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MUNICIPAL BANKRUPTCY UNDER THE 1976 AMENDMENTS TO CHAPTER IX OF THE BANKRUPTCY ACT

*Kenneth W. Bond**

I. Introduction

Chapter IX of the Bankruptcy Act¹ has recently been replaced² in an effort to provide an improved procedure for adjusting debts of a state's political subdivisions, public agencies and instrumentalities (hereinafter collectively referred to as "municipalities"). New Chapter IX serves the same function as did its predecessor; namely, to provide an insolvent municipality with a forum to meet with its creditors, under the control and supervision of a federal district court, in an effort to effect an adjustment of its financial matters pursuant to a plan which the court deems mutually advantageous to the interests of creditors and the municipality alike.³

Financially distressed municipalities did not frequently invoke Old Chapter IX. A review of relevant case law suggests that it was helpful primarily to small municipalities such as irrigation districts,⁴ water conservation districts,⁵ and county natural gas author-

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1. Act of August 16, 1937, ch. 657, 50 Stat. 653, as amended, Act of July 1, 1946, ch. 532, 60 Stat. 409 (formerly codified at 11 U.S.C. §§ 401-03 (1970) [hereinafter cited as Old Chapter IX].

2. Act of April 8, 1966, Pub. L. No. 94-260, 90 Stat. 315, [hereinafter cited as New Chapter IX].

3. H.R. REP. No. 207, 73 Cong., 1st Sess. (1933).

4. Indeed, the Depression-era plight of local improvement districts was a major impetus for the statute's enactment. In *United States v. Bekins*, 304 U.S. 27 (1938), the Supreme Court said that Chapter IX was intended:

To provide a remedy for a serious condition in which the states alone were unable to afford relief. Improvement districts . . . were in distress. Economic disaster had made it impossible for them to meet their obligations. As the owners of property within the boundaries of the district could not pay adequate assessments, the power of taxation was useless. The creditors of the district were helpless. The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the . . . impairment of contracts by state legislation. The bankruptcy power is competent to give relief to debtors in such a plight

Id. at 51-52. See also *Mason v. Lane*, 107 Cal. App. 2d 480, 237 P.2d 273 (3d Dist. 1951). The

ities.⁶ However, in recent years many municipalities, including major metropolitan centers, have been confronted with skyrocketing expenses,⁷ a declining tax revenue base and a resulting dependence on intergovernmental aid.⁸ As prospects for insolvency have grown,

Court held in *Bekins* that Chapter IX did not constitute an unconstitutional interference with state sovereignty. 304 U.S. at 53-54. Thereafter, troubled improvement districts frequently availed themselves of Chapter IX's remedy. *See, e.g.*, *Mason v. Paradise Irr. Dist.*, 326 U.S. 536 (1946); *Kiles v. Trinchera Irr. Dist.*, 136 F.2d 894 (10th Cir. 1943); *Nolander v. Butte Valley Irr. Dist.*, 132 F.2d 704 (9th Cir. 1942); *In re South Beardstown Drainage & Levee Dist.*, 125 F.2d 13 (7th Cir. 1941); *Fano v. Newport Heights Irr. Dist.*, 114 F.2d 654 (9th Cir. 1940); *In re Drainage Dist. No. 2*, 28 F. Supp. 84 (D. Idaho 1939); *In re Corcoran Irr. Dist.*, 27 F. Supp. 322 (D.C. Cal. 1939).

5. *See, e.g.*, *Buell v. City of Montague*, 190 F.2d 1019 (9th Cir. 1951).

6. *See, e.g.*, *Monzingo v. York County Natural Gas Auth.*, 352 F.2d 78 (4th Cir. 1965), *cert. denied*, 383 U.S. 970 (1966); *Ex parte Chester County Natural Gas Auth.*, 255 F.Supp. 495 (D.S.C. 1966).

7. Financial information regarding operating expenses, as disclosed in the Reports of Essential Facts (prospectuses) accompanying 1976 bond issues for several New York municipalities, indicates that such expenses have increased dramatically during the period from 1971 to 1975, inclusive. Table 1 indicates the rate of increase for selected New York municipalities.

Table 1

Operating Expenses for Selected New York
Municipalities, 1971 - 75

Municipality	Operating Expenses		Percentage Increase
	1971	1975	
County of Westchester	\$187,398,179	\$330,213,024	76.21
County of Erie ¹	283,476,000	364,477,000	28.57
City of Newburgh	6,026,655	8,325,030	38.12
City of Rochester ¹	145,393,000	184,855,000	27.14
Town of Ramapo ²	4,936,943	10,427,121	111.21
Town of Seneca Falls	285,410	362,184	26.90
Village of Great Neck Plaza	492,087	722,897	46.90
Village of Tarrytown ³	2,283,143	3,891,419	70.44

1) 1972-75.

2) 1970-74, town and special districts.

3) 1972-76, fiscal year ending May 31.

8. Financial information regarding real property tax revenues and state and federal aid, as disclosed in the Reports of Essential Facts (prospectuses) accompanying bond issues of several New York municipalities, indicates that state and federal aid have increased at a faster rate than real property tax revenues during the period from 1971 to 1975, inclusive.

it is evident that Old Chapter IX has been rendered archaic and incapable of providing an adequate remedy for municipal insolvencies. On some occasions creditors have resorted to mandamus proceedings in order to compel the payment of outstanding obligations.⁹

The notion of actually liquidating a large municipality in a bankruptcy proceeding would be inconceivable unless the state legislature first acted to repeal the municipality's charter, suspending its powers and reserving them to the state.¹⁰ Most states, by constitution or statute, provide that a municipality may tax its real property without limitation to meet debt service on its obligations.¹¹ But the

Furthermore, such aid constituted a larger percentage of total revenues for 1975 than for 1971, while real property taxes constituted a decreasing portion of total revenues. Table 2 gives examples from selected New York municipalities.

Table 2

State and Federal Aid and Real Property Taxes as a
Percentage of Total Revenues for Selected New York
Municipalities, 1971-75

- A. Percentage Increase in State and Federal Aid
- B. Percentage Increase in Real Property Taxes
- C. Portion of Total Revenues, State and Federal Aid
- D. Portion of Total Revenues, Real Property Taxes

Municipality	A		B		C		D	
	1971-75	1971-75	1971	1975	1971	1975	1971	1975
County of Westchester	43.23	35.68	51.51%	50.90%	38.40%	35.93%		
County of Erie ¹	36.05	(4.76)	43.68	49.02	33.92	26.65		
City of Newburgh	136.80	10.47	17.60	30.30	46.84	37.30		
City of Rochester ¹	4.78	29.33	21.58	17.27	40.61	40.11		
Town of Ramapo ²	152.44	131.51	8.00	12.88	57.98	62.78		
Town of Seneca Falls	73.19	3.08	26.09	34.68	66.66	51.27		
Village of Great Neck Plaza	170.36	91.42	4.51	6.79	27.27	29.07		
Village of Tarrytown ³	43.43	45.91	4.43	3.91	66.34	59.69		

- 1) 1972-75.
- 2) 1970-74, town and special districts.
- 3) 1972-75, fiscal year ending May 31.

