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COURTS AND ADMINISTRATIVE PRACTICE
OF THE SENATE COMMITTEE ON THE
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**STATEMENT OF THE NATIONAL BANKRUPTCY CONFERENCE SUBMITTED
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Following is the Statement of the National Bankruptcy Conference with respect to the above hearings. The National Bankruptcy Conference is an organization of lawyers, judges and professors which was established at the behest of the Congress in the mid-1930's to assist it in the formulation and promulgation of what came to be known as the Chandler Amendments to the Bankruptcy Act of 1898. Since that time, the National Bankruptcy Conference has devoted its efforts to the improvement of the bankruptcy laws of the United States and the practice of bankruptcy law through the legislative process.

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**REPORT OF THE NATIONAL BANKRUPTCY CONFERENCE
ON PROPOSED MUNICIPAL BANKRUPTCY AMENDMENTS**

In 1978, Congress enacted sweeping revisions of all aspects of the bankruptcy law. One of the five major purposes of the revision, as stated in the Report of the House Judiciary Committee, was to conform bankruptcy law in many respects to the vast changes in commercial law that had taken place since the last prior revisions of the bankruptcy law 40 years before. In particular, the House Report noted the near universal adoption of the Uniform Commercial Code and the consequent change in lending practices. In addition, Congress modernized business reorganization procedures, authorizing more consensual plans of reorganization and providing additional protection to secured lenders in the wake of several decisions under the former Bankruptcy Act in the mid-1970s that seriously impaired their position in reorganization cases.

For the most part, these changes were carefully considered only after extensive hearings, debate, and discussions. They have generally been well received and have worked as intended. Although some significant amendments were made in 1984, the basic structure of the amendments made in 1978 has survived intact.

However, the care that was used in the drafting of the provisions relating to ordinary business bankruptcies and reorganizations was not carried over into the revisions of the municipal bankruptcy law, contained in chapter 9 of the Bankruptcy Code. Chapter IX of the former Bankruptcy Act had been recently amended in 1976 as a result of New York City's financial crisis. The 1978 revision largely adopted the decisions made in 1976 and incorporated by reference most of the business bankruptcy amendments made in 1978 insofar as they related to general matters such as a treatment of secured claims, avoiding powers, and plans of reorganization. Because the worlds of commercial finance and municipal finance are so diverse, the simple incorporation by reference of the 1978 commercial finance concepts into the municipal bankruptcy arena simply did not work. Fortunately, no major municipal bankruptcy has tested the potential shortcomings of chapter 9 as it was enacted in 1978. However, more considered study in the past several years by municipal finance practitioners and members of the bankruptcy bar has led the National Bankruptcy Conference to conclude that chapter 9 of the Bankruptcy Code needs revision in specific areas.

HISTORY OF THE PROPOSED AMENDMENTS

The potential problems created by the incorporation of general commercial finance concepts into the municipal bankruptcy provisions first came to light as a result of the

financial crisis confronting the City of Cleveland, Ohio, in 1979. Cleveland needed additional financing, but lenders were unwilling to lend for a variety of reasons, including the incorporation into chapter 9 of the general bankruptcy concept that a lien on after-acquired property will not attach to property acquired after bankruptcy by a reorganizing debtor, unless the property acquired after bankruptcy constitutes proceeds of property held at the time of bankruptcy. Hasty attempts were made during 1979 and 1980 in connection with then-pending legislation to correct technical errors in the 1978 Act. Corrective provisions were included in bills that passed both the House and the Senate in 1980, but the legislation foundered on other issues and was not enacted.

The 1979-80 attempt at corrective legislation was hasty and ill-considered. After the immediate crisis passed, cooler heads prevailed, and a more thorough study of the problems of municipal bankruptcy was undertaken by the National Association of Bond Lawyers ("NABL"). NABL identified several areas in which the general incorporation into chapter 9 of business reorganization concepts simply did not work. Members of NABL contacted members of the National Bankruptcy Conference ("NBC") to explore means of solving the problems for municipal finance presented by the 1978 Bankruptcy Code in a manner that was consistent with sound bankruptcy policy. Representatives of these two groups met during 1983 and 1984 to develop corrective legislation. The legislation proposed

by this Report is the direct result of those efforts. It was approved by the Executive Committee of the NBC during its March 1985 meeting.

