended and restructured. There are limitations on how these adjustments can be made, and it may be possible for creditors to block a debtor from making the adjustments it would like (or feel that it needs) to make. Nevertheless, in situations where it is not possible to fully repay all creditors absent some sort of debt relief, the plan of adjustment can provide a fresh start and the ability to achieve long-term financial stability for the municipality by deferring and/or reducing past obligations.

DISADVANTAGES

Credit Markets Reaction. Municipalities that seek bankruptcy relief (and even those that seriously consider filing) should expect the immediate suspension

and/or downgrade of their credit ratings. Particularly if bondholders are not fully repaid, this credit stigma may last for many years. However, it is certainly possible, as was seen, for example, with Orange County and Stockton, that the municipality may emerge from bankruptcy and have its credit standing restored to robust levels within only a few years. Often overlooked by those who argue against a chapter 9 filing is that, absent bankruptcy, an illiquid and insolvent municipality would likely have little to no access to the capital markets in any event over a potentially extended period.

Municipalities contemplating bankruptcy should expect intense scrutiny from their capital markets creditors and rating agencies. One of the best things a municipality can do to position itself to get its credit ratings restored is to be able to provide timely and transparent information about its financial condition to the capital markets and rating agencies. Establishing a track record of providing trustworthy information, even if it is not favorable information, is an absolute necessity if a municipality expects to emerge from bankruptcy and get back on its feet in the credit markets. In connection with this process, as is discussed below, municipalities must be mindful of applicable securities law requirements governing disclosure to investors, an area in which the guidance of competent disclosure counsel usually will be essential. This effort also takes time and resources from the municipality's finance staff at a time when the staff will be under tremendous stress, and municipalities must take this burden into account when they contemplate a filing.

Cost and Distraction. Filing and pursuing a chapter 9 case is very expensive. Legal and financial consulting fees easily can range into seven figures (or even more for very large and complex entities). Every dollar spent on these costs is a dollar that cannot go toward solving the underlying financial problem. It is therefore in the interest of all stakeholders to realize that unless they can come to a negotiated settlement that avoids bankruptcy, these costs ultimately will consume funds that otherwise could be more productively used.

Another component of cost is the opportunity cost that will be expended by taking valuable senior staff time away from solving core problems and directing it to managing and responding to the demands of the case itself. Most municipalities that take the drastic step of filing a bankruptcy petition already will have cut staff to the bone in order to try to avoid insolvency.

The distraction of dealing with a bankruptcy case — preparing for and attending hearings and depositions, responding to endless requests for information and documents from creditors, rating agencies, collective bargaining units, elected officials and the public — can be a major distraction from the core work the staff must do to enable the municipality to serve its residents. A municipality contemplating a bankruptcy filing should have a clear plan regarding how to address these issues going in, lest the demands of the case simply overwhelm the ability of the organization to function effectively.

Stigma on the Community. Bankruptcy likely will be viewed by residents, workers, and creditors as a stigma, and that perception can affect the self-esteem of inhabitants and have an adverse impact on the overall business climate in the community. New businesses may be reluctant to locate there, real estate sales may be affected, and general economic conditions may be depressed. This stigma could even linger for a period after the municipality emerges from the bankruptcy in the legal sense. Of course, the bankruptcy filing is not the cause of the municipality's problems, but rather the result of not being able to solve them any other way. It is the underlying financial health of the municipality, including its ability to deliver services and promote a strong community, that really matters.

CHAPTER 3

Preparing for Chapter 9

THE IMPORTANCE OF NEGOTIATIONS

It is crucial that, once the magnitude of a financial crisis is established, the municipality attempt to commence negotiations with creditors and stakeholders to avoid insolvency. In fact, such negotiations, undertaken in good faith, are a legal prerequisite to filing a chapter 9 case in some jurisdictions. Even if the municipality already has determined that it likely will be forced to file for bankruptcy protection, it should continue to try to negotiate with key creditors to avoid that result. It also should carefully document what steps are taken to reach agreement. It is not necessary or even prudent that a municipality accept a short-term fix that only briefly defers an inevitable meltdown. But if such a fix is offered, the municipality must analyze it carefully to determine whether it will resolve the municipality's problems sufficiently to avoid both short-term and long-term insolvency. For example, it makes no sense to renegotiate a long-term debt obligation by deferring interest or other payments for a year if, on the first anniversary of the deferral, the municipality will be unable to satisfy the revised obligation absent something akin to divine intervention. Similarly, a municipality should not accept one-time concessions from labor that would avoid insolvency in the short term but extend unsustainable labor agreements by one or more years such that insolvency is inevitable and the deficit facing the municipality will be even deeper as a result of the extension. Indeed, labor made such a proposal at the outset of the Vallejo chapter 9 case, and the City's firm rejection of the proposal was approved by the bankruptcy court.

