Remarks by Chief Judge of the Sourthern District of New York, Cecelia G. Morris[1]

Chapter 9

Mr. Orr will tell you about the results of the city of Detroit, Michigan filing under chapter 9 of the United States Bankruptcy Code. It is the largest municipal bankruptcy filing in U.S. history by debt, estimated at $18–20 billion, and by population.

More than 60 years after Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed—making such restructurings rare.

The purpose of a chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.

Although similar to other chapters, you are more familiar with the corporate chapter 11, of the US Bankruptcy Code chapter 9 is significantly different in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Such a liquidation or dissolution would undoubtedly violate the U.S. Constitution and the reservation to the states of sovereignty over their internal affairs. Indeed, due to the severe limitations placed upon the power of the bankruptcy court in chapter 9 cases, the bankruptcy judge generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under chapter 11.

The functions of the bankruptcy court in chapter 9 cases are generally limited to

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approving the petition to affirm that the debtor is eligible, confirming a plan of debt adjustment, and ensuring implementation of the plan. Only a "municipality" may file for relief under chapter 9.[2] The term "municipality" is defined in the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State."[3] The definition is broad and includes most revenue-producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities. (Prof. Tuillo refers to these as “in-house” companies)

Section 109(c) of the Bankruptcy Codes sets forth four additional eligibility requirements for chapter 9:

- the municipality must be specifically authorized to be a debtor by state law or by a governmental officer or organization empowered by State law to authorize the municipality to be a debtor;
- the municipality must be insolvent;
- the municipality must desire to effect a plan to adjust its debts; and
- the municipality must either:
  1. obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan in a case under chapter 9;
  2. negotiate in good faith with creditors and fail to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan;
  3. be unable to negotiate with creditors because such negotiation is

[2] 11 U.S.C. § 109(c).
[3] 11 U.S.C. § 101(40).

impracticable; or

4. reasonably believe that a creditor may attempt to collect before all other creditors.

Municipalities must voluntarily seek protection under the Bankruptcy Code. The Bankruptcy Code provides that the debtor must file a plan.[4] No other entity may file a plan. Neither creditors nor the court may control the affairs of a municipality indirectly through the mechanism of proposing a plan of adjustment of the municipality's debts that would in effect determine the municipality's future tax and spending decisions.

A discharge in a chapter 9 case is conditioned on: (1) confirmation of the plan; (2) deposit by the debtor of any consideration to be distributed under the plan with the disbursing agent appointed by the court; and (3) a determination by the court that securities deposited with the disbursing agent will constitute valid legal obligations of the debtor and that any provision made to pay or secure payment of such obligations is valid.[5]

Different types of bonds receive different treatment in municipal bankruptcy cases. General obligation bonds are treated as general debt in the chapter 9 case. The municipality is not required to make payments of either principal or interest on account of such bonds during the case. The obligations created by general obligation bonds are subject to negotiation and possible restructuring under the plan of adjustment.

The standards for plan confirmation in chapter 9 cases are a combination of the statutory requirements of portions of Chapter 9 and Chapter 11. The court must confirm a plan if certain conditions are met.

[4] 11 U.S.C. § 941.
[5] 11 U.S.C. § 944(b).

Detroit, Michigan USA

Detroit, a municipality within the state of Michigan, was found to be eligible to file for bankruptcy relief under chapter 9 and so it had several things that were useful to it in the reorganization process: judicial oversight; the automatic stay; proofs of claim process; plan process; confirmation standards; ability to discharge debt and **creditor's right to be heard.**

All of these things are provided for under the Bankruptcy Code and they allow the plan to be successful. Simply put, Detroit had no practical way of negotiating down its debt outside of a federal bankruptcy courtroom. Bankruptcy also provides cover for politicians who otherwise could not politically do things like cut pensions of city workers. Chapter 9 makes it the responsibility of the bankruptcy judge who appoves the plan.

Argentina

Notably, the organized, binding process and finality in Detroit is what Argentina's restructuring lacked. Argentina began a process of debt restructuring on January 14, 2005, that allowed it to resume payment on the majority of the $82 billion (USD) in sovereign bonds that defaulted in 2002 at the depth of the worst economic crisis in the country's history. A second debt restructuring in 2010 brought the percentage of bonds out of default to 93%, though ongoing disputes with holdouts remain.

In the 1980s, when sovereign debts were mainly held by banks, restructurings could be done relatively smoothly. But with the growth of capital markets, these matters have become more difficult. And with the growth of credit-default swaps[6] and

[6] A sovereign credit default swap is a type of credit protection available to an individual or entity that owns a debt instrument issued by national government. If a government defaults on its debt obligation, the debt

derivatives, held by private bondholders make it even more difficult.

These holdout bondholders have cause a great deal of stress for the country and have the potential to derail the entire restructuring by causing Argentina to default on its payments to those bondholders that have accepted the country's debt restructuring plan.

