FEBRUARY 2011

EXECUTIVE SUMMARY

**BUSINESS LAW
AND GOVERNANCE
PRACTICE GROUP**

Overview of the Chapter 9 Bankruptcy Process and Specific Issues With Public Hospital Filings

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Chapter 9 of the Bankruptcy Code, entitled *Adjustment of Debts of a Municipality*, provides financially distressed public hospitals (and other "municipalities") with an avenue under federal law to obtain protection from creditors while formulating and negotiating a plan for the adjustment of debts.[1] This article explores the legal issues involved in municipal bankruptcies under Chapter 9 of the Bankruptcy Code, 11 U.S.C. §§ 901–946, and focuses specifically on how these issues are addressed in a bankruptcy case commenced by a public hospital. In Section I, the co-authors identify certain unique aspects of Chapter 9, and compare and contrast municipal bankruptcy proceedings under Chapter 9 with bankruptcy reorganizations under Chapter 11 and bankruptcy liquidations under Chapter 7. The unique aspects of Chapter 9 include Constitutional limitations on the bankruptcy court's authority, the requirement for express state authorization to commence a Chapter 9 case, and the broad powers of a Chapter 9 debtor. In Section II, the co-authors identify and discuss certain matters that often arise in Chapter 9 bankruptcy cases commenced by public hospitals. These matters include the preservation of prepetition bondholder liens on the hospital's post-filing revenues, the subordination of such post-filing liens to the hospital's necessary

[1] *See*, *e.g.*, *In re Addison Community Hosp. Auth.*, 175 B.R. 646, 648-49 (Bankr. E.D. Mich. 1994) (noting that the "general policy considerations underlying the municipal debt adjustment plan of chapter 9 are the same as that of chapter 11 reorganization: to give the debtor a breathing spell from debt collection efforts and establish a repayment plan with creditors.").

operating expenses, and the relative ease by which a municipal hospital debtor can reject burdensome labor contracts.

The Chapter 9 Bankruptcy Process

In the following sections, we discuss some of the salient similarities and differences between Chapter 9 bankruptcies, on the one hand, and Chapter 7 liquidations and Chapter 11 reorganizations, on the other.

Assignment of the Bankruptcy Case

One distinction between Chapter 9 cases and those filed under Chapter 7 or Chapter 11 is the process by which the case is assigned to a bankruptcy judge following the filing of a Chapter 9 petition. In a Chapter 7 or Chapter 11 case, the clerk of court automatically assigns the case to a particular bankruptcy judge. However, in a Chapter 9 case, Bankruptcy Code section 921(b) requires that "[t]he chief judge of the court of appeals for the circuit embracing the district in which the case is commenced [to designate] the bankruptcy judge to conduct the case."[2]

Eligibility Under Chapter 9

Once a bankruptcy judge has been assigned to the case, the municipality must prove that it is eligibility to be a debtor under Chapter 9. There are very few eligibility requirements for being a debtor in a Chapter 7 liquidation or a Chapter 11 reorganization. For example, a debtor corporation or partnership may avail itself to relief under Chapter 7 or Chapter 11 without demonstrating that it is insolvent or that it has attempted to negotiate with its creditors. Moreover, the unsecured creditors of a for-profit corporation or partnership may commence an involuntary bankruptcy case against a debtor under Chapter 7 or Chapter 11.[3] In contrast, a municipality that files a petition for relief under Chapter 9 must satisfy more onerous eligibility criteria, and the Bankruptcy Code does not permit creditors to commence an involuntary bankruptcy case against a municipal debtor.[4] As noted by one commentator:

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[2] 11 U.S.C. § 921(b).
[3] 11 U.S.C. § 303.
[4] 11 U.S.C. § 109(c).

> A municipality must satisfy more prerequisites in order to file a Chapter 9 petition than any other person or entity under the Bankruptcy Code. *Strong policy considerations against municipal filings led to creation of the hurdles that a municipality must comply with prior to being eligible for Chapter 9 relief*.[5]

To be a debtor under Chapter 9, an entity must satisfy the eligibility criteria set forth in Bankruptcy Code section 109(c). The putative debtor bears the burden of proving to the bankruptcy court that it meets these requirements.[6] Collectively, the requirements under Section 109(c) can be fact-intensive and may require the municipality to establish its compliance by a preponderance of the evidence.[7] Consequently, if a Chapter 9 filing is contested, the bankruptcy court may need to preside over a lengthy discovery period and evidentiary hearing. If the entity demonstrates that it is eligible to be a debtor under Chapter 9, then the bankruptcy court will enter an order for relief allowing the case to proceed.[8]

Under Section 109(c), an entity is eligible to be a debtor under Chapter 9 if and only if such entity –