AUTHORIZATION TO FILE

A municipality may not validly file a chapter 9 petition unless the governing body of the municipality specifically authorizes the filing. Local law determines what form this authorization must take, but the typical approach would be by resolution adopted by the governing board in an open meeting.

In many states, while discussions with counsel leading up to and after a filing usually are conducted in closed or executive sessions under the litigation exception to most open meeting laws, the actual vote on whether or not to file typically must take place in an open meeting, or at least be reported out immediately after the vote in an open meeting.

Authorization could take the form of an immediate direction to file, or, as is more common in both chapter 9 and chapter 11 cases, a delegation to the executive officer of the municipality to file in the event that certain conditions are not satisfied (such as approval by creditors or bargaining units of offers made by the municipality pursuant to authorizations from the governing body).

Taking a vote to initiate a bankruptcy case obviously is a momentous step; the municipality should expect significant public and media attention and should be prepared to respond fully and accurately to inquiries, providing relevant details and information regarding the process. While media strategy is beyond the scope of this pamphlet, municipalities should carefully consider how they will provide timely responses to media inquiries and should have a clear plan in place including identification of one or more spokespersons. Also, legal counsel should be consulted about public statements and press releases so as not to inadvertently waive important privileges concerning confidential negotiations and strategy or violate applicable securities laws.

FEDERAL SECURITIES LAW CONSIDERATIONS

If the municipality has any outstanding publicly traded securities, counsel should be consulted regarding the municipality's obligations under the federal securities laws with respect to the bankruptcy filing and other material events. Securities issued after July of 1995 generally are covered by Securities Exchange Commission ("SEC") Rule 15c2-12, which requires both annual and material event disclosure to be made by the issuing municipality. Filing for bankruptcy protection is a material event that triggers disclosure. It is possible (even likely) that leading up to the bankruptcy filing, deteriorating finances and public discussion of the potential for insolvency will trigger rating agency actions, which may constitute material events as well.

Any statement to the market by an issuer, such as a material event notice, must comply with applicable securities laws. For example, the SEC's Office

of Municipal Securities recently stated that information provided to the public by municipalities and reasonably expected to reach investors and the trading markets must comply with applicable antifraud provisions of the Securities and Exchange Act of 1934, including Rule 10b-5 promulgated by the SEC, meaning such statements may not make an untrue statement of material fact nor omit to state a material fact necessary, to make the statements made, in the light of the circumstances under which they were made, not misleading. The omission portion of the rule almost always is the most difficult with which to comply in the context of municipal bankruptcy. In general, saying that a credit rating has been downgraded or that a bankruptcy petition has been filed by itself will not be enough. Experienced counsel should be consulted to assist in crafting a public statement that provides the relevant facts and materials in order to satisfy the broader standard of Rule 10b-5. Special consideration should be given promptly, for example, if the municipality's financial condition or potential bankruptcy is discussed in public by members of the municipality's governing board, its officers or staff in the absence of continuing disclosure regarding the topic. Establishing a pattern of complete and accurate information dissemination to the market not only facilitates compliance with federal securities law, but also will be important in helping a municipality maintain credibility with the market and reestablish a good credit rating after it emerges from bankruptcy. Bad news is made worse by late discovery, much more so if it appears that suppression or obfuscation was involved.