NEED FOR THE AMENDMENTS

The current deficiencies in chapter 9 of the Bankruptcy Code primarily affect "revenue bonds," that is, obligations of a municipality that are secured by a lien on specific revenue to be received by the municipality. These differ from "general obligation bonds", which constitute simply the promise by the municipality to use its taxing power to collect sufficient funds to pay the principal and interest on the bonds. Over the years, revenue bonds have occupied an increasing portion of the municipal bond market. As of 1983, they constituted about half of the bonds issued by state and local governmental units for publicly owned and operated facilities.

Chapter 9 as currently written could easily be read to terminate a lien on revenues upon the filing of a municipal bankruptcy by the bond issuer and could also be read to convert bonds payable solely from specific revenues into general obligations of the debtor municipality. These results are wholly inconsistent with municipal finance principles and many State and local constitutional and statutory provisions authorizing the issuance of bonds. If chapter 9 were interpreted in this way, the burden of bonds designed to be paid

only from special revenues could be imposed on the people generally through taxation, despite the fact that the bonds might thereby exceed the municipality's debt limit or would require a vote if originally issued as general obligation bonds.

Similarly, a municipality often has enterprises with separate funds, and, except to the extent specifically permitted, the funds derived from one source are often legally unavailable for other enterprises or for general governmental purposes. Thus, for example, water receipts may be legally unavailable under nonbankruptcy law for general governmental purposes except to the extent that provision is made by law for payments by the water department in lieu of local property taxes. Although the various enterprises are not separate entities, they are operated almost as if they were. In many cases they are managed by separate autonomous governing boards.

If a municipality is unable to meet its obligations for general governmental purposes and for that reason files a bankruptcy petition, the assets of its water department should not be reached to pay general creditors of the municipality unless they could be reached under applicable nonbankruptcy law. Conversely, if water revenues are insufficient to pay operating expenses and the debt service on water revenue bonds, other funds of the city should not be reachable to pay the bonds. In many cases it would violate state constitutional limitations to do so. Similarly, insolvency in the

water department should not trigger preference treatment of payments made to general fund creditors, or vice versa.

State "joint action" agencies often finance electric generating units and transmission lines for the benefit of their municipal members on a project-by-project basis under documents which permit funds derived from each project to be used only for the purpose of that project. In such a case the funds of one project should not be reachable for the purposes of another project in the event the agency files a bankruptcy petition.

These conclusions are really truisms under State law, but it is not sufficiently clear that they would apply in municipal bankruptcy proceedings under federal law. There is no clear statement that the Bankruptcy Code cannot be applied so as to make obligations payable from a source from which they are not payable under applicable nonbankruptcy law. Nor is there any provision to the effect that administrative expenses attributable to any function or project of the municipality will not be charged against funds derived from other functions or projects except as permitted by nonbankruptcy law.

In one respect, by its express terms, the Bankruptcy Code creates an apparent risk that revenue bonds can be converted into general obligation bonds. Under section 1111(b), unless the property subject to the lien is "sold" under the

plan, a partially secured bondholder (i.e., one whose lien on revenues is insufficient to pay his bonds), if he does not have "recourse" against the debtor for the remainder of his claim under nonbankruptcy law, will be treated as if he did have "recourse." Although the term "recourse" fits municipal revenue bonds only poorly, this could be read as converting revenue bonds into general obligations.

The same problems could be said to exist with respect to "conduit" financing where bonds are issued for an industrial or nonprofit user and are payable solely from payments to be made by the user. But in pure conduit financing, where the municipality has no financial interest in the enterprise and no direct or contingent obligation to pay the bonds from other funds, the payments by one conduit user are probably safe from being reached to pay the bonds issued for another user since, according to the legislative history, these transactions do not create either assets or debts of the municipal issuer for bankruptcy purposes. S. Rep. 95-989, 95th Cong., 2d Sess. 109-10 (1978).