> 1. is a "municipality;"
>
> 2. is "specifically authorized" to be a Chapter 9 debtor under state law or by a duly-authorized state official;
>
> 3. is "insolvent;"
>
> 4. desires to effect a plan to adjust its debts; and
>
> 5. either: (a) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan of adjustment; (b) has negotiated in good faith with creditors but has failed to obtain its creditor's consent; (c) is unable to negotiate with creditors because

[5] *See* NATIONAL BANKRUPTCY REVIEW COMMISSION, *Bankruptcy: The Next Twenty Years* (October 20, 1997) (emphasis added).
[6] *See In re Valley Health Sys.*, 383 B.R. 156, 161 (Bankr. C.D. Cal. 2008).
[7] *See In re Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. 60, 72 (Bankr. D.N.H. 1994); *In re Green County Hosp.*, 59 B.R. 388 (Bankr. S.D. Miss. 1986).
[8] 11 U.S.C. § 921(d).

such negotiation is "impracticable;" or (d) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable as a preference under Bankruptcy Code section 547.

Each of these requirements is discussed in greater detail below.

The Putative Debtor Must Be a Municipality

The first eligibility requirement states that the putative debtor must be a "municipality."[9] The term municipality is defined under the Bankruptcy Code as a "political subdivision or public agency or instrumentality of a State."[10] The Bankruptcy Code does not define the terms "political subdivision," "public agency," or "instrumentality of a state," but the legislative history of Chapter 9 reveals that Congress intended the definition of municipality to be interpreted broadly.[11] Hence, a "political subdivision" generally includes cities, counties, townships and the like, and "public agency" and "instrumentality of a State" generally include hospital districts, school districts, public finance authorities, public improvement districts, and other revenue-producing bodies that are sponsored or controlled by the state.[12] Notably, states themselves are not eligible for relief under Chapter 9 or any other chapter of the Bankruptcy Code.

The Municipality Must Be Specifically Authorized to Be a Debtor

Second, the municipality must be specifically authorized, either by state law or by a government officer or organization empowered by state law, to be a debtor under Chapter 9.[13] General authorization to file is insufficient, and courts may not infer that authorization exists. Rather, the specific authorization to file provided by state law must be "exact, plain, and direct with well-defined limits so that nothing is left to inference or implication."[14] Approximately one half of the states provide specific authorization to their

[9] 11 U.S.C. § 109(c)(1).
[10] 11 U.S.C. § 101(40).
[11] H.R. REP. NO. 686, 94th Cong., 1st Sess. 19-20 (1976).
[12] *See, e.g., Greene County Hosp.*, 59 B.R. at 389; *In re Pierce County Housing Auth.*, 414 B.R. 702, 710 (Bankr. W.D. Wash. 2009); *In re Westport Transit Auth.*, 165 B.R. 93, 95–96 (Bankr. D. Conn. 1994); *In re Ellicott School Building Auth.*, 150 B.R. 261, 264 (Bankr. D. Colo. 1992).
[13] 11 U.S.C. § 109(c)(2).
[14] *Sullivan County Reg'l Refuse Disposal Dist.*, 165 B.R. at 73.

municipalities to become Chapter 9 debtors, while the remainder of the states either offer little guidance on authorization or explicitly prohibit access to bankruptcy relief.[15]

The Municipality Must Be Insolvent

Third, the municipality must demonstrate that it is "insolvent."[16] For bankruptcy purposes, a municipality is insolvent if: (1) it is generally not paying its debts as they become due, unless such debts are the subject of a *bona fide* dispute; or (2) it is unable to pay its debts as they become due.[17] These insolvency tests are different from the more traditional balance sheet insolvency test. The first insolvency test is satisfied if the municipal debtor demonstrates that it, in fact, is not paying its debts as they become due.[18] The second test typically involves a prospective analysis of whether the municipality expects to have sufficient cash flow to meet its budgeted expenses as due.[19] Under both tests, insolvency is determined as of the petition date.[20]

The Municipality Must Desire to Effect a Plan of Adjustment

Fourth, the municipality must "desire to effect a plan to adjust [its] debts."[21] In essence, this requirement tests whether the debtor filed for Chapter 9 relief in good faith. A municipality may not commence a bankruptcy case merely to delay its payment obligations to creditors.[22] Rather, to satisfy this eligibility requirement, the municipality must demonstrate that it filed the Chapter 9 petition with the good-faith intention of consummating a plan to restructure its debts.