TIMING

As noted earlier, it is important to monitor the municipality's cash position in the period leading up to a potential bankruptcy filing so as not to knowingly violate the law—for example by permitting employees to work when the municipality lacks the ability to pay them, disregarding legal restrictions on special funds, or entering into essential contracts knowing that there will be a lack of sufficient funds to meet the contract terms. Having an idea of when this crossover point may occur is crucial in determining when a petition must be filed in order to protect the municipality and its officers. While there will be tremendous pressure from many quarters to delay the ultimate step of filing a chapter 9 petition until the last possible moment, it is prudent to leave at least some room between the time management would be compelled to shut

the doors of the municipality and the date of filing the petition. The precise amount of time will depend on the circumstances of each municipality, but in general, 60 to 90 days would be a prudent period. The reason is to allow the bankruptcy court time to conduct an orderly process of considering the petition and any objections to it before drastic actions that potentially affect public health and safety (such as forced furloughs of essential service personnel) must be taken.

DEALING WITH VENDORS AND TRADE CREDITORS

Most local government agencies have significant commercial relationships with vendors and trade creditors of various types, such as specialized service providers and suppliers. A municipality preparing to file a chapter 9 petition should expect that these providers will stop extending credit to the municipality in the form of delayed billing arrangements once news of the filing becomes public. They very well may require COD or prepayment terms for future transactions, and the municipality should be prepared to implement these arrangements for critical services and supplies. Moreover, payments made within 90 days of the filing of the bankruptcy case on account of prior unpaid invoices may be recoverable as preferences, so in order to protect favored vendors that have not put it on COD terms, the municipality should pay them during the normal payment cycle rather than to fall behind and then make catch-up payments. Unlike in chapter 11, though, payments on account of a note or bond are not avoidable as preferences.

CHAPTER 4

Seeking Bankruptcy Protection

PRE-FILING REQUIREMENTS

The Bankruptcy Code includes specific threshold requirements that the court must conclude have been satisfied in order for a municipality to be eligible for relief under chapter 9:

1. The entity must be a municipality within the meaning of the Bankruptcy Code. The definition of municipality is quite broad, and includes cities, counties and other instrumentalities of the state. It does not include states themselves. Section 109(c) defines municipality to mean *"a political subdivision or public municipality or instrumentality of a state."*
2. Applicable state law must authorize municipalities to seek chapter 9 protection. In some states, there is a very broad statute that grants blanket filing authority to all municipalities. However, many states limit which entities can file and under what circumstances or require special approval of state authorities to permit a filing. For example, in California, unless it is facing a fiscal emergency, a municipality must complete a mediation process with its key creditors that takes at least 60-90 days. In Connecticut, the governor must approve all chapter 9 filings. There are no relevant laws about chapter 9 eligibility in approximately half of the states, meaning that a municipality in those states in need of bankruptcy relief must seek enactment of a specific statute particular to it authorizing the filing. It goes without saying that a floundering municipality faces an uphill timing battle in such states.
3. The municipality must be insolvent as defined in the Bankruptcy Code, which means that the municipality either must not be paying its undisputed debts as they come due at the time of filing, or be unable to pay such debts when they become due in the near future. The latter test is a prospective, but must be based on a projection of the current or immediately ensuing fiscal year. A projection that the municipality will not be able to meet its obligations in subsequent years is insufficient to establish insolvency.

4. The municipality must “desire to effect a plan to adjust its debts.” It is important to note that the plan of adjustment does not have to be in existence as a precondition to filing, but there must be evidence that the municipality wants to affect a plan through the vehicle of the bankruptcy case.
5. The municipality must demonstrate that it has attempted to avoid the filing or that the filing was necessary by proving at least one of the following:
 - a. It has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that the municipality intends to impair under a plan of adjustment;
 - b. It has negotiated a plan outline or term sheet in good faith and is unable to reach such an agreement;
 - c. Negotiations are impracticable (for example, because there are a multitude of claimants and no practical way to negotiate with all of them individually or to identify a representative with authority to negotiate); or
 - d. A creditor is attempting to gain a preference (basically a payment that would unfairly disadvantage other creditors because it disproportionately favors the creditor that seeks to receive the payment).