While the fresh start policy of bankruptcy embodied in the termination after bankruptcy of liens on after-acquired property and the equality of distribution policy embodied in the nonrecognition (at least in business debtors) of separate though unencumbered funds for separate groups of creditors are important, the Bankruptcy Code also strongly embodies the policies of protecting the rights of secured creditors in

their collateral and of protecting State control over its municipalities. See Bankruptcy Code § 903. On the one hand, if the municipality's revenues could be pledged in perpetuity, the rehabilitative prospects for a financially distressed municipality would be impaired or non-existent. The only asset that a municipality has to offer its creditors in a municipal reorganization is its future revenues. If some creditors have obtained a priority with respect to these revenues due to prior financing, then reorganization would be next to impossible unless other creditors are willing to give up their claims entirely. On the other hand, reorganization should not be at the expense of a legitimate expectation to rely on and receive specific collateral, nor should it redo established procedures for handling separate municipal funds. Clearly, a compromise is in order. It is needed to protect the integrity of the municipal finance process in the event of a significant municipal bankruptcy and to protect the fresh start and ability to reorganize offered to municipal debtors by the Municipal Bankruptcy Act.

**GENERAL ANALYSIS OF THE PURPOSES
AND EFFECTS OF THE AMENDMENTS**

A. Revenue Pledge Protection and Preferences

Revenue bonds are generally secured by revenue derived from a system, project, or facility, or by an interest in a specific tax levy. Mortgages or liens on the system,

project, or facility itself are rare. They are usually forbidden by law and almost always considered to be against public policy. Under section 552 of the Bankruptcy Code, incorporated by section 901 into chapter 9, a lien on after-acquired revenues is only valid to the extent that the revenues constitute "proceeds" of other property that is subject to a lien. Uniform Commercial Code section 9-306(1) defines "proceeds" to include "whatever is received upon the sale, exchange, collection or other disposition of collateral." Section 552 was written with the Uniform Commercial Code definition in mind. To the extent that section 552 is construed in harmony with the U.C.C., the lien on a municipality's revenues after bankruptcy would be defeated.

Similarly, section 547(e)(3) may have the effect of moving the lien termination back to the ninetieth day before bankruptcy. Section 547(e)(3) provides that for purposes of determining when a preferential transfer is "made", "the transfer is not made until the debtor has acquired rights in the property transferred". A debtor does not acquire rights in revenues until the tax or assessment is levied or the service from which the revenue is derived is provided. Thus, a lien on revenues received during the 90 days before bankruptcy (or possibly on rights to revenues which arise during that period) is deemed made within the preference period, even though the grant of the security interest was made long before bankruptcy.

This provision was designed to overrule cases such as DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), and Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), cert. denied, 396 U.S. 827 (1969). H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 374 (1977). In the commercial context, it works well, because it was matched with an exception to the preference section that preserves liens on after-acquired inventory and receivables to the extent that the secured creditor does not improve its position during the 90 days before bankruptcy. 11 U.S.C. § 547(c)(5). In the municipal context, however, no comparable savings provision is possible, because the revenue pledges are not related to inventory and receivable financing, as they are in the commercial context, and there is no collateral from which the revenues are derived.

The proposed legislation undoes the effect of these provisions in a chapter 9 case. It recognizes a postpetition security interest in revenue under certain specified circumstances, more fully described below. And it makes the preference section inapplicable to payments on bonds or notes of a municipality. The former change corrects the problem posed by section 552. It also makes it more difficult, if not impossible, for a municipal debtor to utilize the preference section (even without the latter change) to recover payments to bond holders made from pledged revenues within 90 days before bankruptcy, because it will be difficult to prove the "more than liquidation" test of section 547(b)(5). The latter change has

the same effect and in addition protects ordinary "defeasance" transactions.

