

## Deploying the “Prepackaged” Plan of Adjustment in Chapter 9

By Henry C. Kevane

### Introduction

Prepackaged plans of reorganization are not uncommon under Chapter 11 of the Bankruptcy Code. Section 1126(b) of the Bankruptcy Code specifically contemplates the solicitation of acceptances for a plan prior to the commencement of a bankruptcy case. In most instances, such prepackaged plans are designed to restructure a debtor’s balance sheet and capital tiers, and generally do not entail the impairment of trade creditor classes or complex changes to a debtor’s operations, assets, or contractual relationships. Prepackaged plans are attractive because they offer a speedy exit from bankruptcy oversight and a more predictable outcome for constituents.

#### *The Growing Role of Prepackaged Plans in Bankruptcy Cases*

A recent survey conducted by AlixPartners LLP in June 2011 found that many restructuring professionals expect that more than 50 percent of large Chapter 11 filings over the next year will be based on some form of prepackaged (*i.e.*, a plan that has been actually accepted by the requisite votes before the commencement of a Chapter 11 case) or prearranged plan (*i.e.*, a plan that has been substantially negotiated before the commencement of the case but where votes are solicited post-petition). According to the survey, 52 percent of large companies commenced such an orchestrated bankruptcy filing in 2010, up from approximately 21 percent in 2009.

#### *Prepackaged Plans and Chapter 9 Eligibility*

Sections 1125 and 1126(b) of the Bankruptcy Code are specifically incorporated into Chapter 9 of the Bankruptcy Code and are therefore available to solicit acceptances for a plan of adjustment (the equivalent to a plan of reorganization under Chapter 11) prior to a municipal filing. In addition, the eligibility requirements under Chapter 9 contemplate that a municipal debtor seeking an order for relief must both “desire to effect a plan to adjust [its] debts” *and* have “obtained the agreement of creditors” that it intends to impair under its proposed plan (or, at a minimum, have engaged in certain pre-filing negotiations). A prepackaged plan, naturally, would satisfy both of these eligibility prongs. Yet, although Chapter 9 cases are relatively infrequent (only approximately 600 filings since the enactment of Chapter 9 in 1934), the use of a prepackaged plan of adjustment is even more rare, if not non-existent. In most cases, Chapter 9 debtors satisfy the pre-filing negotiation requirement merely by demonstrating that such negotiations have failed or are impracticable.

In today’s climate of faltering municipal finances and ballooning public employee benefits, a prepackaged plan of adjustment might, however, offer a more palatable alternative to a municipality than the expensive, time-consuming and sometimes meandering course of a Chapter 9 case. Although Chapter 9 rightly remains an option of last resort, triggered mainly in true crises or when municipalities emulate revenue-producing business enterprises that are otherwise distressed (such as health care districts or infrastructure authorities), it now seems more probable that municipalities will begin to use federal bankruptcy relief as an active tool to re-calibrate revenues, services and expenses. A prepackaged plan could provide a useful template to focus discussion and forge consensus while satisfying a key test for a municipality’s eligibility to file, and simultaneously offer the traditional benefits of a prepackaged plan in the form of speed and certainty. Moreover, a prepackaged plan could provide a less confrontational means to make changes to a municipality’s

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collective bargaining agreements and retiree benefits by addressing both the modification of future expenditures and the satisfaction of accrued, past claims in a single, comprehensive settlement.

### **Constitutional Foundation for Chapter 9**

The U.S. Constitution authorizes Congress to enact uniform bankruptcy laws. The Constitution also limits the reach of federal judicial power over the states. Chapter 9, thus, has been crafted to both respect state sovereign control over municipal debtors and limit federal court interference with municipal affairs, property and operations. Hence, the bankruptcy court in a Chapter 9 case has two main functions: to determine the eligibility of the municipality to file at the beginning of the case, and to consider the confirmation of a plan of adjustment at the end of the case. Of course, the court will also consider various intermediate matters such as the assumption or rejection of agreements, avoidance actions (except against bond- or note-holders, who are immune in a Chapter 9 case from preference actions), or the possible dismissal of the case for “want of prosecution” or if confirmation of a plan has been denied or refused. The major tasks of the court, however, are to regulate the debtor’s entry to and exit from federal bankruptcy oversight.