ASSIGNMENT OF THE BANKRUPTCY JUDGE

In chapter 11 cases and all other types of bankruptcy cases, the bankruptcy judge is assigned by lot as each case is filed. Due to the importance and rarity of municipal bankruptcies, the Bankruptcy Code provides that the Chief Judge of the Circuit in which the case is filed has the task of assigning a judge to each chapter 9 case. While it is probable that a judge from the District in which the case is filed will be assigned, the Chief Judge could assign it to any bankruptcy judge in the Circuit. For example, the bankruptcy judge who presided over the Central Falls, Rhode Island, chapter 9 case sat in Boston. This is an important feature because it means it is very likely that a chapter 9 case will be assigned to a highly competent and very experienced judge, which is a benefit to all parties. Moreover, the Chief Judge will consider whether a judge who resides in or near the debtor municipality ought to play a role in the case filed by that municipality.

Judges of the U.S. Supreme Court, the various Circuit Courts of Appeal and the numerous U.S. District Courts are appointed for life pursuant to Article III of the United States Constitution. Bankruptcy judges are appointed under Article I of the Constitution and serve for terms of 14 years. Any party to a chapter 9 case has the right to petition the District Court to remove the case to the District Court so that it can be heard by an Article III judge. It is up to the District Court to decide whether to take the case away from the bankruptcy court or to leave it there. In either case, all rulings by the bankruptcy court are appealable to the Article III court system.

CHAPTER 5

The Tenth Amendment and Limitations on the Role of the Court

TENTH AMENDMENT LIMITATIONS

The Tenth Amendment to the United States Constitution reserves certain powers to the states regarding the management of their internal affairs. In chapter 11 cases (which municipalities are ineligible to file), the bankruptcy judge wields significant power to control what the debtor may and may not do. For example, without court approval, any proposed action by the debtor outside the ordinary course of its business must be approved by the court after creditors and other parties in interest have been provided with the time and the opportunity to object. Nor may the debtor borrow funds outside of the ordinary course of business, grant collateral for a new loan or settle a significant claim against it absent court approval. However, in light of the Tenth Amendment and the provisions of the Bankruptcy Code that implement it, the court plays a significantly more limited role in a chapter 9 case, and state law restrictions on the activities of municipalities and their uses of funds must continue to be observed.

Thus, for example, the court cannot take over the operation of the municipality, remove governing board members, direct the actions of the governing board or appoint a receiver or trustee to run the affairs of the municipality. Similarly, the court cannot permit the municipality to override state laws such as those requiring voter approval for new taxes or limiting the use of restricted funds for particular purposes. Obviously, the court lacks the power to require the sale or lease of a park or a sewage facility in order to satisfy the municipality's obligations to creditors.

One important effect of the Tenth Amendment on municipal bankruptcies, distinguishing them from nongovernmental entity bankruptcies, is that there can be no forced liquidation of a municipality under the Bankruptcy Code. If a corporation files a chapter 11 case seeking to reorganize and thus continue to

operate, but it fails to achieve that objective, the case likely will be converted to a liquidation case under chapter 7 of the Bankruptcy Code. In chapter 7, a trustee is appointed, and is charged with liquidating all assets for the benefit of creditors, who go away with whatever share they can receive. Assets are sold or foreclosed upon, the entity no longer operates, and it ceases to conduct business. For obvious practical reasons, and due to the Tenth Amendment's limitations on the powers of the federal courts, there is no chapter 7 analogue for municipalities other than those that may be provided by applicable state law outside of the bankruptcy court system.⁴ Thus, if the chapter 9 case fails to produce a plan of adjustment allowing the municipality to exit bankruptcy, the case will be dismissed and the municipality will continue to face all of the problems bedeviling it before bankruptcy, with whatever remedies are available to the municipality and its creditors under state law.

ROLE OF THE BANKRUPTCY JUDGE

The primary responsibilities of the bankruptcy judge are to approve or disapprove the bankruptcy petition by determining eligibility, to oversee the assumption or rejection of executory contracts and unexpired leases, to decide avoidable transfer actions (i.e., preferences and fraudulent transfers) and to confirm or decline to confirm a plan of adjustment. The municipality may in its sole discretion consent to the judge's exercise of jurisdiction in many of the more traditional areas of bankruptcy court oversight in bankruptcy in order to obtain the protection of court orders and eliminate the need for multiple fora to decide issues. Indeed, these latter features reflect some of the benefits of filing for bankruptcy in the first place.