9. See, e.g., *Van Dezree v. City of Long Beach*, 265 App. Div. 1059, 39 N.Y.S.2d 401 (2d Dep't 1943); see also *Touchton v. Fort Pierce*, 109 F.2d 370 (5th Cir. 1940).

10. *Meriwether v. Garrett*, 102 U.S. 472, 501 (1880).

11. See, e.g., N.Y. CONST. art. 13, §§ 5, 10; see also N.Y. LOCAL FIN. LAW § 100.00

dire economic effects of raising ad valorem taxes without limit constitute a practical limitation to the security behind the "full faith and credit" pledge of a municipality.¹²

Some states provide their own remedies for adjusting municipal debt,¹³ a procedure specifically permitted by both Old and New Chapters IX.¹⁴ However, any such composition of municipal debt is deemed not binding on nonconsenting creditors.¹⁵ In the absence of a federal statute, such creditors would be left with no remedy except a mandamus proceeding. Thus, New Chapter IX comes at a time when major municipalities may need it most.¹⁶ Its provisions retain the basic form and content of Old Chapter IX but add specific measures which facilitate the difficult process of guiding a municipality with a complex credit structure through orderly proceedings to adjust its debt.

(McKinney 1968), which provides: "Every municipality . . . shall pledge its faith and credit for the payment of all indebtedness contracted by it."

12. In *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942), the Supreme Court held that the full faith and credit pledge of a municipality at best makes its obligations unsecured claims. *Id.* at 509. *But see* N.Y. GEN. MUNIC. LAW § 7 (McKinney 1965), which required municipalities to levy and collect taxes on real property to meet debt service.

13. *See, e.g.*, N.Y. LOCAL FIN. LAW, § 85.00 (McKinney 1968); N.J.S.A., tit. 52, ch. 27 (1955).

14. Old Chapter IX, ch. 657, § 83(i), 50 Stat. 653, (1937), *as amended*, ch. 532, 60 Stat. 409 (1946); New Chapter IX, Pub. L. No. 94-260, § 83, 90 Stat. 317 (1976). The Supreme Court in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 508 (1942), held that although Chapter IX provided one means whereby the debts of a municipality might be adjusted, it did not deprive a state of the power to provide for similar proceedings of its own under state statutes which would be binding on creditors. The 1946 amendments to Old Chapter IX were intended to modify this ruling by exempting nonconsenting creditors from compliance with adjustments reached under state law.

15. Old Chapter IX, ch. 657, § 83(i), 50 Stat. 653 (1937), *as amended*, ch. 532, 60 Stat. 416 (1946). The policy behind the 1946 amendments was explained in S. REP. No. 1633, 79th Cong., 2d Sess. (1933):

State adjustment acts have been held to be valid, but a bankruptcy law under which bondholders of a municipality are required to surrender or cancel their obligations should be uniform throughout the . . . states, as the bonds of almost every municipality are widely held. Only under a Federal Law should a creditor be forced to accept such an adjustment without his consent.

Id.

16. The data contained in Tables 1 and 2 portray a clear trend toward increasing reliance on intergovernmental aid as a component of total operating revenues raised to meet increasing total operating expenses. *See* notes 7 and 8 *supra*. In particular, annual debt service on outstanding bonds and notes has increased dramatically during the period from 1971 to 1975, inclusive. Table 3 indicates the increase in debt service for selected New York municipalities.

II. The New Chapter IX Procedure

A. The Petition: Clearing the Way to Court.

The primary purpose of New Chapter IX is to enable a municipality to adjust or refinance the claims of its creditors without disrupting its ordinary administrative and governmental functions. The municipality initiates proceedings toward this end by filing its petition for bankruptcy in federal district court.¹⁷

Under Old Chapter IX, a municipality could not file a petition unless it had first prepared a plan of composition which had been accepted in writing by creditors owning at least 51 percent of the outstanding securities affected by the plan.¹⁸ New Chapter IX elimi-

Table 3

Annual Debt Service for Selected New
York Municipalities, 1971 - 75

Municipality	Annual Debt Service		Percentage Increase
	1971	1975	
County of Westchester	\$ 5,048,605	\$ 5,680,761	16.09
County of Erie ¹	9,347,000	18,343,000	96.24
City of Newburgh	281,980	390,123	38.65
City of Rochester ¹	19,794,000	30,973,000	56.48
Town of Ramapo ²	469,830	2,331,955	396.34
Town of Seneca Falls	61,316	71,007	15.81
Village of Great Neck Plaza	16,028	28,470	77.63
Village of Tarrytown ³	223,293	356,636	59.72

- 1) 1972-75.
- 2) 1970-74, town and special districts.
- 3) 1972-76, fiscal year ending May 31st.

Thus, should state or federal aid be suspended or terminated for any reason, a particular municipality may find itself unable to meet current operating expenses, including annual debt service payments, causing the threat of default and triggering a bankruptcy filing. If, for example the city of New York had defaulted in early December, 1975, it would have incurred a net operating deficit for the subsequent five months of 1.2 billion dollars—even had it suspended all payments for debt service. See H.R. REP. 94-686, 94th Cong., 2d Sess. 55 (1976).

17. New Chapter IX, Pub. L. No. 94-260, § 85(a), 90 Stat. 317 (1976). Also note that once the petition is filed, the case is assigned to a district judge of the circuit in which the district court is located. *Id.* § 82(d), 90 Stat. 316.

18. Old Chapter IX, ch. 657, § 83(a), 50 Stat. 653 (1937), as amended, ch. 523, 60 Stat. 410 (1946), required the petition to state:

nates this requirement.¹⁹ Thus, the streamlined procedure affords quicker relief from creditors' suits and set-off claims; upon the filing of the petition, an automatic stay forbids the commencement or continuation of any proceedings against the municipality, judicial or otherwise.²⁰

New Chapter IX imposes some new pre-filing requirements. First, the municipality must have specific authorization to file the petition, either from the state legislature or a properly empowered state officer.²¹ Second, the municipality must allege a good faith effort to negotiate a plan of adjustment with creditors holding at least fifty percent in amount of claims of each class affected by the plan.²² It must report whether the plan has been accepted or rejected by a majority of such creditors, that such negotiations are impractical, or that there is a "reasonable fear" that one creditor may seek to obtain a preference over the others.²³ These allegations go to the question of good faith. The drafters of New Chapter IX seemed to understand that in the weeks preceding the maturity of a series of bonds or notes, the municipality's financial officers, with the assistance of bond counsel, may engage in earnest efforts to arrange for refinancing of such obligations from banks and underwriters. When such efforts prove fruitless due to market conditions, it seems reasonable to allow the municipality to avail itself immediately of the bankruptcy court's stay of potential creditor actions.²⁴ Thus, abolition of the "51 percent rule" improves the accessibility and desirability of the bankruptcy route.