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[15] California is currently contemplating legislation that would sharply curtail access to Chapter 9. For example, the California state senate has advanced Assembly Bill 155, which would require municipalities to satisfy a number of separate requirements before being eligible to be a Chapter 9 debtor under the Bankruptcy Code. As of the date hereof, the California legislature has not approved Assembly Bill 155 or any variation thereof. *See, e.g.*, www.mercurynews.com/opinion/ci_15882290?nclick_check=1.
[16] 11 U.S.C. § 109(c)(3).
[17] 11 U.S.C. § 101(32)(C).
[18] *See In re Town of Westlake, Texas*, 211 B.R. 860, 864 (Bankr. N.D. Tex. 1997).
[19] *See In re Hamilton Creek Metropolitan Dist.*, 143 F.3d 1381, 1385 (10th Cir. 1998), *In re City of Bridgeport*, 129 B.R. 332, 338 (Bankr. D. Conn. 1991).
[20] *See In re Slocum Lake Drainage Dist. of Lake Cty.*, 336 B.R. 387, 391 (Bankr. N.D. Ill. 2006).
[21] 11 U.S.C. § 109(c)(4).
[22] *See Sullivan Cty. Reg'l Refuse Disposal District*, 165 B.R. at 80-81.

The Municipality Must Demonstrate Proof of Negotiations

The final eligibility requirement under Bankruptcy Code section 109(c)(5) is intended to promote pre-petition negotiations between a municipality and its creditors with respect to a plan of adjustment.[23] To satisfy the requirement, the municipality must demonstrate that either: (1) it obtained pre-bankruptcy approval of its plan of adjustment by a majority of the creditors whose claims are to be impaired under the plan; (2) it negotiated in good faith with its creditors but was unable to obtain pre-bankruptcy approval of its plan of adjustment; (3) it did not negotiate with its creditors because such negotiations were "impracticable"; or (4) it did not negotiate because it reasonably believed that a creditor may attempt to obtain a preferential payment or transfer of assets from the municipality.[24] Although the requirement was intended to promote pre-filing negotiations between municipalities and their creditors, in practice, municipalities have been able to satisfy the requirement without such negotiations.[25]

The Automatic Stay

As with a case under Chapter 7 or Chapter 11, the automatic stay of Bankruptcy Code Section 362 is applicable in Chapter 9 cases.[26] With certain enumerated exceptions, the automatic stay operates to stop all collection actions against the debtor and its property upon the filing of the Chapter 9 petition.[27] The scope of the stay is broader under Chapter 9, however, because it also prohibits actions against officers of the municipal debtor if the actions seek to enforce a claim against the debtor.[28] For

[23] *See In re Cottonwood Water and Sanitation Dist.*, 138 B.R. 973, 979 (Bankr. D. Colo. 1992) ("The 'creditor protection' provided by section 109(c)(5) . . . insures that creditors have an opportunity to negotiation concerning a plan on a level playing field with the debtor before their rights are further impaired by the provisions of section 362 of the Code.").
[24] 11 U.S.C. § 109(c)(5).
[25] *See Valley Health Sys.*, 383 B.R. at 164 (negotiations may be "impracticable" if "infeasible" or "incapable of being performed or accomplished by the means employed.").
[26] *See* 11 U.S.C. §§ 362(a) & 901(a).
[27] Moreover, as in Chapter 11 cases, secured creditors who are harmed by the automatic stay may be entitled to "adequate protection" in the form of cash payments or other consideration that protects the value of the creditor's lien on property used by the municipal debtor. *See, e.g.*, 11 U.S.C. §§ 361 & 363(e).
[28] *See* 11 U.S.C. § 922(a).

example, this stay would enjoin a creditor from bringing a mandamus action against an officer of the municipal debtor on account of a prepetition debt.

Limited Authority of the Bankruptcy Court

Chapter 9 was designed by Congress to provide a mechanism under which a financially distressed municipality may obtain bankruptcy relief without violating the Tenth Amendment of the U.S. Constitution.[29] The Tenth Amendment is implicated when a federal law potentially interferes with a state's right to govern the affairs of its municipalities. Thus, unlike a Chapter 7 or Chapter 11, Chapter 9 places severe limitations on the authority of the bankruptcy court over the municipal debtor's assets and operations. These limitations are designed to ensure that the bankruptcy court does not substitute its decisions over political or governmental affairs, or property of the debtor for the decisions of the state or the municipality's elected representatives.