Although Argentina has failed to pay holdout bondholders in the past, after the Supreme Court denied certiorari to hear Argentina's appeal of a lower court's decision requiring it to pay holdouts who did not participate in debt restructurings in 2005 and 2010. The United States Court of Appeals for the Second Circuit, in New York, ruled in August 2013 that Argentina had violated a contractual promise to treat all bondholders equally. Now Argentina has to decide whether or not it will pay these holdouts or try to come to some kind of a deal with them.

Since this process is not governed by any international treaty and there is no

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payments are made by the entity that issued the credit default swap. While these instruments work similarly to insurance products, there are regulations in many countries that impact insurance firms, while swap issuers are often unregulated.
National governments sell debt securities known as bonds in order to raise money for short-term projects. In most instances, government agencies use tax revenues to pay off these debts. During periods of recession governments, like other borrowers, sometimes run short of money and in some instances end up defaulting on debt payments. Consequently, investors are often reluctant to buy securities issued by nations with poor credit ratings and during periods of recession, some investors even refuse to invest in financially stable nations.
Financial companies including banks make it easier for governments to borrow money by issuing sovereign credit default swap contracts. These entities agree to insure government bonds in return for regular premium payments that bondholders must pay. If the bond issuer misses a single payment, the swap issuer covers the missed payment. In a worst-case scenario, the swap issuer covers the bondholder's entire losses if a government chooses to default on the debt.
While insurance companies have to keep a certain amount to cash on hand to cover outstanding obligations, firms that issue sovereign credit default swap contracts are typically not required to keep any cash on hand to cover possible payouts. Credit defaults involving wealthy nations are historically unusual; this means that many swap issuers regard sovereign credit default swap contracts as an easy way to generate revenue while assuming minimal levels of risk. Firms that sell swaps on debt instruments issued by poor nations assume a much higher level of risk. These firms typically charge much higher premiums and keep substantial cash on hand to cover possible payouts. Many swap issuers reduce risk by selling on these swaps to other investment firms such as hedge fund companies or mutual funds.
Within the global economy, a debt default involving a particular nation may have a knock-on effect as lenders may become reluctant to buy bonds issued by neighboring countries. Many nations such as those within the European Union have close economic and political ties. Therefore, national governments often lend money to struggling nations to prevent bonds defaults. This means that the interests of bondholders are often protected by both political pressure and credit default swap contracts.

bankruptcy regime for sovereign nations, the Sovereign Country-States have to negotiate with the bondholders in order to agree to the conditions and terms of a voluntary debt restructuring agreement. Occasionally creditors do not agree to participate in that agreement. Instead, they file lawsuits in order to recover the money they invested in sovereign debt bonds. Having to litigate with holdout bondholders really dampens the benefits of sovereign restructurings.

In the Argentine Fiscal Agency Agreement (i.e. the agreement that governs the issuance of Argentinian bonds), there is no collective action clause (a clause which compels the dissenting minority of creditors to accept the restructuring plan if the majority of them agrees with the debtor-State). Therefore, there is no judicial process which could compel Argentina's creditors to participate in the restructuring of its debt. The Argentine case provides an extreme example of the negative consequences that can unfold due to the absence of a binding international treaty that would assist sovereigns and holders of government debt in the coordination of debt restructuring.

Puerto Rico

In June 2014, Associated Free State of Puerto Rico (a territory of the United States – similar to a state within the United States) passed legislation that would allow for the restructuring of public agencies. Such a law would be applicable to debts that are currently outstanding.

The proposed law offers two methods for restructuring debts. One encourages the distressed corporation to negotiate and come to a consensual resolution with creditors. If discussions fail to produce a solution, the entity can enter into proceedings before a commonwealth court in Puerto Rico.

- Creditors have moved in federal district court to have this legislation declared unconstitutional.
- The argument is that under the U.S. Constitution, the Commonwealth has no power to enact a bankruptcy law for the adjustment of the debts of its instrumentalities and public corporations where the Congress of the United States has enacted the Bankruptcy Code, excluded Puerto Rico's instrumentalities from its reach, and explicitly indicated that states have no power to enact their own laws providing for the adjustment of such debts

The Contracts Clause of the United States Constitution,[7] provides "No State shall ... pass any ... Law impairing the Obligation of Contracts, ...".

The Bankruptcy Clause[8] necessarily authorizes Congress to make laws that can impair contracts. It long has been understood that bankruptcy law demands impairment of contracts.

There is another option that Puerto Rico may be the federal equity receivership. The equity receivership is a vehicle that was used for restructuring railroads before they were permitted to file bankruptcy. Essentially, this receivership was the precursor for chapter 11 in the United States. It has an injunction. It allows for committees. It can bind creditors and allow for a more orderly restructuring process.

The federal receivership should work for any entity that has access to the federal courts. This is an old federal common law instrument. This method only works if creditors believe restructuring the debt is in their best interest.

[7] Article I, Section 10.
[8] Article I.

No matter the process the commonwealth of Puerto Rico is seriously unable to meet the needs of its citizens. If Puerto Rico had to choose between paying bills and keeping the police force working or keeping hospitals open, it might be able to argue that it could not raise taxes any higher and thus, the restructuring in some form is the only option.