As in Old Chapter IX, the petitioning municipality must allege that it is insolvent or unable to meet its debts as they mature, and that it desires to effect a plan to adjust its debts.²⁵ (Cases decided

That a plan of composition has been prepared, is filed and submitted with the petition, and that creditors of the petitioner owning not less than 51 per centum in amount of the securities affected by the plan (excluding, however, any such securities owned, held, or controlled by the petitioner) have accepted it in writing.

19. New Chapter IX, Pub. L. No. 94-260, § 85(e)(1), 90 Stat. 317 (1976).

20. *Id.* See text accompanying notes 38-48 *infra*.

21. See New Chapter IX, Pub. L. No. 94-260, § 84, 90 Stat. 317 (1976); N.Y. LOCAL FIN. LAW, § 85.00 (McKinney 1968).

22. New Chapter IX, Pub. L. No. 94-260, § 84, 90 Stat. 317 (1976).

23. *Id.*

24. See text accompanying notes 38-48 *infra*.

25. New Chapter IX, Pub. L. No. 94-260, § 84, 90 Stat. 317 (1976); Old Chapter IX, ch. 657 § 83(a), 50 Stat. 654 (1937), as amended, ch. 532, 60 Stat. 416 (1946).

under Old Chapter IX suggest that "insolvency" and inability to meet debt service on obligations are synonymous, and that insolvency can arise from a reasonable anticipation of default prior to actual default.)²⁶ If the court finds that the petition was not filed in good faith (*i.e.*, the municipality was not truly insolvent or had no sincere desire to effect a plan), or was filed merely to evade creditors, it may dismiss the petition after hearing on notice.²⁷

New Chapter IX retains the implied provision that a municipality may come before the bankruptcy court only by voluntarily filing its own petition. Unlike Chapter X, creditors may not force a municipality into bankruptcy.²⁸ The municipality must file a list of its known creditors together with the petition or at some later time determined by the court.²⁹ Supplemental lists must be provided as unknown creditors become identified.³⁰ Old Chapter IX merely required that a list of creditors be filed together with the petition.³¹ The New Chapter IX provision and Rule 9-7 of the Bankruptcy Rules,³² recognize that many of the municipality's obligations may be held in bearer form, and that the holders of such obligations might not become identified for some time after the filing of the petition. Also, since claims of those creditors on the petitioner's list are allowed by the bankruptcy court (unless objection is raised), and since such creditors are entitled to notice throughout the proceedings,³³ it is vital to their interest that the list of creditors be periodi-

26. See, *e.g.*, *Newhouse v. Corcoran Irr. Dist.*, 114 F.2d 690 (9th Cir. 1940); *Lorber v. Vista Irr. Dist.*, 127 F.2d 628 (9th Cir. 1942).

27. New Chapter IX, Pub. L. No. 94-260, § 85(a), 90 Stat. 317 (1976).

28. In Chapter X, relating to corporate reorganizations, three or more creditors whose liquidated claims against the corporation amount in the aggregate to \$5000 or over may file a petition, thereby taking the debtor corporation into court against its will. 11 U.S.C. § 526 (1970).

29. New Chapter IX, Pub. L. No. 94-260, § 85(b), 90 Stat. 317 (1976).

30. BANKR. R. 9-9(b) provides:

A list of creditors or holders of record of title to real property filed pursuant to Rule 9-7 may be amended as a matter of course at any time before the expiration of the time fixed for filing claims pursuant to Rule 9-22. Thereafter, such a list may be amended only with leave of court on such notice as the court may direct. The court may, on application of any party in interest, or on its own initiative, order any list to be amended.

31. Old Chapter IX, ch. 657 § 83(a), 50 Stat. 653 (1937), *as amended*, ch. 532, 60 Stat. 410 (1946), required that the petitioner list all known creditors and their securities, and specify which creditors had accepted the plan of composition.

32. BANKR. R. 9-7.

33. New Chapter IX, Pub. L. No. 94-260, § 85(d), 90 Stat. 318 (1976).

cally updated, as new creditors may become identified.

When a large municipality files a petition, related or subordinate taxing and assessment jurisdictions within or adjacent to the municipality (*e.g.*, sewer districts, parking authorities, and the like) may also be affected. Accordingly, the governing body of such public entities, regardless of whether they are incorporated municipalities under state law, may also file a petition under New Chapter IX.³⁴ Such a procedure was included in Old Chapter IX,³⁵ however, the new statute provides for joint administration if any related municipalities file such a petition.³⁶ The advantages of joint administration are twofold. First, it should promote efficiency in effecting a plan of adjustment. Second, as the drafters of New Chapter IX pointed out, joint administration makes possible the consolidation of related municipalities' petitions, thus suggesting the possibility of multi-municipality debt adjustment on a metropolitan or regional basis.³⁷

B. Operation of the Stay

The filing of the petition operates as an automatic stay of the commencement or continuation of all actions, judicial or otherwise, which seek to enforce a lien against the municipality, its property, its officers or inhabitants.³⁸ The stay is governed by Rule 9-4 of the New Chapter IX Rules³⁹ and conforms with procedures under Chapters X, XI, and XII,⁴⁰ which indicate that the municipality need take no affirmative action to obtain the benefits of the stay. By

34. *Id.* § 85(a), 90 Stat. 317.

35. Old Chapter IX, ch. 657, § 83(a), 50 Stat. 653 (1937), *as amended*, ch. 532, 60 Stat. 416 (1946).

36. New Chapter IX, Pub. L. No. 94-260 § 87(c), 90 Stat. 320 (1976). *See note 16 supra*; *see also* BANKR. R. 117(b).

37. *See* H.R. REP. No. 686, 94th Cong., 1st Sess. 25 (1975). The Committee was quick to point out, however, that:

Joint administration has as its objective the joint handling of *purely administrative* matters in order to expedite the cases. Joint administration should be distinguished from consolidation, which is neither prohibited nor authorized by this sub-section. The appropriateness of consolidation, which results in a pooling of the assets, revenues, liabilities and expenses of the two entities, depends upon substantive considerations which affect the substantive rights of the creditors of the different entities.

Id. at 25-26 (emphasis added).