Under Chapters 7 and 11 of the Bankruptcy Code, the filing of a petition automatically constitutes an order for relief and triggers the imposition of the automatic stay provided under section 362 of the Bankruptcy Code. Under Chapter 9, by contrast, the entry of an order for relief does not follow automatically from the filing of the petition (although the automatic stay provided under sections 362 and 922(a) of the Bankruptcy Code is operative immediately upon filing and does not depend upon the order for relief). Rather, an order for relief must be affirmatively entered by the court after the municipality’s eligibility to file has been scrutinized after notice and a hearing. *See* 11 U.S.C. §§ 921(c), (d). If the municipality does not qualify for Chapter 9, the court “may” dismiss the case (although most cases that have construed the eligibility requirements have concluded that dismissal is mandatory, not permissive, following a determination of ineligibility). If the municipality does meet the eligibility criteria, then the court enters an order for relief.

The municipality has the burden of proving that it qualifies to be a Chapter 9 debtor – typically, the debtor will file a statement of its qualifications together with its initial petition and its list of creditors (filed in lieu of schedules of assets and liabilities but serving essentially the same purpose with respect to a creditor’s obligation to file a proof of claim if it disagrees with the debtor’s listing). Since the Bankruptcy Code does not specify a deadline or schedule for making the eligibility determination, the debtor will also frequently request a “first day” order from the court establishing a bar date for objections to eligibility as well as a timetable for a hearing in the event an objection is timely filed.

The limitations on the eligibility of a municipality to file a Chapter 9 case arise because of the tension between two constitutional imperatives. On the one hand, as instrumentalities of a state, Chapter 9 municipal debtors enjoy substantial freedom from federal interference. This freedom derives from the Tenth Amendment to the Constitution which provides that “[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” On the other hand, only federal law can overcome the constitutional prohibition on the impairment by states of the obligation of contracts or otherwise override contrary state law. U.S. Const., art. I, § 10, cl. 1 (Contracts Clause); art. I, § 8, cl. 4 (Uniform Bankruptcy Laws); art. VI, cl. 2 (Supremacy Clause).

Chapter 9 was thus designed to accommodate both the reserved sovereign rights of the states and the debt adjustment powers of federal law. This accommodation is reflected both in certain unique provisions of Chapter 9 and in the omission of various “standard” bankruptcy provisions from Chapter 9. Section 903 of the Bankruptcy Code, for example, provides that (with certain limited exceptions) the provisions of Chapter 9 do not “limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise.” Notably, however, section 903 prohibits state laws “prescribing a method composition of indebtedness” for a municipality on the grounds that, absent such restriction, each state could enact its own

version of Chapter 9 “which would frustrate the constitutional mandate of uniform bankruptcy laws.” S. REP. NO. 95-989, at 110 (1978).

Other provisions of Chapter 9 render certain municipal decisions impervious to court review or creditor scrutiny. Section 904 prohibits the Bankruptcy Court from interfering, “unless the debtor consents or the plan so provides,” with any of the debtor's political or governmental powers, property or revenues, or its use or enjoyment of income-producing property. In addition, section 363 of the Bankruptcy Code, concerning the use or sale of property, is wholly omitted from Chapter 9. Thus, a Chapter 9 debtor has significant latitude to pay pre-petition claims outside of a plan or to sell assets without court approval. Moreover, a Chapter 9 case may be neither commenced involuntarily by creditors nor converted to another case under the Bankruptcy Code. The Bankruptcy Court may not appoint a trustee to manage or control the debtor (except to pursue avoidance actions), nor compel a liquidation of municipal assets. Last, only the municipality can propose a plan of adjustment; creditor plans are not permitted. A Chapter 9 debtor, thus, has the freedom (a) to determine whether and when a bankruptcy case will be filed, (b) to manage its own affairs and property during the pendency of the case, and (c) to file a plan of adjustment during a virtually perpetual exclusive period.