Bond indentures generally provide for "defeasance" by "irrevocably" depositing a sufficient sum (usually with earnings thereon) to retire the outstanding bonds. In view of the possibility that the municipality may file a bankruptcy petition within 90 days, the deposit may be a preference and therefore, might not be "irrevocable." Defeasance with revenues received within 90 days before a bankruptcy may be riskier. This applies equally to unpledged revenues and to revenues which are already subject to a lien to pay the bonds if that lien can be defeated by virtue of section 547(e)(3). It is especially troublesome if a defeasance can be "avoided" as a preference where another transaction (such as a new bond issue) has occurred in reliance on it.

A more difficult analysis applies to the use of refunding proceeds for defeasance. Generally speaking, it is not a preference to borrow from Peter to pay Paul if that use of the borrowing proceeds is required by the terms of the borrowing. See, e.g., Virginia National Bank v. Woodson, 329 F.2d 836 (4th Cir. 1964). But the application of this principle to a defeasance by "advance" refunding is disturbingly unclear, because interest rate differences on the two issues may mean that principal amounts differ, resulting in a possible preference. The proposed amendments remove this danger.

B. "Insolvent"

Chapter 9 uses the term "insolvent" in two important contexts. First, in order for a municipality to be eligible to file a chapter 9 petition, it must be "insolvent or unable to meet its debts as they mature." Section 109(c)(3). Second, certain prebankruptcy transfers are avoidable as preferences or fraudulent transfers only if the debtor was "insolvent" at the time of the transfer. Sections 547(b)(3); 548(a)(2)(B)(i). These are general bankruptcy sections that are incorporated by reference into chapter 9. In none of these instances does the use of the word "insolvent", as defined in Code § 101(29), work.

"Insolvent" is defined as liabilities in excess of fair market value of nonexempt assets. By the nature of municipalities and generally by State law, most of the assets of a municipality are exempt from process to satisfy the claims of creditors. As such, virtually every municipality, by definition, is insolvent. But because a municipality's assets could not be seized or sold to pay debts, or are so tailored to a specific purpose that their value is uncertain at best, it should make little difference to creditors what the "value," for example, of City Hall is. A more reasonable test would be whether the municipality is paying or is able to pay its debts as they become due, which are the alternate standards for filing a municipal bankruptcy petition under section 109(c)(3) and the test for an involuntary bankruptcy against a non-

municipal debtor contained in section 303(h)(1). This test is directly relevant to the financial health of the municipality. Thus, one of the proposed amendments provides that in a chapter 9 case, "insolvent" means only a nonpayment of debts or inability to pay debts as they come due. The assets versus liabilities test is made inapplicable.

C. Nonrecourse Debt

In order to solve a specific problem arising in non-recourse commercial lending, section 1111(b) of the Bankruptcy Code permits a nonrecourse claim to be treated as having recourse against the general assets of the debtor. This provision, being part of the general plan provisions of chapter 11, was incorporated into chapter 9. However, if applied to municipal revenue bonds, it could convert them into general obligations of the municipality in violation of State or local constitutional or statutory provisions. For example, in many States, State law requires a vote of the people for the issuance of general obligation debt by a municipality, but does not require a vote on bonds payable solely from pledged revenues. One proposed amendment prevents the application of section 1111(b) and thereby prevents the conversion of bonds backed only by specific revenues into general obligation bonds. The amendment does so in a manner that is consistent with the general scheme of the reorganization provisions of chapters 9 and 11 by preventing the bifurcation of partially secured claims.

D. Automatic Stay

The automatic stay of Bankruptcy Code section 362 is extremely broad, preventing any postpetition collection activities against the debtor, including application of the debtor's funds held by a secured lender to secured indebtedness. This provision is overly broad in chapter 9, requiring the delay and expense attendant upon a request for relief from the automatic stay to accomplish what the statute contemplates -- the application of pledged revenues (after payment of operating expenses) to the payment of secured bonds. One of the proposed amendments so provides by making the automatic stay inapplicable to application of such revenues. The bankruptcy court would retain the power to enjoin application of proceeds, however, upon a specific showing of need, for example, where a secured creditor was about to apply proceeds of a gross revenue pledge in a manner inconsistent with the policies of proposed section 927.