38. New Chapter IX, Pub. L. No. 94-260, § 85(e), 90 Stat. 318 (1976).

39. BANKR. R. 9-4.

40. *See* BANKR. R. 10-601, 11-44, 12-43.

contrast, Old Chapter IX provided for a stay of creditors' actions only after the petition had been filed and a hearing upon notice had been held.⁴¹ Although Old Chapter IX allowed a municipality to obtain a temporary stay in contemplation of filing, the pre-filing stay expired after sixty days.⁴² Thus, creditors could cloud bankruptcy proceeding by seeking preferences in collateral actions prior to the bankruptcy court's grant of a stay.⁴³

The automatic stay provision also applies to set-offs or counter-claims relating to a contract, debt or obligation of the municipality.⁴⁴ Furthermore, set-offs effected within four months prior to filing the petition are voidable after hearing on notice.⁴⁵ Such a provision relating to set-offs was lacking in Old Chapter IX. The new rule follows the rationale of *Baker v. Gold Seal Liquors, Inc.*,⁴⁶ in which the Supreme Court held that allowing such set-offs would subvert the rehabilitation of a "going enterprise" (in this case, a railroad), and prevent a fair and equitable distribution to creditors under the plan of adjustment.⁴⁷ The new stay and avoidance provisions should afford municipalities protection from the set-off claims of banks, municipal unions, and other institutions which hold obligations of a particular municipality and in which the municipality may have deposited bond proceeds, intergovernmental aid funds, tax revenues, or other cash for operating purposes. Except for the stay and avoidance of set-offs, cash flow could be cut to levels where the municipality may no longer have funds available to provide essential services.

41. Old Chapter IX, ch. 657, § 83(c), 50 Stat. 651 (1937), as amended, ch. 532, 60 Stat. 412 (1946).

42. *Id.* Before the temporary stay could be obtained, however, the municipality was required to plead that it was insolvent, wished to effect a plan of composition of its debts, and that a creditor was attempting to obtain payment of a claim in preference to other creditors. The creditors had to allege that it was making a good faith effort to secure approval of the plan by the required 51 percent of creditors, that there was a reasonable prospect of such acceptance within a reasonable time, and that upon obtaining such acceptance, the petitioner intended to file a Chapter IX petition under § 83(a). Upon hearing and notice, the judge was permitted, in his discretion, to enjoin or stay continuation of the creditor's suit. *Id.*

43. However, a federal court was empowered to enjoin further pursuit of state remedies and require submission of the suit to the bankruptcy court for inclusion in a county natural gas authority's plan of adjustment. *Carolina Pipeline Co. v. York County Natural Gas Auth.*, 388 F.2d 297 (4th Cir. 1967), cert. denied, 393 U.S. 824 (1968).

44. New Chapter IX, Pub. L. No. 94-260, § 85(e)(4), 90 Stat. 319 (1976).

45. *Id.*, § 85(g), 90 Stat. 319.

46. 417 U.S. 467 (1974).

47. *Id.* at 470-71.

A stay or any other "act or proceeding" (*i.e.*, not involving enforcement of a lien) may be granted; but the court, in its discretion, may require the municipality to post security.⁴⁸

The stay endures until the case is closed or dismissed or until property subject to a lien has been transferred or abandoned, with the approval of the court.⁴⁹ However, anyone subject to the stay may seek relief;⁵⁰ and the court, for cause shown, may terminate or modify the stay.⁵¹ This procedure indicates an even-handed congressional intent. Financially distressed municipalities are granted immediate and broad relief from anxious creditors' objections to the stay. The effect is to expedite the task of preparing a plan to adjust the municipality's debts.⁵²

C. Powers of the Chapter IX Court

1. *Original and Exclusive Jurisdiction.*

Once the petition has been filed, the bankruptcy court or the judge of that court⁵³ is empowered to exercise original subject matter jurisdiction to adjust municipal debt.⁵⁴ For purposes of New Chapter IX the court also has exclusive jurisdiction over the "petitioner (municipality) and its property."⁵⁵ This specific reference to "peti-

48. New Chapter IX, Pub. L. No. 94-260, § 85(e)(4), 90 Stat. 317 (1976).

49. BANKR. R. 9-4(b).

50. New Chapter IX, Pub. L. No. 94-260, § 85(e)(3), 90 Stat. 317 (1976).

51. BANKR. R. 9-4(c).

52. Section 85(a) of New Chapter IX also shows the intent of Congress to dispense quickly with objections to the petition, especially those based on alleged failure to comply with eligibility requirements. A party in interest is required to file answers to the petition within fifteen days after publication of notice. Objections may not relate to issues regarding the plan of adjustment, since there is no requirement that the plan be filed with the petition. New Chapter IX, Pub. L. No. 94-260, § 85(a), 90 Stat. 317 (1976).

53. New Chapter IX, Pub. L. No. 94-260, § 82(a), 90 Stat. 316 (1976), indicates that Chapter IX cases are to be adjudicated in a district court, before a district judge, rather than before a referee in bankruptcy. Furthermore, New Chapter IX forbids a general reference to a referee in bankruptcy, permitting such reference for only a "special issue of fact" and providing that "reference to a referee in bankruptcy shall be the exception and not the rule." *Id.*, § 87(a), 90 Stat. 320. Thus, the amendments to Chapter IX have upgraded its judicial status.

54. New Chapter IX, Pub. L. No. 94-260, § 82(a), 90 Stat. 316 (1976), provides that the court in which a petition is filed:

Shall exercise exclusive original jurisdiction for the adjustment of the petitioner's debts, and . . . shall have exclusive jurisdiction of the petitioner and its property, wherever located.

55. *Id.*

tioner and property” seems to indicate that the court has jurisdiction over all the municipality’s resources,⁵⁶ including disputes over property subject to a lien or creditors’ claims.⁵⁷ But New Chapter IX does not clearly specify the extent to which its jurisdiction applies to municipal resources and property.⁵⁸ State law, on the constitutional theory of separation of powers,⁵⁹ may determine the extent to which taxes may be levied on real property or to which execution against property devoted to a public use may be allowed to effect a plan adjusting debt.⁶⁰

2. Rejection of Leases and Contracts

The court may permit the municipality to reject its executory contracts and unexpired leases.⁶¹ These powers are new to Chapter IX, but follow provisions of Chapter X and Chapter XI.⁶² The mu-

56. “Upon approval of the debtor’s petition as properly filed the resources of the debtor came within the exclusive jurisdiction of the bankruptcy court.” *Poinsett Lumber and Mfg. Co. v. Drainage Dist. No. 7*, 119 F.2d 270, 272 (8th Cir. 1941).