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## Prepackaged Plans Generally

A prepackaged plan is one where the solicitation of votes to accept or reject the plan has been completed prior to the commencement of the bankruptcy case. (Some prepackaged plans, however, may be partially accepted by certain creditor classes, deferring the solicitation of other classes until after the bankruptcy filing.) The petition commencing the case will be accompanied, or shortly followed, by the filing of a plan, a solicitation document (such as a disclosure statement), and a tabulation of votes. Naturally, if the plan has *not* been accepted by the requisite votes then the debtor may not be able to proceed with an accelerated confirmation hearing and exit from bankruptcy. If, however, all impaired classes save a class of interests (*i.e.*, stockholders) have accepted the plan, and all that remains is to apply the requirements of section 1129(b) for a nonconsensual, cram-down plan, then it may still be possible for the debtor to seek an expedited confirmation track (although valuation disputes and corresponding fact-finding might hinder that goal). If the prepackaged plan is either rejected (or deemed rejected) by a class of creditors, then it may be difficult to confirm the plan on a speedy timetable. In most prepackaged plans, however, all requisite acceptances have been obtained and all that remains is for the Bankruptcy Court to scrutinize compliance with the solicitation provisions of section 1126(b) and the confirmation elements under section 1129 of the Bankruptcy Code.

### *The Advantages and Goals of Prepackaged Plans*

The twin advantages of a prepackaged plan – speed and certainty – can have enormous consequences to the costs of Chapter 11 and to a debtor’s successful reorganization. A prepackaged plan will typically stifle the expensive and distracting creditor jockeying that often accompanies the Chapter 11 process (because the bankruptcy exit is visible and proximate) and will also avoid negative repercussions to the debtor’s business (because vendors and customers are assured of a quick and normal resumption of operations). In some instances, it may be possible for the debtor to even skip the meeting of creditors (expressly permitted by section 341(e) of the Bankruptcy Code), avoid the need to file its schedules of assets and liabilities and statement of financial affairs (upon approval of the court) and even obviate the need for the appointment of a creditors’ committee (particularly if creditors are unimpaired, although Bankruptcy Rule 2007 does contemplate the appointment of an official committee from members of a committee of creditors organized prior to the petition date).

The principal goal of the prepackaged plan, like all plans, is to bind dissenting creditors to the treatment provisions of the plan by using the voting thresholds established under the Bankruptcy Code (*i.e.*, acceptance

by at least two-thirds in amount and one-half in number of those creditors in a particular class that have actually voted on the plan). These thresholds are particularly important where the non-bankruptcy requirements for a consensual restructuring might require unanimous consent, or where claims are so widely held (or held by foreign creditors, or through multiple layers of intermediaries) that obtaining a majority is not feasible (again, the Bankruptcy Code provides a mechanism to not only bind rejecting creditors but also creditors that do not vote since the voting thresholds pertain to claimants that voted on the plan).

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## Chapter 9 Confirmation Elements

Chapter 9 has certain unique statutory requirements to confirm a plan of adjustment (such as electoral approval, where necessary), although various other requirements are borrowed directly from Chapter 11. Moreover, the feasibility, “best interests of creditors” and “fair and equitable” requirements have unique meanings under Chapter 9 (since there are no shareholders of a municipality, nor may its assets be liquidated). *See* H.R. REP. NO. 95-595, at 263 (1977) (“[A] municipality is generally not a business enterprise operating for profit, and there are no stockholders. These differences dictate some modifications of the standards governing the proposal and confirmation of a plan.”).