The protection of state sovereignty and the limitations on the bankruptcy court's authority are expressed under Bankruptcy Code Sections 903 and 904. Section 903 states that Chapter 9 "does 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 the municipality, including expenditures for such exercise."[30] However, because bankruptcy laws are the exclusive domain of the federal government, a state law that prescribes a method of composition of municipal debt does not bind a non-consenting creditor, and any judgment entered under such state law does not bind a non-consenting creditor.[31]

Similarly, under Bankruptcy Code Section 904, bankruptcy courts are not permitted to "interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any

[29] *See* H.R. REP. NO. 95-595, 95th Cong., 1st Sess. 262-264 (1977) ("This bill takes . . . care to insure that there is no interference in the political or governmental functions . . . of the State in its power to control its municipalities).
[30] 11 U.S.C. § 903.
[31] *See id*.

income-producing property."[32] As a result, a municipal debtor has the discretion and authority to, among other things, obtain financing and hire restructuring professionals without bankruptcy court approval. In a Chapter 7 or Chapter 11 proceeding, a non-municipal debtor would need such approval.

In effect, the powers of the bankruptcy court in a Chapter 9 case are limited to: (1) determinations of eligibility under Section 109(c); (2) approving the debtor's assumption or rejection of executory contracts and unexpired leases (including collective bargaining agreements); (3) confirming or denying confirmation of the debtor's plan of adjustment; and (4) dismissing the bankruptcy case under certain circumstances.

Powers of a Municipal Debtor

Not only does Chapter 9 restrict a bankruptcy court's authority over a municipal debtor, it also confers broad powers upon the debtor. For example, bankruptcy court approval generally is not required for a municipal debtor to pay its prepetition vendors and suppliers, sell its properties, or conduct other transactions outside of the ordinary course of business, obtain new secured or unsecured financing, or pay its attorneys and professional advisors. Moreover, like debtors under Chapter 11, a municipal debtor has the power to "avoid" (i.e., recover) pre-bankruptcy preferential transfers and fraudulent conveyances.

Role of Creditors

The role of creditors in a Chapter 9 case is more limited than in a case under Chapter 7 or Chapter 11. For example, creditors may not file an involuntary Chapter 9 petition against a municipality or propose a competing plan of adjustment for the municipality. Chapter 9 does provide for the appointment of a creditors' committee, and the committee has powers and duties that are similar to those of a committee appointed in a Chapter 11 case.[33] These powers and duties include: (1) selecting and engaging

[32] 11 U.S.C. § 904.
[33] *See* 11 U.S.C. 11 U.S.C. §§ 901(a) & 1103.

professionals; (2) consulting with the debtor concerning administration of the case; and (3) participating in the formulation of a plan.

Confirmation of a Plan of Adjustment

The primary purpose of Chapter 9 is to allow a municipality to confirm a plan of debt adjustment. A Chapter 9 plan of adjustment is similar to a Chapter 11 plan of reorganization in that both plans seek to replace the debtor's pre-bankruptcy debts and obligations with new contractual rights and considerations. Generally speaking, the adjustment of long-term debts under Chapter 9 may take the form of an extension of maturity, a reduction of interest or principal, or a refinancing,[34] and is implemented through a court-approved plan of adjustment (the Chapter 9 analogue to a Chapter 11 plan of reorganization).[35]

A plan under Chapter 9 or Chapter 11 is not effective unless it is "confirmed" (i.e., approved) by creditors and the bankruptcy court. In order to confirm a Chapter 9 plan of adjustment, a municipal debtor must satisfy a combination of statutory requirements set forth in Bankruptcy Code section 943(b) and certain provisions of Bankruptcy Code Section 1129.[36] Section 943(b) lists the following seven requirements for confirmation:

> 1. the plan complies with those provisions of the Bankruptcy Code made applicable by Bankruptcy Code section 103(e) and 901;
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> 2. the plan complies with the provisions of Chapter 9;
>
> 3. all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
>
> 4. the debtor is not prohibited by otherwise applicable non-bankruptcy law from taking any action necessary to carry out the plan;
>
> 5. the plan provides for the payment of administrative expenses under Bankruptcy Code section 507(a)(1);

[34] *See*, *e.g.*, *In re Sanitary & Improvement Dist*., 98 B.R. 970, 974 (Bankr. D. Neb. 1989) (holding that a municipal debtor may pay bonds at less than face amount under a plan for adjustment, despite contrary state law).
[35] *See generally* 11 U.S.C. §§ 943 & 944.
[36] 11 U.S.C. §§ 901(a) & 1129. Section 1129 sets for the confirmation requirements for a Chapter 11 plan.