Despite this limited role, the judge in a chapter 9 case does exert considerable influence over the parties and can be a very helpful neutral arbiter of difficult disputes. While the only real "hammer" the judge ultimately has is to dismiss the case and throw the municipality out of court, the judge nevertheless is likely to be very helpful in bringing the parties to the point where a plan can be approved.

⁴ The rules governing the ability of municipalities to disincorporate or otherwise be dissolved vary greatly by jurisdiction and type of entity and are beyond the scope of this pamphlet.

CHAPTER 6

The Chapter 9 Case

The following sections discuss specific aspects of filing and prosecuting the chapter 9 case that are of key import to municipalities.

INITIATING THE CHAPTER 9 CASE

In addition to filing the chapter 9 petition itself, the municipality must file several pleadings in order to initiate the bankruptcy case. These include the following:

Creditors List—This is a list of all persons who may assert a claim against the municipality. The Bankruptcy Code defines the term “claim” very broadly, and the list should include each and every person that may assert a claim, even if the municipality believes that a given claim is specious.

List of Creditors Holding the 20 Largest Unsecured Claims—This list contains more detail than the general list of creditors, including the requirement that contact persons and phone numbers be listed. The list is used by the United States Trustee to solicit creditors to join an official committee or committees.⁵

Pleadings Establishing Eligibility—As discussed above, the Bankruptcy Code contains several eligibility requirements, and the municipality must prove that it satisfies each one. It does so by submitting a memorandum of law and supporting declarations and exhibits thereto. If the municipality anticipates that one or more creditors or parties in interest will object to the claim of eligibility, the pleadings and declarations will need to be more extensive than in a case where eligibility is unquestioned.

Notice by Publication—The municipality must publish a notice once a week for three weeks in a local newspaper and in a national publication read by bondholders. The notice must provide details about the filing of the chapter 9 case and provide the date by which objections to eligibility must be filed. The form of notice and the eligibility objection date must be approved by the bankruptcy judge in advance of publication.

OFFICIAL COMMITTEES

Following the entry of the order for relief—in other words, after the court determines that the municipality is eligible to be a chapter 9 debtor—the United States Trustee for the relevant district may appoint a committee or committees to represent the interests of creditors holding similar classes of claims. For example, in each of the Vallejo and Stockton cases, there was a committee that represented the interests of retirees. Unlike in the case of a chapter 11 debtor, a municipality is not obligated to fund the costs of counsel to such a committee, but prudence may dictate that the municipality should pay reasonable costs because an informed and organized creditor body will expedite the resolution of the case. Both Stockton and Vallejo agreed to fund the retiree committees for that reason, among others.

EFFECT ON LITIGATION

As discussed in more detail above, the automatic stay that becomes effective the moment the chapter 9 petition is filed serves to enjoin litigation against the debtor, its officers and its inhabitants. The stay also prevents all other forms of creditor enforcement remedies such as seeking a judgment lien or foreclosing on an asset (excepting, potentially, special revenues as described in detail below). The stay continues throughout the chapter 9 case, although a claimant may seek permission to terminate or modify the stay by filing pleadings that attempt to convince the bankruptcy judge that cause exists for the litigation to proceed in court or for an enforcement action to resume.

ASSUMPTION AND REJECTION OF CONTRACTS AND LEASES

The Bankruptcy Code provides a chapter 9 debtor with the ability to assume its favorable contracts and real and personal property leases and to reject its burdensome ones. Neither is automatic, though. To assume a contract or lease, absent consent by the nondebtor party, the municipality must cure all monetary defaults and provide adequate assurance that it will be able to perform under the agreement in the future. So-called ipso facto clauses in contracts or leases (which provide that the contract or lease terminates on account of insolvency or a bankruptcy filing by one of the parties) are not enforceable in a chapter 9 case or any other bankruptcy case. In the event a lease or contract is rejected, the nondebtor party will have a general

unsecured claim against the municipality for the damages it has suffered on account of the rejection of the agreement. The damage claim will have to be addressed in the plan of adjustment along with the other general unsecured claims against the municipality.