E. Financing Leases

A "financing lease" is generally treated as debt in bankruptcy and not as a true "lease" subject to rejection under section 365 or to the claim limitation under section 502(b)(6). The 1984 amendment (Code § 365(m)), providing that "any rental agreement to use real property" will be treated as a "lease" under § 365 has generated a fear that a more expansive view will now be taken of "true leases" and a less expansive view of "financing leases". Because of State law

restrictions, most municipal financing leases are subject to termination if the "rent" is not appropriated. Under a more restrictive conception of financing leases, these may now arguably be treated as "true leases" for bankruptcy purposes although they are treated as debt for tax purposes and sold as debt in the tax-exempt bond market. The amendments treat them the same way for bankruptcy purposes.

F. Rate Regulation

In a corporate reorganization, a change in the debtor's rates is subject to applicable rate regulation. Code § 1129(a)(6). Municipal utilities are subject to rate regulation in a number of States, and the same provisions should apply to them as to private corporations. A proposed amendment makes this provision applicable to municipal bankruptcies.

Municipal systems are often also subject to other regulatory requirements and to political requirements, unique to governments, such as voter approval of additional debt. Another amendment makes a municipal plan of adjustment subject to these requirements. Some have expressed a concern that a failure to make a plan subject to requirements of this sort could override State and local financial and political controls and raise constitutional issues as to the scope of the bankruptcy power that need not be resolved to further sound municipal bankruptcy policy.

G. Adequate Protection

Sections 362 and 364 require adequate protection to secured creditors in order to continue an automatic stay or to permit a priority borrowing by the bankruptcy trustee. These provisions apply to all bankruptcies. If the "adequate protection" in fact proves to be inadequate, the secured creditor has a "superpriority" claim under section 507(b). But this applies only to individual and corporate bankruptcies and not to municipal bankruptcies.

In municipal bankruptcy, since liquidation is not permissible and since all priority claims must be paid as a condition to plan confirmation, the ranking of various types of administrative expenses in a priority or super-priority order may not add anything to the statute. However, there should not be any doubt that a failure of adequate protection should give rise to an administrative expense claim. One amendment makes this explicit.

DETAILED ANALYSIS OF REVENUE PLEDGE AMENDMENTS

Under Bankruptcy Code § 552, except for "proceeds, product, offspring, rents, or profits" of other "property" already subject to a preexisting security interest,

". . . property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by

the debtor before the commencement of the case."

As applied in the municipal context, in which a security interest in underlying assets is rare, section 552 appears to terminate a security interest in revenues received after the commencement of the bankruptcy case, regardless of the validity of the lien under State law. The problem is particularly acute with respect to project or system financing, such as bonds secured by municipal utility revenues or other nontax revenues. The problem also presents itself in certain instances in which tax revenues act as collateral for bonds.

There are exceptions to the rule that underlying assets are not given as collateral for revenue bonds. For example, in South Dakota, there may be a "statutory mortgage lien" on plant assets. See, e.g., 9 S.Dak. Codified Laws Sections 9-40-25 to 9-40-27. It would be highly artificial for the result under Bankruptcy Code section 552 to turn on the difference between the statutory mortgage and the more customary pledge of revenues without a lien on the plant. Even where foreclosure on the underlying assets is permitted, there appears to be little, if any, practical difference between the two situations. See Fordham, Revenue Bonds Sanctions, 42 Col.L.Rev. 395, 432-33 (1942).

Proposed section 927, along with the definition of "special revenues" in proposed section 902(2), protects the lien on revenues. It is closely modeled on section 552(a).

It is intended to negate section 552(a) in the municipal context and to go no further. In other words, it is not intended to create new rights that otherwise would not exist. Section 552(a) limits preexisting rights. The proposed amendment only removes that limitation in the circumstances described in proposed section 927(a).

The proposed amendment applies only to "special revenues," as defined in proposed section 902(2). Examples of the kinds of revenues included within the definition are revenues from municipally-owned utility systems, betterment assessments, special excise taxes and fees, and in some instances local sales, income, or property taxes.

Utility revenues include revenues from the sale of water, power, natural gas or other energy sources. It also includes revenues from a toll highway or bridge or other projects or systems which impose user fees.