6. any regulatory or electoral approval necessary to consummate the plan has been obtained, or such provision is expressly conditioned on such approval; and

7. the plan is in the best interests of creditors and is feasible.[37]

Much like in the Chapter 11 process, creditors who hold impaired claims are entitled to vote to accept or reject the plan. In essence, a claim is impaired under a Chapter 9 if the legal, equitable, or contractual rights of the holder of such claim are to be altered in any way (e.g., maturity will be extended) under the plan.[38] If the requisite votes are received in favor of the plan and it determines that all other Bankruptcy Code requirements have been satisfied, the bankruptcy court will confirm the plan.[39] In addition, like Chapter 11, Chapter 9 provides a mechanism for a municipal debtor to "cram-down" a plan of adjustment on non-consenting creditor classes so long as at least one impaired class of creditors votes to confirm the plan.[40]

Upon confirmation, a municipal debtor and all of its creditors, including those that voted to reject the plan, are bound by the terms of the plan of adjustment. Confirmation also discharges all of the debtor's debts except those retained under the plan and those owed to creditors who had no prior notice or actual knowledge of the case. Unlike Chapter 11, however, the scope of the Chapter 9 discharge is not entirely clear.[41] The discharge is likely limited to pre-petition debts and does not include debts arising during the Chapter 9 case, but the Bankruptcy Code is ambiguous on this issue.

Particular Issues in a Chapter 9 Bankruptcy Filed by a Public Hospital

A hospital or other healthcare provider that is established under a state enabling statute or is otherwise owned, operated, or controlled by a city, county, or state constitutes a "municipality" for the purposes of Chapter 9. A number of public hospitals and hospital

[37] *See* 11 U.S.C. § 943(b).
[38] *See* 11 U.S.C. § 1124 (made applicable in chapter 9 proceedings by 11 U.S.C. § 901(a)).
[39] *See* 11 U.S.C. § 943(b).
[40] *See* 11 U.S.C. § 1129(b) (made applicable in chapter 9 proceedings by 11 U.S.C. § 901(a)).
[41] Bankruptcy Code Section 1141(d) generally provides that the confirmation of a plan discharges all debts incurred prior to confirmation.

systems have filed Chapter 9 petitions over the past five years, including –

- Valley Health System in Hemet, CA;[42]
- Natchez Regional Medical Center in Natchez, MS;[43]
- Sierra Kings Health Care District (d/b/a Sierra Kings District Hospital) in Reedley, CA;[44]
- Lost Rivers District Hospital in Arco, ID;[45]
- Palm Drive Health Care District in Sebastopol, CA;[46] and
- West Contra Costa Healthcare District (d/b/a Doctors Medical Center) in San Pablo, CA[47]

In bankruptcy cases filed by public hospitals, certain unique aspects of Chapter 9 are particularly important given the commonality of public financing structures (i.e., municipal bond issues secured by pledges of hospital revenues) and prevalence of organized labor concerns. As discussed below, the Chapter 9 process provides additional protections for the holders of municipal revenue bonds issued by or on behalf of the municipal debtor. In addition, the process by which a municipal debtor may reject its collective bargaining agreements (CBA) generally is easier in Chapter 9 than in Chapter 11.

Preservation of Liens in Special Revenues

Public hospitals often issue tax-exempt municipal bonds, or borrow the proceeds of an issue of such bonds, to finance significant capital construction projects. Unlike general obligation bonds, revenue bonds are typically payable from and secured only by the

[42] Case No. 07-18293 (Bankr. C.D. Cal.), which was filed on December 13, 2007, and remains pending before the California bankruptcy court.
[43] Case No. 09-00477 (Bankr. S.D. Miss.), which was filed on February 2, 2009, and was closed on June 16, 2009.
[44] Case No. 09-19728 (Bankr. E.D. Cal.), which was filed on October 8, 2009, and remains pending.
[45] Case No. 10-40344 (Bankr. D. Idaho), which was filed on March 10, 2010, and remains pending.
[46] Case No. 07-10388 (Bankr. N.D. Cal.), which was filed on April 5, 2007, and remains pending.
[47] Case No. 06-41774 (Bankr. N.D. Cal.), which was filed on October 1, 2006, and soon will be closed.

gross revenues or net revenues generated by the bond-financed property. One of the key features of Chapter 9 is that it protects the indenture trustees' and bondholders' liens upon and payment rights associated with such project revenues, referred to under the Bankruptcy Code as "special revenues."

In a Chapter 11 case, pursuant to Bankruptcy Code Section 552(a), property acquired by the debtor after the commencement of the case is not be subject to any lien granted by the debtor under a security agreement entered into before the commencement of the case. Consequently, in a Chapter 11 reorganization, the trustees' or bondholders' prepetition lien on hospital revenues does not attach to revenues that are earned by the debtor after the bankruptcy case commences. In a Chapter 9 case, however, the special revenues acquired by the municipal debtor after commencement of the bankruptcy case will continue to be subject to the prepetition pledge, pursuant to Bankruptcy Code Section 928(a). Specifically, Section 928(a) states that:

> [n]otwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.[48]

By continuing the indenture trustees' or bondholders' prepetition liens on postpetition special revenues earned by the public hospital, Chapter 9 provides a great benefit to secured bondholders. Most notably, the continuing lien on special revenues makes it very difficult for a public hospital debtor to achieve confirmation of its plan of adjustment by "cram down" over the objections of the secured bondholder class. Consequently, a municipal debtor often has to negotiate with and make significant concessions to its bondholders in order to obtain confirmation of its Chapter 9 plan of adjustment.