Labor agreements are subject to assumption and rejection as well. However, due to the importance and the widespread impact rejection of such an agreement could have, the U.S. Supreme Court has placed extra burdens on debtors seeking to reject labor agreements. These include mandating that the bankruptcy court balance the hardships employees would suffer as a result of rejection of the agreements against the benefits to the municipality for rejecting those agreements. The court also must conclude that the municipality employed reasonable efforts to resolve contract issues short of rejection, and that a prompt resolution would not be forthcoming. A special Bankruptcy Code provision makes it even more difficult to reject a collective bargaining agreement in a chapter 11 case, but Congress has not extended the sweep of that provision to chapter 9 cases.

SPECIAL REVENUES

As discussed above, many agencies have separate governmental enterprises that are owned and operated by the municipality but are not separate legal entities. For example, a city may own and operate a system that provides potable water to its inhabitants and businesses. Typically, such systems are treated as separate accounting units and are paid for from revenues received from the users of the system in the form of fees and charges for service. Often, new users that desire to connect to the system and receive service must pay a capital charge or assessment to contribute their share of the capital cost of the system. These systems often are financed through debt obligations secured by a pledge of a lien on the system revenues, and the capital, operations and maintenance costs of the system are similarly supported only by the system revenues. In most cases, this is the sole source of security and payment for the obligations of the system, but in some cases, the municipality also is obligated to pay such amounts from the general fund if revenues are insufficient.

Chapter 9 includes a detailed definition of the term, "special revenues." And while the following discussion summarizes the key aspects of the definition, ultimately the bankruptcy judge will make the determination of whether a

stream of payments qualifies as special revenues. There are few published cases that address the issue, but a recent one arising out of the Puerto Rico debt restructuring cases (under a separate statute that incorporates the Bankruptcy Code definition) read "special revenues" very narrowly.

Once a stream of payments is determined by the court to constitute special revenues, such funds may not be diverted to pay the debts of the municipality that are unrelated to the system or enterprise that generated them. As noted above, in many jurisdictions, this also is the result under state law, which restricts the use of such revenues to the enterprise itself.

Another class of special revenues obligation is special assessment or special tax financing, which is commonly used to construct infrastructure to serve new development or to improve infrastructure of special benefit to the assessed property. In these situations, the special assessments or taxes levied and pledged to support the bonds issued to provide such financing are treated as special revenues and cannot be invaded to pay other obligations of the municipality in bankruptcy. This also is generally consistent with most state laws restricting the use of these types of revenues solely to the purposes for which the assessment or tax was levied.

Notwithstanding the automatic stay that otherwise prohibits certain post-bankruptcy actions by creditors, the automatic stay in chapter 9 permits the holder of a lien on special revenues to apply such revenues to the obligation secured by the lien. However, according to the one Circuit Court of Appeal decision on the subject, that provision does not require the debtor to make payments during the case. The same court also ruled that a lender seeking to compel the payment of special revenues during the case must obtain relief from the automatic stay from the federal trial court and then seek to enforce the payment obligation in state court.

Obligations payable from special revenues are treated as secured obligations for bankruptcy purposes, and as such the plan of adjustment may not impair those obligations — at least to the extent they can be paid from the special revenues (but, for example, if the special revenues are insufficient, the municipality's obligation, if any, to backfill from general revenues, could be impaired by the plan).

FINANCING LEASES

Municipal agencies in many states use lease financing for capital projects and equipment. Although styled as leases (usually to avoid limitations on the incurrence of debt under state statutory or constitutional provisions), these instruments typically bear tax-exempt interest to the investors who fund the projects or equipment (which requires that they be treated as debt for federal tax purposes), and also are treated as debt for accounting purposes. Although the matter is not entirely free from doubt and will depend on the facts and circumstances of each case, these instruments should in general be treated as debt obligations under the Bankruptcy Code and not as true leases. The significance of such characterization might be that the municipality would not be required to assume or reject a real property lease within a relatively short period of time after the court's having ruled that the debtor is eligible for chapter 9 relief, and that the creditor (lessor) might be unable to evict the municipality from the "leased" property (or to require return of the "leased" equipment) in the event of a payment default.

⁵ The Office of the United States Trustee is an arm of the United States Department of Justice, and the various regional offices assist the the court system in administering bankruptcy cases. The U.S. Trustee's role in a chapter 9 case is much more limited than it is in cases under chapters 7 or 11.