Betterment assessments are typically imposed on landowners benefitted by particular improvements to finance the cost of those improvements. In most states, betterment assessments are constitutionally required to bear a reasonable relationship to the benefit conferred. Bonds (known as "special assessment bonds"), payable solely from these assessments, are sometimes issued to pay the cost of the improvement, but general obligation bonds are also issued for this purpose.

Hotel-motel taxes, meal taxes, and license fees are included in special excise taxes. They are often imposed for particular purposes. For example, a hotel-motel excise or a meal tax might be imposed in a particular area of a municipality or throughout a city to finance the construction and operation of a convention center. Bonds secured by the special excise tax are issued to finance construction.

Tax increment financing will also receive the benefit of the proposed amendment. A city may finance street, utility, and land assembly costs for a downtown renewal project on a tax increment basis. That is, the bonds issued to pay for the project are payable solely from and are secured by a lien on the additional tax resulting from the increased valuations in the project area.

Property, sales, and income taxes would generally not be considered special revenues. However, some exceptions may exist. For example, where a special property tax is levied and collected for the specific purpose of paying principal and interest coming due on bonds issued in conjunction with the levy of the property tax, the revenues may constitute special revenues. In these cases, there is generally a prohibition under State law on using the special tax revenue for any purpose other than payment of bonds. However, where the revenue may be used for other purposes, it should not constitute "special revenues." Similarly, a city may impose an additional one-half percent or one percent sales tax to finance a parti-

cular project, such as rapid transit. While general sales taxes would not constitute special revenues, with appropriate limitations on the use of the additional sales tax, it could constitute special revenues.

Project financing can also create special revenues. A municipality may attempt to finance separate projects by liens on the revenue of each project, issuing separate bonds for each project. Project revenues, whether based on sale of goods or services or based on cost-sharing among users, would constitute special revenues.

In all of these cases, communities have determined it to be financially or politically unsound to finance a major utility or other project or system with general obligation debt, i.e., debt payable from the general funds of the municipality including tax receipts. Accordingly, they issue revenue bonds payable solely from the revenues of the project or system. To make sure that those revenues are not converted to other purposes, they pledge or assign revenues as security for the bonds, usually under State enabling legislation which provides expressly that they can do so.

Absent the mortgage, there is really no alternative for the municipality. The effect of the pledge of revenues is not unlike the result of a private utility's mortgage of its entire plant to a trustee for the benefit of bondholders. Nor is it unlike the lien on "proceeds" which is recognized in the Code. The proposed amendment amounts to a recognition of a

hypothetical mortgage on the plant from which the revenues are derived where a "real" mortgage cannot be created either for legal reasons or because of compelling considerations of public policy.

Proposed section 927 does not distinguish between bonds backed solely by special revenues and so-called double-barrelled bonds. These latter bonds are backed not only by special revenues but also by the general credit of the municipality, including its power to levy property and other taxes. There is no security interest, however, in the general property tax receipts.

Nor does section 927 distinguish between projects or systems owned and operated by a municipality that also performs other functions or by a so-called special purpose municipality, such as a separate "body politic and corporate" established to finance, construct, and operate a utility system or other project or system.

These latter distinctions only go to the issue of whether the bondholders have a recourse against the general municipality on any shortfall of project or system revenues to pay amounts owed under the revenue bonds. This is an issue addressed by proposed section 925(b), which renders ineffective Bankruptcy Code § 1111(b) in the revenue bond context.

Subsection (b) of proposed section 927 provides for the payment from pledged special revenues of operating expenses of the project or system producing the revenues

before use of those revenues to pay interest or principal on the bonds. In very general terms, a net revenue pledge would survive, and a gross revenue pledge would be treated as if it were a net revenue pledge. Pledged revenues received after the commencement of the bankruptcy case would be applied first to the operating expenses of the system, project or function producing the revenues (whether or not the bonds financed construction or purchase of the system, project, or function producing the revenues) before application to the indebtedness for which the revenues were pledged and only then to other lawful purposes.