57. See 5 COLLIER, BANKRUPTCY § 81.10 (14th ed. 1975).

58. The language of section 82(a) is similar to that contained in the jurisdictional provisions of Chapter X and Chapter XI. See 11 U.S.C. § 511 (1970) (Chapter X); 11 U.S.C. § 711 (1970) (Chapter XI). Cases decided under both Chapter X and Chapter XI have concluded that the bankruptcy court’s jurisdiction extends to the administration of all liens (except when the property is the custody of another court), and that the bankruptcy court may determine the validity, status, and amount of such liens. See *Texas v. Donoghue*, 88 F.2d 48 (5th Cir.), *rev’d on other grounds*, 302 U.S. 284 (1937); *In re Willow Cafeterias*, 22 F. Supp. 522 (S.D.N.Y. 1937). However, some statutes, such as N.Y.C.P.L.R. § 5203(a)(5) (McKinney Supp. 1975), provide that a judgment cannot be filed as a lien against the real property of the municipality.

59. U.S. CONST. amend. X; see *United States v. Bekins*, 304 U.S. 27, 52 (1938).

60. If a judgment rendered against a municipality is unpaid, the municipality is under a mandatory duty to assess, levy, and collect taxes to pay the judgment. N.Y. GEN. MUNIC. LAW § 82 (McKinney 1965). Otherwise, the judgment creditor may proceed by mandamus to compel payment. N.Y. GEN. MUNIC. LAW § 70 (McKinney 1965); see *Starr Contracting Co. v. Gandia*, 247 App. Div. 906, 287 N.Y.S. 149 (2nd Dep’t), *aff’d*, 271 N.Y. 647, 3 N.E.2d 465 (1936). But relevant case law indicates that municipal property held for “public use” is not subject to execution to satisfy a judgment against a municipal corporation. See *Leonard v. City of Brooklyn*, 71 N.Y. 498, 500 (1877); *Darlington v. City of New York*, 31 N.Y. 164, 193 (1865).

61. New Chapter IX, Pub. L. No. 94-260, § 82(b)(1), 90 Stat. 316 (1976).

62. 11 U.S.C. § 713(1) (1970) (Chapter XI) allows the judge to “permit the rejection of executory contracts of the debtor, upon notice to the parties to such contracts and to such other parties in interest as the court may designate” 11 U.S.C. § 516 (1970) (Chapter X), contains substantially the same language.

municipality may also reject executory contracts and leases as part of the plan of adjustment.⁶³ This power is necessary, in the same way that a stay of set-off claims is necessary, to assure that creditors, other than holders of municipal obligations, do not perfect liens against the municipality's operating revenues and assets, thereby threatening the continued delivery of essential services and subsequent financial rehabilitation.⁶⁴

The court may reject an executory contract or unexpired lease only after hearing on notice,⁶⁵ and only for cause shown, *i.e.*, that the contract is onerous or burdensome, and that its rejection will aid the municipality with its scheme of financial rehabilitation.⁶⁶ If such contracts or leases are rejected, the rejection constitutes a breach of contract and the contracting parties and landlords become creditors who may assert their claims for damages against the municipality under the plan of adjustment.⁶⁷ However, New Chapter IX limits a landlord's damages to rent reserved, without acceleration, under a covenant in the lease for one year following the municipality's rejection;⁶⁸ there is no corresponding limit on the amount of damages which may be awarded for the rejection of an executory contract.

New Chapter IX has no special provisions for handling the rejection of executory labor contracts with municipal labor unions. Recent cases suggest that such contracts may not be rejected unless they impose a greater hardship than being merely burdensome and onerous upon the municipality.⁶⁹ The drafters of New Chapter IX

63. New Chapter IX, Pub. L. No. 94-260, § 91, 90 Stat. 322 (1976).

64. *Id.* § 82(b)(1), 90 Stat. 316.

65. *Id.* § 82(a)(1), 90 Stat. 316. In *Texas Importing Co. v. Bank of Ponce*, 360 F.2d 582, 584 (5th Cir. 1966), the Court of Appeals for the Fifth Circuit stated:

[C]ongress intended that before an executory contract should be rejected, a judicial hearing and inquiry, at which interested parties might be heard, should be held, and that an executory contract should be rejected only with permission of the court. . . .

Furthermore, the power to order rejection is vested in the bankruptcy judge exclusively and may not be exercised by a referee, even when proceedings have been specially or generally referred. See New Chapter IX, Pub. L. No. 94-260, § 82(a)(1), 90 Stat. 316 (1976).

66. H.R. REP. No. 686, 94th Cong., 1st Sess. 17 (1975).

67. New Chapter IX, Pub. L. No. 94-260, § 88(c), 90 Stat. 320 (1976).

68. *Id.* The statute further provides that:

The court shall scrutinize the circumstances of an assignment of a future rent claim and the amount of the consideration paid for such assignment in determining the amount of damages allowed the assignee of that claim.

Id.

69. Before the bankruptcy court may reject a labor contract, it must consider the loss of intangible employee rights and the social consequences which would result from failure to

must have thought that labor contracts would have a significant impact on the plan of adjustment, since labor unions are statutorily permitted to be heard regarding the economic soundness of the plan.⁷⁰ Another problem with labor contracts is posed by conflicts between state and federal law. For example, in cities such as New York, where labor contract terms must be approved by an Emergency Financial Control Board,⁷¹ the rejection of a labor contract may constitute a prohibited interference with the municipality's political or governmental powers—unless the rejection is consented to by the municipality or the state or is incorporated into the plan of adjustment.⁷²

3. *Certificates of Indebtedness*

The Chapter IX court is also empowered to issue certificates of indebtedness,⁷³ somewhat as Old Chapter IX provided.⁷⁴ However, unlike Old Chapter IX, such certificates have priority over existing obligations, secured and unsecured, and over costs and expenses of administration of the bankruptcy proceeding, but not over the municipality's operating expenses.⁷⁵ The power to issue such certifi-

compensate employees for the loss of their jobs. See *Shopmen's Local 455 v. Kevin Steel Prod., Inc.*, 519 F.2d 698 (2d Cir. 1975); *In re Overseas Nat'l Airways, Inc.*, 238 F. Supp. 359 (E.D.N.Y. 1965).

70. New Chapter IX, Pub. L. No. 94-260, § 94(a), 90 Stat. 323 (1976).

71. Act of Sept. 9, 1975, N.Y. Sess. Laws, chs. 868-70 (McKinney 1975). The legislation created an Emergency Financial Control Board whose purpose is to supervise the development of a financial plan designed to create a balanced budget fiscal condition by the end of the emergency period. See generally, Note, *The Limits of State Intervention in a Municipal Fiscal Crisis*, 4 *FORDHAM URBAN L.J.* 545 (1976). One of the board's functions is to approve all contracts to which the municipality is a party. *N.Y. Sess. Laws* ch. 868, § 7 (McKinney 1975).

72. See New Chapter IX, Pub. L. No. 94-260, § 82(c)(1), 90 Stat. 316 (1976).

73. *Id.* § 91, 90 Stat. 322 (1976).