Under Chapter 11, the feasibility requirement is intended to evaluate a debtor’s ability to meet its plan obligations, without the need for further financial reorganization. The feasibility requirement under Chapter 9 is similar, although the debtor’s ability to make the payments contemplated by the plan is measured with reference to the municipality’s contemporaneous ability to sustain its ongoing governmental functions, not avoid a subsequent bankruptcy. In other words, can the municipality *both* distribute the plan consideration and meet its governmental functions?

The “best interests of creditors” and “fair and equitable” requirements are intended to protect, respectively, dissenting creditors and dissenting classes of creditors. In Chapter 11, the best interests test provides a floor for payments under a plan, ensuring that creditors will receive *at least* as much under the plan as they would realize in a Chapter 7 liquidation. A Chapter 9 case, however, may not be converted to Chapter 7 nor may the assets of a municipal debtor be involuntarily liquidated. Accordingly, under Chapter 9, the best interests test has been construed to mean that the plan offers a better alternative than dismissal of the bankruptcy case. If plan recoveries are superior to state law creditor remedies, then the plan is generally considered in the “best interests of creditors.”

The “fair and equitable” requirement, naturally, only comes into play if a class of creditors rejects the plan. Under Chapter 11, the requirement embodies the absolute priority rule, ensuring that any senior class that has rejected the plan is paid in full *before* a junior class may receive or retain property under the plan. There are, however, no holders of equity interests in a municipality and, hence, strict application of the “fair and equitable” test to a dissenting class of unsecured creditors (who are senior to shareholders in a corporate context) is not practicable under Chapter 9. Although there are varying interpretations, the legislative history to Chapter 9 suggests that, in order to be fair and equitable, a plan of adjustment must provide creditors with the “going concern” value of their claims – this standard entails a comparison of the reasonably expected revenues, expenditures and taxing powers of the municipal entity.

## Conclusion

A prepackaged plan of adjustment is both permitted under Chapter 9 and would simultaneously satisfy several eligibility requirements for entry to Chapter 9. Although there are some formidable constraints to a municipality’s ability to adjust certain common types of municipal debt, such as special revenue bonds or financing leases, a prepackaged plan, or the very effort to seek consensus around such a plan, may deliver

significant advantages to the cost and outcome of a Chapter 9 case. A municipality can actively seek to modify its public employee obligations in a more formal context (the plan) that assures affected employees and residents that both accrued and future obligations are being addressed, while offering a mechanism to implement such changes through the binding class votes under the confirmation procedures of the Bankruptcy Code. Moreover, the process of formulating a prepackaged plan can itself generate meaningful dividends whether or not a case is commenced. By pursuing the prepackaged plan route, and preparing for a potential Chapter 9, a municipality may obtain consensual changes that might obviate the need to file. If not, even a partially prepackaged plan (where certain, selected constituencies have either not been solicited or have not yet accepted the plan) can materially reduce the expense and uncertainty of a Chapter 9 case. Since Congress has required some form of genuine pre-filing negotiation as a condition to entering Chapter 9, municipalities should seriously consider borrowing this technique from the corporate insolvency practice.

## Related Resources

1. The Milken Institute and The Ewing Marion Kauffman Foundation, *Ensuring State and Municipal Solvency*, Financial Innovations Lab™ Report (October 2010), ©2011 Milken Institute, <http://www.milkeninstitute.org/publications/publications.taf?function=detail&ID=38801248&cat=fnlab>
2. *Municipal Bankruptcy*, 31 Cal. L. Revision Comm'n Reports 143 (2001) (included as part of publication #212, *2001-2002 Recommendations* of the California Law Revision Commission, March 2002)
3. S.B. No. 1276, 1995-1996 Reg. Sess. (Cal. 1995) (*Orange County—Bankruptcy Adjustment Plan—Trustee Appointed by Governor*) (enacted at Cal. Gov't Code §§ 30400 *et seq.*)