The general purpose of this approach is to permit the continued operation or functioning of the system, project, or function that was financed by the revenue bonds. Without such continued operation, there is not likely to be a continued source of funds from which to service the bonds. The pledged revenues would not be permitted to be used for any other governmental purpose, but would be used to pay operating expenses to facilitate a workout and successful confirmation of an adjustment plan.

This approach should work fairly easily in utility situations or in user fee situations such as toll bridge authorities, and the like. Other situations may require more explanation. One such situation is tax increment financing. In this type of financing, bonds issued for public improvements are secured by a pledge of the additional tax resulting

from the increased valuations in the area affected by the project. In this context, the pledged revenues could be used for operating expenses of the improvements before being applied to the secured indebtedness. Another situation might concern a project financed by a pledge, not of project revenue, but of revenue from some other special source. An example would be a convention center financed by a pledge of hotel-motel excise taxes or a rapid transit system financed by an increased sales tax. Here again, the pledged revenues could be used first for operating expenses of the project and second to pay the secured debt.

However, these revenues would not necessarily be subordinate to all of the operating expenses of the center or the improvements if they had their own source of revenues, such as from user fees. In each case, the court will be required to examine the need to protect the source of the pledged revenue and to determine whether maintaining operating expenses of the project, system or function contributes to the ability of the project, system, or function to continue to produce the revenues needed to operate and service the bonds.

In determining whether operating expenses are "necessary," as provided in subsection (b), the court should not step beyond the bounds of Bankruptcy Code sections 903 and 904. This provision, like all others in chapter 9, are subject to the limitations of those sections. The provision should not permit the court to become involved in possible

control over political or governmental functions. At most, the court should use a "business judgment" test in applying the provision, examining only whether the business judgment of the debtor's management in incurring or proposing the expenditure (or proposed expenditure) is a reasonable one. The court should not substitute its own business judgment. See Group of Institutional Investors v. Chicago M., St.P., & P.Ry. Co., 318 U.S. 523 (1943). Moreover, the phrase "operating expenses" should not be construed to exclude capital expenses or expenditures, because they may be as necessary as ordinary operating expenses to maintain the source of revenue from which bonds are to be paid.

Finally, in developing and adopting a plan of adjustment, a gross revenue pledge would be treated in the same manner as during the case, under section 927. It will be analyzed and evaluated as it provided for the use of future revenues to pay operating expenses of the system, project, or function first and debt service on the secured indebtedness second.

SECTION BY SECTION ANALYSIS

Sec. 1.

This amendment and the proposed § 902(1) (see section 3 below) go together. They make a general failure to pay debts the criterion for municipal insolvency and eligibility

for filing. They replace the assets vs. liabilities test. The assets vs. liabilities test is not meaningful in the case of a municipality. See the Comment on proposed § 902(1) below.

Sec. 2.

Section 1129(a)(6) should apply to municipalities, as it does to other debtors, since municipal utilities are subject to rate regulation in a number of states.

Sec. 3.

Section 101(26) defines insolvency as debts exceeding the fair value of assets. Many municipal assets are special-purpose assets and have a highly uncertain market value, which is probably less than cost. Under these circumstances, many healthy municipalities would be treated as "insolvent". Also many municipal assets cannot be reached to pay debts, rendering the assets vs. liabilities test somewhat irrelevant to creditors. This amendment uses a more realistic test to determine whether the municipality is insolvent. It is the same as that applicable to involuntary bankruptcy under section 303(h)(1) and the alternate eligibility test for a municipality under current law. The change in § 109(c)(3) (above) is correlative to this change.

If a department of a municipality is financed by indebtedness payable solely from revenues attributable to that department a general failure or inability to pay such indebt-

edness as it becomes due would, if it is substantial in amount, cause the municipality to be considered insolvent.

The present tense in the definition of "insolvent" refers to the time at which the definition is important, i.e., at the petition date for purposes of § 109(c), at the transfer date for purposes of § 547, and the like.

A deliberate failure to pay indebtedness in order to create eligibility to file a petition under this chapter would be grounds for dismissal under section 921(c) as a failure to file in good faith.

The definition of special revenues is needed for the purposes of revised sections 922, 925 and 927. Examples of the special revenues mentioned in clause (a) include receipts from the operation of a municipal water or electric system.