74. Old Chapter IX, ch. 657, § 83(a), 50 Stat. 653 (1937), as amended, ch. 532, 60 Stat. 410 (1946), provided that:

The "plan of composition" within the meaning of this chapter, may include provisions modifying or altering the rights of creditors generally, or of any class of them, secured or unsecured, either through issuance of new securities of any character, or otherwise, and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire.

Unlike New Chapter IX, however, Old Chapter IX did not specify the priority of newly-issued securities in relation to existing obligations.

75. New Chapter IX, Pub. L. No. 94-260, § 82(b)(2), 90 Stat. 316 (1976).

cates follows the provisions of Chapter X and Chapter XI.⁷⁶

Creation of a new debt by a bankruptcy court as part of a plan of adjustment, in order to generate revenues for the municipality's capital budget or to meet debt service on existing obligations, is somewhat of an anomaly in the area of municipal finance. Theoretically, existing obligations would be guaranteed as to payment of principal and interest by the pledge of the municipality's faith and credit.⁷⁷ Holders of such obligations would be entitled to payment prior to all other creditors of the municipality from the "first revenues" received.⁷⁸ However, the immediate reason for a pending default on existing obligations (and thus the immediate reason to resort to Chapter IX) is not usually because taxes cannot be increased to meet debt service requirements on those obligations⁷⁹ but rather because the financial posture of the municipality is in such disrepute in the market that the municipality cannot sell or renew its short-term notes issued in anticipation of the collection of taxes or other revenues.⁸⁰ Thus, if the municipality's pledge of its faith and credit can not convince buyers in the market to purchase its obligations, what feature of the "certificates of indebtedness" (which are seemingly no more than ordinary faith and credit obligations) would make them more attractive investments? Nothing, save perhaps that they may carry a guarantee of the federal government as to payment of principal and interest, since they are issued

76. 11 U.S.C. § 516(1) (1970) (Chapter X); 11 U.S.C. § 744 (1970) (Chapter XI).

77. N.Y. LOCAL FIN. LAW § 100.00 (McKinney 1968). N.Y. GEN. MUNIC. LAW § 7 (McKinney 1965) places upon a municipality an affirmative duty to assess, levy, and collect taxes sufficient to meet debt service on existing obligations. Such taxes may exceed any constitutional limit. See N.Y. CONST. art. 8, §§ 5, 10.

78. N.Y. CONST. art. 8, § 2.

79. The tax limit on taxable real property is determined with reference to a percentage of average full valuation of such real property. N.Y. CONST. art. 8, § 10. Most municipalities seldom reach this limit; however, even if tax rates could be raised, the additional tax revenue generated would not be applied to the municipality's budget until its next succeeding fiscal year—at the earliest—which would not help avoid an immediately pending default.

80. Among smaller municipalities in New York, it is not unusual that a large percentage of the total net indebtedness constitutes bond anticipation notes, revenue anticipation notes and tax anticipation notes, issued for a term of one year or less, as authorized by N.Y. LOCAL FIN. LAW, §§ 23.00-25.00 (McKinney 1968), *as amended*, (McKinney Supp. 1975) and § 30.00 (McKinney 1968). These notes enable the municipality to generate cash prior to the receipt of proceeds from issuing bonds, from state and federal aid, and from the collection of taxes. The fear in the market is that bonds may not sell for lack of investor interest, that state or federal aid may be cancelled, or that tax collection may be inadequate.

under the supervision of a federal court. However, no such guarantee is provided or implied in New Chapter IX. It is difficult to understand why the drafters of New Chapter IX may have thought these certificates of indebtedness could be successfully marketed on the strength of a defaulting municipality's faith and credit.⁸¹ The only legal protection New Chapter IX affords such certificates is a guarantee of their validity as against a party in interest which has objected to the jurisdiction of the bankruptcy court.⁸² However, insofar as this provision assumes that the certificates of indebtedness have already been authorized and issued by the court,⁸³ relief may be impractical.

4. *Preservation of Governmental and Political Functions*

The court, in effecting a plan of adjustment, is specifically limited (absent the municipality's consent) from interfering by means of a stay, order or decree with (1) any of the political or governmental

81. However, the drafters of New Chapter IX *did* intend assurances that would make the certificates of indebtedness more attractive investments than mere "faith and credit" obligations. The House Report states:

The process of the issuance of certificates of indebtedness is a method which enables a financially embarrassed municipality to enter the private credit market again. The municipality seeks out a private lender who is willing to lend for either a short or long term. Because the petitioner is in a Chapter IX case, few if any lenders would be willing to lend *without some assurance of payment*. The court can supply that assurance by giving the lender security and priority over existing obligations.

H.R. REP. No. 686, 94th Cong., 1st Sess. 25 (1975). (emphasis added).

82. New Chapter IX, Pub. L. No. 94-260, § 85(a), 90 Stat. 317 (1976).

83. There are serious questions as to whether issuing certificates of indebtedness impairs the contracts between existing obligation-holders and the municipality (in violation of U.S. CONST. art. I, § 10), and as to whether such court-ordered issuance interferes with the separation of powers between State and Federal governments (U.S. CONST. amend. X). Furthermore, there is a question as to whether such issuance unlawfully deprives existing obligation-holders of the "first revenues" of the municipality, in violation of New York Constitutional provisions. N.Y. CONST. art. 8, § 2. In *Flushing Nat'l Bank v. Municipal Assistance Corp.*, 84 Misc. 2d 976, 982-83, 379 N.Y.S.2d 978, 985-86 (Sup. Ct. 1975), *aff'd*, 52 App. Div. 2d 84, 382 N.Y.S.2d 764 (1st Dep't 1976), the court held that a "statutory moratorium" on the payment of principal of notes did not impair such contracts where the state legislature had acted to meet a "public emergency." This suggested that in New York State, the issuance of certificates of indebtedness and the appropriation of specified tax revenues to meet their debt service would withstand the attack of constitutional validity. But on Nov. 19, 1976, the New York Court of Appeals reversed the lower courts, holding such moratorium unconstitutional as a violation of the State Constitution's requirement that a municipality must pledge its "faith and credit" to the payment of its indebtedness. 1976 N.Y.L.J. 5, col. 1 (Nov. 23, 1976). See note 171 *infra*.

powers of the municipality, (2) its property or revenues, or (3) its use or enjoyment of any income producing property.⁸⁴ Precisely what constitutes "income producing property" is unclear. Technically, it may be any property which can be sold at a gain. But the term most likely refers to proceeds derived from enterprise operations, such as municipal parking garages or community hospitals, revenues which the court may wish to earmark for payment of debt service on certificates of indebtedness. Read literally, these limitations seem to retract most of the jurisdiction conferred on the court by Section 82 of New Chapter IX.⁸⁵ However, they codify the holdings of *Ashton v. Cameron Water Improvement District*⁸⁶ and *United States v. Bekins*,⁸⁷ which require that the bankruptcy court not materially restrict the municipality's control over its own fiscal and other affairs. They underscore the essential purpose of the court; that is, merely to adjust the municipality's debt and preserve the municipality as a functioning entity, without contemplating liquidation, contraction, or conversion of its activities in providing municipal services. However, if a municipality consents⁸⁸ to a plan of adjustment, then the court may interfere.