[48] 11 U.S.C. § 928(a).

While Section 928(a) inures to the benefit of bondholders by preserving the prepetition liens on the public hospital's post-petition special revenues, Section 928(b) subordinates the lien on special revenues to the debtor's "necessary operating expenses," effectively transforming a gross revenue pledge into a net revenue pledge. Section 928(b) provides as follows:

> Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system shall be subject to the necessary operating expenses of such project or system, as the case may be.[49]

The term "necessary operating expenses" is not defined under the Bankruptcy Code, but the legislative history of Chapter 9 suggests that it is intended to be limited in scope:

> Necessary operating expenses are operating expenses which are necessary to keep the project or system going and producing special income . . . 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 non-bankruptcy law. The operating expenses are to be necessary and directly related to the project or system generating the special revenues and are not the expenses of the public medical facility generally or for other systems or projects.[50]

A public debt holder or other secured creditor who opposes the municipal hospital's use of pledged revenues may need to seek adequate protection to ensure that its collateral interests in such special revenues remains protected. Generally, a secured creditor is entitled to adequate protection when a debtor proposes to use, sell, or lease property in which it has an interest.[51] Adequate protection affords a secured creditor protection from the depreciation, deterioration, or diminution in the value of its collateral as of the date

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[49] 11 U.S.C. § 928(b).
[50] Pub. L. 100-597.
[51] *See* 11 U.S.C. §§ 361 & 363(e); *see also In re of Continental Airlines, Inc.*, 146 B.R. 536, 539 (Bankr. D. Del. 1992); *Metromedia Fiber Network Servs v. Lexent, Inc.* (*In re Metromedia Fiber Network, Inc.*), 290 B.R. 487, 491 (Bankr. S.D.N.Y. 2003) ("Section 363(e) is not permissive or discretionary– it states that the court 'shall' grant the relief specified, at any time, on the request of secured entity.").

that the bankruptcy petition is filed.[52] In doing so, adequate protection maintains the status quo between the petition date and the date a plan is confirmed or the underlying claim is otherwise satisfied.[53] By preserving the status quo, adequate protection ensures that the secured creditor's rights and interests are not prejudiced during the pendency of the bankruptcy case.[54]

The fight over the use of special revenues, and whether such use by the municipal debtor is appropriate, can be a key battle during the early part of a Chapter 9 filing. Bondholders or other secured creditors contesting a municipality's filing are likely to argue for a narrow interpretation of "necessary operating expenses," and claim that bankruptcy-related and non-operational expenses, like legal and professional fees, are not subject to this carve-out. On the other hand, municipal debtors will likely promote a broad-reading of the "necessary operating expenses." Without such a broad reading, the municipal debtor may be unable to fund its Chapter 9 case.[55]

The Limitations of the Automatic Stay With Respect to the Pledge of Special Revenues

In a typical Chapter 11 case, a secured bondholder or indenture trustee is unable to access its collateral because of the automatic stay. Chapter 9, however, includes an important exception to the automatic stay. Pursuant to Bankruptcy Code Section 922(d), the filing of a Chapter 9 petition does not stay the application of the "special revenues" pledged by the public hospital to payment of its bond indebtedness.[56] Accordingly, an indenture trustee may continue to apply pledged funds to principal and interest

[52] *See* 11 U.S.C. § 361(1); *Travelers Life Insurance and Annuity Co. v. Ritz-Carlton of D.C., Inc. (In re Ritz-Carlton of D.C. Inc.),* 98 B.R. 170, 173 (S.D.N.Y. 1989) ("The general rule is that for adequate protection purposes a secured creditor's position as of the petition date is entitled to adequate protection"); *see also Confederation Life Ins. Co. v. Beau Rivage Ltd,.* 126 R.B. 632, 639 (N.D. Ga. 1991): *In re 354 East 66th Street Realty Corp.*, 177 B.R. 776, 781 (Bankr. E.D.N.Y. 1995).
[53] *See In re 354 East 66th Street*, 177 B.R. at 781.
[54] *See United States v. Smithfield Estates, Inc.* (*In re Smithfield Estates, Inc*.), 48 B.R. 910, 914 (Bankr. D. R.I. 1985); *In re Roe Excavating*, 52 B.R. 439, 440 (Bankr. S.D. Ohio 1984).
[55] A similar battleground will often arise in an operating Chapter 11 bankruptcy case, where the secured creditor will attempt to limit the debtor's use of the secured creditor's cash collateral.
[56] *See* 11 U.S.C. § 922(d).

payments as they become due or distribute the pledged funds to bondholders without violating the automatic stay.