CHAPTER 7

Emerging From Bankruptcy

DISMISSAL OF THE CASE

The bankruptcy court may dismiss the chapter 9 case for cause, including unreasonable delay by the debtor or denial of confirmation of a plan of adjustment. Conversely, the case may be voluntarily dismissed by the municipality at any time, as the bankruptcy judge cannot force it to remain in bankruptcy against its will due to Tenth Amendment considerations. Thus, if the municipality and its key creditors (such as indenture trustees, major vendors and unions) reach agreements during the case and such agreements are binding on the parties under applicable nonbankruptcy law, the municipality can and should dismiss the case not only because confirming a plan of adjustment is no longer necessary, but also because there is no need to incur the significant cost and delay of drafting, confirming and consummating a plan of adjustment and related pleadings.

THE PLAN OF ADJUSTMENT

A Plan Should be the Product of Negotiation Among All Constituencies.

A plan of adjustment, like a chapter 11 plan of reorganization, is little more than a contract among various parties that provides for the treatment of the various claims against the municipality. One of the benefits of chapters 9 and 11, other than preserving assets by way of the automatic stay during the negotiation period, is that the bankruptcy court has the power to approve a plan over the objection of dissenting creditors so long as the requisite majorities of creditors holding similar claims have approved the plan and so long as the plan does not discriminate unfairly among holders of similar claims.

As described above, the municipality is not eligible for chapter 9 unless it has, among other things, negotiated with its creditors prior to filing the case in an attempt to avoid the need for a filing. Once the case is filed, the negotiations should resume as soon as possible with the goal of either reaching agreement and dismissing the case or reaching agreement with the requisite majorities

and confirming a plan of adjustment. Unfortunately, if a creditor (or creditors) mount an eligibility challenge (as was the case in the Stockton, Vallejo, Detroit and San Bernardino cases), there is less room for negotiation during the several month period that will be devoted to litigating over whether the debtor is eligible for chapter 9 relief.

The Role of Committees in the Plan Process. Committees serve and speak for all similarly situated creditors, and the members of and professionals employed by a committee have a fiduciary duty to the class they represent. An energetic and informed committee, particularly one that is both proactive and constructive during the process of negotiating a plan of adjustment, will be beneficial for all parties to the bankruptcy case.

The Role of the Court in Approval of the Plan of Adjustment. The bankruptcy court must confirm the plan of adjustment if it finds that the various chapter 9 confirmation requirements have been satisfied. These include, among others, that at least one class of impaired creditors has voted to accept the plan; that post-bankruptcy claims will be paid in full on the plan's effective date (unless an impacted creditor agrees to different treatment); that any necessary approval by regulators or voters (in the case of most tax increases) has been obtained; and that creditors will receive as much under the plan as they would were the case dismissed. Broadly stated, the court should find that the debtor municipality has used all reasonable efforts to pay its creditors as much and as quickly as possible, recognizing that application of state law (such as tax limitation initiatives or other restrictions) may dramatically limit the ability of municipality to raise revenues. The court also must find that the plan is feasible, which means that the municipality will not need further reorganization or another chapter 9 case in the relatively near future.

Failure to Approve a Plan of Adjustment. In the event the bankruptcy judge does not approve the plan, he or she has the discretion to send the parties back to the drawing board to craft a better plan, or to dismiss the chapter 9 case. Due to the Tenth Amendment and the applicable Bankruptcy Code provisions, the judge has no ability to craft a plan of adjustment and compel the municipality to accept it. Dismissal of the case, of course, is a nightmare scenario because the municipality, which the judge earlier concluded (during the eligibility phase of the case) was unable to pay its debts, is now out of court, without the protection of the automatic stay,

and is still unable to pay its debts. Such a result benefits neither the municipality nor its residents nor its creditors and should provide a compelling incentive for the parties to the chapter 9 case to reach agreement on a plan of adjustment.

Confirmation of a Plan When an Impaired Class has not Consented -

Cramdown. While proposing a plan of adjustment that is supported by all impaired classes is the goal of any chapter 9 debtor, the Bankruptcy Code provides bankruptcy judges the discretion to confirm a plan despite the rejection thereof by a class of impaired creditors. Such a process, which is known as a cramdown, should be avoided if possible because it will mean litigation (including discovery), and it will increase the legal fees that the debtor as well as those of the objector(s) will incur.