To assure that the municipality may continue to operate and provide essential services by retaining contracts with its suppliers, the court may void any clause in a supplier's contract which purports to terminate or modify the contract because the municipality is insolvent or because it may have filed a petition under New Chapter IX.⁸⁹ However, the municipality may cure any prior defaults in payment and offer adequate assurance of future performance.⁹⁰ Suppliers of "service and materials" receive priority in payment over other creditors for debts incurred within three months prior to the

84. New Chapter IX, Pub. L. No. 94-260, § 82 (c), 90 Stat. 316 (1976).

85. *Id.*

86. 298 U.S. 513 (1936).

87. 304 U.S. 27 (1938).

88. This consent apparently is required. *See, e.g.,* *Ware v. R.E. Crummer & Co.*, 128 F.2d 114 (5th Cir.), *cert. denied*, 317 U.S. 644 (1942); *Leco Properties v. R.E. Crummer & Co.*, 128 F.2d 110 (5th Cir. 1942). In *Leco*, the court of appeals upheld a liquidation, to which the municipality consented, of certain assets deposited with the court for distribution under the plan which was never confirmed. However, in *Ware*, the same court reversed a similar order where the municipality had not consented.

89. New Chapter IX, Pub. L. No. 94-260, § 85 (f), 90 Stat. 317 (1976).

90. *Id.* The language of section 85(f) is taken from UCC § 2-609(1), and apparently attempts to place commercial standards on the municipality's purchase of goods and services.

filing of the petition and for costs and expenses incurred subsequent to the filing.⁹¹ Suppliers' interests are thus fully protected and the chances that a shortfall of supplies will cripple the delivery of essential services are greatly reduced.

5. *Appointment of a Trustee*

As a policy matter, Chapter IX proceedings allow the municipality to retain the control over the management of its own affairs; thus, Old Chapter IX did not provide for the appointment of a trustee in bankruptcy. New Chapter IX continues this policy, with one important exception.⁹² The sections of the Bankruptcy Act relating to the avoidance of secret liens and fraudulent transfers⁹³ are incorporated by reference into New Chapter IX.⁹⁴ The municipality may void such liens and transfers with respect to its property.⁹⁵ In other forms of bankruptcy, such powers are normally exercised by a trustee; New Chapter IX in effect, permits the municipality to act as its own trustee; but should the municipality refuse, for any reason whatsoever, to exercise these avoidance powers, the court may appoint a trustee for this purpose.⁹⁶ The avoidance powers are the only ones conferred upon the trustee.

The legislative history of New Chapter IX is silent regarding the reason for sanctioning the appointment of a trustee (as opposed to compelling the municipality to exercise its voiding powers). The most obvious reason is to insure arms length dealing to protect creditors' interests, since the issuer municipality and the creditor purchasers are usually regarded as adversaries in the arena of municipal finance. Appointment of a trustee assures holders of municipal obligations that their interests will not be dissipated or diminished by any "insider" actions of municipal officials who may attempt to misappropriate municipal property for their own direct or indirect benefit.

Finally, New Chapter IX contains a provision allowing the court

91. New Chapter IX, Pub. L. No. 94-260, § 89 (1)-(2), 90 Stat. 321 (1976).

92. *Id.* § 85(a), 90 Stat. 317 (1976).

93. See 11 U.S.C. §§ 96(a)-(c); 107(a), (d); 110(c), (e)(1) (1970).

94. New Chapter IX, Pub. L. No. 94-260, § 85(h), 90 Stat. 317 (1976).

95. *Id.*

96. *Id.*

to retain jurisdiction to ensure successful execution and enforcement of the plan of adjustment.⁹⁷ Although the court may dismiss the case after confirmation of the plan, it may also retain jurisdiction so that it can act if the municipality defaults with respect to any term of the plan, or if the plan terminates by reason of the happening of a stated condition.⁹⁸ In this connection, it seems reasonable to presume that the court would retain jurisdiction for at least the term of the maturity of certificates of indebtedness, in order to insure that the principal and interest are paid when due. Still, the court may direct the municipality under section 96(b) of New Chapter IX⁹⁹ to be solely responsible for meeting the debt service requirements of such certificates.

D. Identifying and Classifying Creditors

New Chapter IX defines "creditor" as a holder of a claim against the petitioning municipality. Creditors may include the United States, a state, or a political subdivision, public agency, or instrumentality of a state.¹⁰⁰ Prior case law indicates that an agency of the United States may be a creditor.¹⁰¹ "Claims" include demands of any character asserted against the municipality, not merely the claims of bond and note holders.¹⁰² Identifying creditors and their respective classifications is important in determining whether the plan of adjustment has been adopted,¹⁰³ and in fixing the priority of payment to classes of creditors under the plan.¹⁰⁴

New Chapter IX states that the claims of creditors appearing on the initial or supplemental lists filed by the municipality shall be

97. New Chapter IX, Pub. L. No. 94-260, § 98(a)(4), 90 Stat. 325 (1976).

98. *Id.* § 98(a)(4)(b).

99. New Chapter IX, Pub. L. No. 94-260, § 96(b), 90 Stat. 325 (1976) provides:

The petitioner shall comply with the plan and the orders of the court relative to the plan, and shall take all actions necessary to carry out the plan. The court may direct the petitioner . . . to perform such . . . acts . . . as the court determines to be necessary for the consummation of the plan.

100. New Chapter IX, Pub. L. No. 94-260, § 81(3), 90 Stat. 315 (1976).

101. For example, the Reconstruction Finance Corporation was held to be a creditor when it advanced sufficient funds to pay all bondholders of an irrigation district, in order to facilitate a plan of adjustment of the district's bonded indebtedness. *Jordan v. Palo Verde Irr. Dist.*, 114 F.2d 691 (9th Cir.), *cert. denied*, 312 U.S. 693 (1940).

102. New Chapter IX, Pub. L. No. 94-260, § 81(1), 90 Stat. 315 (1976).

103. *Id.* § 92, 90 Stat. 322 (1976).