An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (b). A general sales tax would not.

In a typical tax-increment financing public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts are part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the pre-existing tax base of the community.

Examples of revenues from particular functions under clause (d) would include regulatory fees and stamp taxes imposed for the recording of deeds.

Under clause (e) an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered special revenues. For this purpose a project or system may or may not be revenue-producing.

Sec. 4.

Where a pledge of revenues survives under section 927, it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay.

This super-priority granted by section 507(b) for a failure of adequate protection does not apply in chapter 9. Nevertheless, the creditor's loss from the automatic stay or from the granting of a priming borrowing lien should be entitled to administrative expense priority, because the creditor's loss came as a result of an attempt to benefit the postpetition debtor. This amendment makes explicit, therefore, what is implicit in section 507(b).

Sec. 5.

Section 1111(b) provides that in some circumstances nonrecourse debt may be treated as recourse debt. Many municipal obligations are, by reason of constitutional, statutory

or charter provisions, payable solely from special revenues. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to nonrecourse financing.

Sec. 6.

In the case of a municipality it is not considered necessary to legislate broadly against preferential treatment of bond and noteholders. There is not likely to be a high incidence of preferential treatment of these creditors and, where there is an actual intent to hinder, delay or defraud other creditors, section 548 would apply. The existing law, under which section 547 applies to municipal bonds and notes, creates unforeseen problems and uncertainties. For example, most municipal revenue bonds involve a pledge of special revenues but do not include a mortgage or other security interest on any revenue source. The application of section 547 to them could cause payments of such bonds in the normal course to be treated as preferences since the lien on revenues received during the preference period would be treated as coming into existence during the preference period and not before. In addition, the deposit of money or securities in escrow to "defease" the lien of a prior bond indenture, which is a common occurrence, could also be treated as a preference notwithstanding the absence of any preferential intent or actual damage to other creditors.

Sec. 7(a).

This section simply redesignates section numbers to provide for the new sections added by section of the bill.

Sec. 7(b).

If deemed to apply, section 552(a) could terminate the security for municipal revenue bonds upon commencement of the case where (as is usually the case) there is no mortgage or security interest on any revenue source. Paragraph (a) makes it clear that such a result is not intended. It permits a lien on special revenues to continue under state law but, under paragraph (b), a lien on project or system revenues would be subordinate to necessary operating expenses of the project or system. Necessary operating expenses are operating expenses which are necessary to keep the project or system going. Prepetition operating expenses are included to the extent payment is deemed necessary by the court for this purpose.

In the case of a project financing the lien would be subordinate to the necessary operating expenses of the project. In the case of a system financing the lien would be subordinate to the necessary operating expenses of the system. An example of a project financing would be the financing of an electric generating plant by indebtedness secured by a lien on revenues from the sale of output of the particular facility. An example of system financing would be the financing of

improvements to a local electric distribution system secured by a lien on revenues of the entire system.

Subsection (b) reflects the fact that betterment assessments are levied to finance the construction costs of sewers, streets, and the like and that the operating costs are financed separately out of current user charges or taxation. In the case of bonds secured by these assessments, subordinating the lien to operating expenses would materially change the bargain.

Subsection (b) sets forth a minimum standard for paying operating expenses ahead of debt service where revenues are pledged. It is not intended to displace any broader standard contained in the terms of the pledge or applicable nonbankruptcy law.

For reasons unique to municipalities, many financing leases are required to be subject to appropriation of the rent. These are generally marketed as debt obligations and treated as debt obligations for tax purposes. They should be treated in the same way for bankruptcy purposes.

Section 943(b) of title 11 of the United States Code is amended by:

Sec. 8.

Many municipal actions require regulatory or electoral approval under constitutional, statutory or charter provisions. These approvals are not limited to rates but extend often to such other matters as the acquisition or dis-

position of property or the incurring of indebtedness. A plan of adjustment should not call for action to be taken without the requisite approval. Paragraph (6) does not require voter approval for the plan but only for actions to be taken under the plan which would require such approval if taken otherwise than under the plan.