"Special revenues" are defined in Bankruptcy Code section 902(2) as follows:

> (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;
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> (B) special excise taxes imposed on particular activities or transactions;
>
> (C) incremental tax receipts from the benefited area in the case of tax-increment financing;
>
> (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or
>
> (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor . . . [57]

In many cases, payments and revenues associated with the public financing will fall within this definition. As such, these payments and revenues may be available to pay debt service during the pending Chapter 9 case, subject to the qualification on payment of operating expense. Thus, depending on the security it provided to its debt holders, a public medical facility may have less leverage in a Chapter 9 case to threaten nonpayment of debt service to gain concessions from its secured public debt holders.

Rejection of Collective Bargaining Agreements

CBAs often represent a significant contractual impediment to orchestrating a hospital workout. Indeed, a public bondholder or other secured creditor may be unwilling to restructure its debt obligations if it knows that the public hospital will continue to be bound under unfavorable CBAs with its labor unions.

[57] 11 U.S.C. § 902(2).

Generally speaking, the Bankruptcy Code allows a debtor to assume or reject any "executory contract."[58] The rationale behind this policy is to further the debtor's rehabilitation by allowing it to be insulated from the obligations and liabilities of a burdensome contract, while, at the same time, being able to take full advantage of contracts that are favorable to the debtor's estate.[59] In its simplest form, an executory contract is an agreement where performance remains due to some meaningful extent on both sides.[60] In other words, a contract will only be deemed executory if "material future performance obligations remain on both sides" of the contract.[61]

In most cases, a CBA between a debtor and a labor union would be classified as an executory contract.[62] In the U.S. Supreme Court's bankruptcy decision, *Bildisco*, the court held that CBAs were executory contracts that could be rejected under Bankruptcy Code Section 365, although at a standard different than that applicable to commercial contracts.[63] The court also ruled that, upon the filing of the bankruptcy petition and prior to court-approved rejection, the CBA was not considered an enforceable contract.[64] As a consequence, a debtor would not commit an unfair labor practice by unilaterally modifying a CBA upon the filing of the bankruptcy petition.[65]

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[58] *See* 11 U.S.C. § 365.
[59] *See Orion Pictures Corp. v. Showtime Networks, Inc. (In re Orion Pictures Corp.)*, 4 F.3d 1095, 1098 (2d Cir. 1993).
[60] More specifically, bankruptcy courts have by and large adopted Professor Vern Countryman's definition of an executory contract as a contract "under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach, excusing performance of the other." *See* Vern Countryman, EXECUTORY CONTRACTS IN BANKRUPTCY, 57 MINN.L.REV. 439, 460 (1973); *see also Sharon Steel Corp. v. National Fuel Gas Dist. Corp.*, 872 F.2d 36, 39 (3rd Cir. 1989).
[61] *See Shoppers World Community Center v. Bradlees Stores, Inc. (In re Bradlees Stores, Inc.)*, 2001 U.S. Dist. Lexis 14755 (S.D.N.Y. 2001) (supporting citations omitted).
[62] *See, e.g., NLRB v. Bildisco & Bildisco*, 465 U.S. 513 (1984).
[63] *See Bildisco*, 465 U.S. at 526 (rejection may be authorized where the "debtor can show that the collective bargaining agreement burdens the estate, and that, after careful scrutiny, the equities balance in favor of rejection of the labor contract.").
[64] *Id.* at 532.
[65] *Id*. Section 1113, on the other hand, establishes that a collective bargaining agreement remains in effect upon the filing of a bankruptcy petition and requires an expedited form of collective bargaining prior to seeking rejection.

Subsequent to *Bildisco*, Congress enacted Bankruptcy Code section 1113, which, in a Chapter 11 bankruptcy case, subjected the ability of a debtor to reject its existing CBAs to several procedural and substantive prerequisites.[66] Bankruptcy Code Section 1113 includes a nine-step process by which a Chapter 11 debtor can reject a CBA.[67] This nine-step process significantly increases the complexity and time involved in seeking a CBA, and makes it more difficult for a debtor to reject a CBA.