CHAPTER 8

Yes, There Is Life After Bankruptcy

CAPITAL MARKETS ISSUES

The capital markets may punish a municipality for having become insolvent. The degree and length of that punishment will depend in large part on several factors:

- The strength and viability of the negotiated settlement or plan of adjustment
- The degree to which capital market debt holders and guarantors are made whole
- The degree of cooperation and “buy in” among stakeholders
- The economic vitality of the municipality following its exit from bankruptcy
- Whether voters and/or elected officials have contributed to the settlement or plan by approving new taxes, fees or other revenue sources
- Whether the municipality can demonstrate that it has stable and effective management in place
- How well the municipality communicates with the market and the timeliness and transparency of the financial information presented
- How well the settlement or plan of adjustment is implemented and monitored

A plan of adjustment developed by a municipality generally should assume that the municipality will be unable to access the public capital markets immediately following its approval, excepting enterprise and other special revenue credits unimpaired by the plan (which might nevertheless suffer some level of pricing penalty for a period of time due to a variety of reasons, including general association or rating agency scrutiny). While it is unavoidable that a municipality's access to the capital markets will be

more expensive and limited than it normally would be for some period of time after a bankruptcy, it is not certain that the fact of a bankruptcy will be a permanent or even a very long-term problem. Focus on the factors listed above will help municipalities mitigate the adverse effects of a bankruptcy and emerge stronger and in a better financial position than before they filed the case.

AVOIDING A “CHAPTER 18”

When a private company successfully navigates through a chapter 11 case with a confirmed plan of reorganization, but either cannot perform its obligations under the plan or the plan is flawed because it failed to adequately resolve all of the company’s financial problems, the company may be forced back into bankruptcy court to seek yet another reorganization. This is euphemistically referred to as seeking “chapter 22” relief. Several commercial airlines have taken this route. If this were to happen to a municipality after a chapter 9 case, we assume that the second round would be deemed a “chapter 18” case. However, given the cost, disruption and pain of going through a bankruptcy case, chapter 18 is to be avoided at all costs. Also, and particularly if the need for new bankruptcy relief occurs soon after the completion of the original case, the bankruptcy court may be very skeptical of the municipality’s eligibility to file again — remember that one of the criteria is that the municipality “desires to effect a plan of adjustment”.

Avoidance of a “chapter 18” scenario will be best achieved by driving the hard bargains required to achieve a settlement or plan of adjustment that not only works, but that can weather contingencies and uncertainties. The successful arrangement must:

- Provide for adequate rainy day reserves
- Leave the municipality with flexibility to adjust costs and service levels to account for future unforeseen downturns
- Limit exposure to undue risks in the debt markets (by for example, relying on too much variable rate debt without appropriate hedges or cushions against rising rates)

- Avoid reliance on uncertain future revenue streams, particularly if they require voter approval or are otherwise outside the control of the municipality
- Be supported by a consensus of at least a majority of the affected stakeholders, and backed by a meaningful commitment to implement the plan

Finally, the municipality's management and governing board must have the discipline to stick to any settlement or plan and make it work. Remember that the bankruptcy court has limited oversight powers due to the Tenth Amendment. It may be tempting in light of the heartfelt and legitimate desires of the citizens and the politicians who represent them to spend more or tax less than the plan contemplates. Perhaps a review of the costs of going through the first bankruptcy—in money, time, energy and reputation—would be warranted if such temptations arise.

CHAPTER 9

Conclusion

For the overwhelming majority of municipalities, even severe economic downturns such as the one currently being experienced in part due to the COVID-19 pandemic will not result in the filing of a petition under chapter 9 of the Bankruptcy Code. Municipalities feeling financial stress should work as hard as possible, accepting as much pain as they and their residents, creditors and employees can endure, to avoid that path. However, for some municipalities, the challenges will be too great, the avenues of solution too limited, and the window of opportunity for corrective action too small, to avoid using chapter 9 as a tool to help right the ship. For those entrusted to manage and govern municipalities, we hope this pamphlet provides some initial guidance and promotes a disciplined and thoughtful approach to avoiding or using chapter 9 in times of fiscal stress.

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