Section 1113, however, is not applicable under Chapter 9. In a Chapter 9 case, a public hospital debtor may be entitled to reject CBAs under the more-favorable standards established by the U.S. Supreme Court in *Bildisco*. [68] While the heightened requirements of Bankruptcy Code Section 1113 will not apply in a Chapter 9 proceeding, a municipal debtor may not be able to reject a labor contract in a Chapter 9 proceeding unilaterally. For example, in the *County of Orange* (California) bankruptcy case, the bankruptcy court held that the *Bildisco* decision applies in Chapter 9 in the absence of Congressional action to incorporate Section 1113, but then ruled that the county could not unilaterally modify the seniority and grievance provisions of its CBA.[69] Drawing on state law standards applicable to financial emergencies, the court held that unilateral modification of contractual rights under a CBA must be viewed as "a last resort" and required the two sides to "meet and confer and attempt to resolve their differences."[70]

These same issues were recently addressed by the Bankruptcy Court for the Eastern District of California in the *City of Vallejo* bankruptcy case.[71] In that case, the city sought to reject certain CBAs in conjunction with its Chapter 9 filing. In opposition, the unions cited to certain California statutes and case law that limited a municipalities' rights in

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[66] *See* 11 U.S.C. § 1113.
[67] *See id., See also In re American Provision Co.*, 44 B.R. 907 (Bankr. D. Minn. 1984).
[68] *See Orange County Employees Association, v. County of Orange*, 179 B.R.177, (Bankr. C.D. Cal. 1995).
[69] *Orange County Employees Association, v. County of Orange*, 179 B.R.177, 183 (Bankr. C.D. Cal. 1995).
[70] *Id*.
[71] *See In re City of Vallejo*, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).

avoiding its contractual obligations under a CBA. The unions argued that such laws needed to be applied to the city's efforts in its Chapter 9 case. The *Vallejo* court concluded that the Bankruptcy Code preempted the California statutes with respect to the rejection of the CBAs. The court also determined that it could reject the unexpired CBAs under Bankruptcy Code Section 365 if the city showed: (1) the CBAs in question burden the public medical facility's ability to reorganize; (2) after careful scrutiny, the equities balance in favor of contract rejection; and (3) the municipal debtor made reasonable efforts to negotiate a voluntary modification, and continued negotiation was not likely to produce a prompt and satisfactory solution.[72] This standard is much easier to meet than the heightened standard to reject a CBA under Bankruptcy Code Section 1113 in a Chapter 11 proceeding.[73]

A public hospital could utilize these more-expansive provisions to negotiate more-favorable labor agreements or reject an existing CBA in conjunction with a Chapter 9 filing. Given the heavy unionization of many public hospitals and the decreased funding received by them from traditional payors (i.e., the U.S. government, insurance companies, etc.), a Chapter 9 filing (or the threat of such a filing) could provide a public hospital with additional leverage in its union negotiations. Consequently, if all parties realize that failure to modify extant CBAs will likely land the public medical facility in bankruptcy court, all parties may be willing to negotiate in good faith toward a consensual, out-of-bankruptcy modification of burdensome agreements.

Conclusion

Chapter 9 of the Bankruptcy Code provides the only means under federal law by which a public hospital or other municipality can restructure or "adjust" its debts and free itself from burdensome contracts. If a financially distressed public hospital desires to adjust

[72] *See id*. at 78.

[73] Under Bankruptcy Code Section 1113, to reject a CBA: (1) a Chapter 11 debtor must make a proposal to modify the CBA that incorporates changes necessary to permit reorganization; (2) the proposal must be based on the most complete and reliable information available at the time; (3) the Chapter 11 debtor must provide to its union with such relevant information as is necessary to evaluate the proposal; (4) the Chapter 11 debtor must meet at reasonable times with the union between the time of making the proposal and the time of the hearing on rejection; and (5) at the meetings, the Chapter 11 debtor must confer in good faith in attempting to reach mutually satisfactory modifications of the CBA.

its debts in bankruptcy, it must first determine whether its state of domicile permits municipalities within the state to commence Chapter 9 proceedings. Assuming that the state has or will authorize the bankruptcy filing, the public hospital and its counsel must then weigh the benefits and burdens of Chapter 9 to decide whether the proceeding would be worthwhile. Health law attorneys who represent public hospitals or their creditors should be aware of the following unique benefits and burdens of Chapter 9:

Benefits

- Creditors cannot file an involuntary bankruptcy petition against the public hospital;
- Minimal judicial oversight of political decisions, governmental functions, and operational affairs;
- Subordination of gross revenue pledges to the payment of necessary operating expenses;
- Less-onerous standard for rejecting troublesome collective bargaining agreements; and
- Creditors cannot file a competing plan of adjustment

Burdens

- Stricter eligibility requirements;
- Continuation of indenture trustees' and bondholders' prepetition liens on postpetition special revenues;
- More difficult to cram down confirmation of a plan of adjustment over the objection of secured indenture trustees and bondholders; and
- Often lengthier and more expensive than Chapter 11 cases.

Overview of the Chapter 9 Bankruptcy Process and Specific Issues With Public Hospital Filings