104. *Id.* § 89, 90 Stat. 321 (1976).

allowed.¹⁰⁵ There is no need to file a proof of claim, unless the claim is disputed, contingent, or unliquidated as to amount.¹⁰⁶ Other claims may be proven before the court or filed with the court prior to the confirmation of the plan of adjustment.¹⁰⁷ If a claim is disputed, contingent, or unliquidated as to amount, the court must give written notice to any creditors holding such a claim within thirty days after the municipality files the required lists.¹⁰⁸ If there are no objections to such claims, they are deemed allowed. This procedure is established for the administrative convenience of the court and relieves it of the burden of collecting and registering such claims.¹⁰⁹ However, the "thirty days notice to creditors" rule raises a due process issue regarding the timely filing of objections. It impliedly grants no more than thirty days after the filing of creditors lists for interested persons to make objection. Thus, such persons must consult the case docket at frequent intervals to determine whether any supplemental creditor lists have been filed.

According to section 88(b) of the New Chapter IX,¹¹⁰ the court classifies the creditors by grouping claims that are "of substantially similar character and the members of which enjoy similar rights".¹¹¹ This language is far more specific than the vague wording employed in Old Chapter IX,¹¹² and more informative than the term "according to the nature of their respective claims and stock" which governs classification under Chapter X.¹¹³

However, the "similar character, similar rights" language does not address the problem posed by different types of obligations

105. *Id.* § 88(a), 90 Stat. 320 (1976).

106. *Id.*

107. *Id.*

108. *Id.*

109. See H.R. REP. No. 686, 94th Cong., 2d Sess. 26 (1975).

110. New Chapter IX, Pub. L. No. 94-260, § 88(b), 90 Stat. 320 (1976).

111. *Id.*

112. Old Chapter IX, ch. 657, § 83(b), 50 Stat. 653 (1937), *as amended*, ch. 532, 60 Stat. 411 (1946), instructs that:

[T]he holders of all claims regardless of the manner in which they are evidenced, which are payable without preference out of funds derived from the same source or sources shall be of one class.

Id.

113. 11 U.S.C. § 597 (1970) (Chapter X). See 11 U.S.C. § 751 (1970) (Chapter XI) which simply provides that ". . . the court may fix the division of creditors into classes." *Id.* No further criteria for classification are offered. See *Bartle v. Markson Bros.*, 314 F.2d 303, 305 (2d Cir. 1963); *IN RE Hudson-Ross, Inc.*, 175 F. Supp. 111, 112 (N.D. Ill. 1959).

which carry the faith and credit pledge of the municipality. For example, it is not uncommon practice for the municipality to guarantee debt service on a subdivision's revenue bonds with its own pledge of faith and credit. Does this pledge place the guaranteed revenue bonds in the same class as general obligations? Ordinarily, revenue bonds and general obligations would constitute different classes because the source of payment of principal and interest is different, notwithstanding the faith and credit pledge on the revenue bonds. Furthermore, if the revenue source of guaranteed revenue bonds is earmarked to meet debt service on certificates of indebtedness, the classification question is likely to lead to litigation to determine whether the earmarking is a just and reasonable method by which to effectuate the plan of adjustment.¹¹⁴

To promote administrative efficiency in composing the plan, unsecured claims in an amount less than \$250 may be deemed to constitute a separate class.¹¹⁵ The legislative history of section 88(b) suggests that in the course of the proceedings, creditors holding such claims will be paid in cash¹¹⁶ and are therefore deemed "not affected by the plan."¹¹⁷

E. Arriving at a Plan of Adjustment

A plan for adjusting the municipality's indebtedness must be submitted to the court at or after the time the petition is filed.¹¹⁸ By allowing post-petition filing of the plan, without requiring prior acceptance by creditors holding a majority in amount of claims, New Chapter IX insures that the municipality will receive both the benefit of the automatic stay of creditors' actions and the time necessary to devise a realistic and workable plan. The municipality may also file modifications to the plan prior to confirmation, and any creditor

114. To further confuse the issue of classifying claims, the New York Court of Appeals has recently held that a collective bargaining agreement entered into prior to a legislatively-declared financial emergency enjoys the same status as other obligations of the municipality, apparently irrespective of the faith and credit pledge securing debt obligations. *Board of Educ. v. Yonkers Fed'n of Teachers*, 40 N.Y.2d 268, 353 N.E.2d 569, 386 N.Y.S.2d 657 (1976).

115. New Chapter IX, Pub. L. No. 94-260, § 88(b), 90 Stat. 320 (1976).

116. H.R. REP. No. 686, 94th Cong., 1st Sess. 27 (1975).

117. New Chapter IX, Pub. L. No. 94-260, § 90(a), 90 Stat. 321 (1976).

118. *Id.*

may also file modifications with the consent of the municipality.¹¹⁹ Within ninety days from the filing of the plan or any modifications thereto, each creditor and "special taxpayer"¹²⁰ whose claims are "affected by the plan," may accept or reject the plan as modified.¹²¹

The bankruptcy court has sole discretion to determine which creditors and special taxpayers are affected by the plan.¹²² Case law suggests a more objective guideline; namely, if the creditor must seek payment directly from the municipality, he is materially and adversely affected.¹²³ However, questions may arise regarding whether holders of obligations such as school district bonds or revenue bonds are materially affected by the plan if they seek payment from a revenue source other than the ad valorem taxes of the municipality (*i. e.*, federal or state aid or revenues of enterprise facilities). If the terms of these obligations are changed by the plan, they would seem to be clearly affected by the plan.

New Chapter IX's provisions governing the plan of adjustment derive from its predecessor, and state simply that creditors' rights may be modified or altered.¹²⁴ The only specific methods contained in the statute deal with the issuance of new securities¹²⁵ (certificates of indebtedness) and the rejection of executory contracts and unex-

119. *Id.*

120. A "special taxpayer" affected by the plan is defined as any owner of real property against which the plan of adjustment proposes to levy a special tax or assessment. New Chapter IX, Pub. L. No. 94-260, § 81(10)-(11), 90 Stat. 315 (1976). Such property is thus taxed at a higher rate than non-affected property. The revenues derived from special taxation become the sole source of payment on obligations issued by the municipality to finance local improvements. This form of financing was common prior to the first municipal bankruptcy act, and was done in connection with small improvement districts, where the local improvement financed by the bond issue benefitted the land served by the district. Thus, the revenue for repayment of the bonds was derived from a tax based on the value of the land. See H.R. REP. No. 686, 94th Cong., 1st Sess. 16 (1975). Query: Are these "obligations" equivalent to certificates of indebtedness?

121. New Chapter IX, Pub. L. No. 94-260, § 92(e), 90 Stat. 322 (1976).

122. *Id.* § 82(a), 90 Stat. 316.

123. *Querbacker v. Henderson County*, 126 F.2d 309 (4th Cir.), *cert. denied*, 317 U.S. 654 (1942).

124. Old Chapter IX, ch. 657, § 83(a), 50 Stat. 654 (1937), *as amended*, ch. 532, 60 Stat. 410 (1946) provided:

The "plan of composition" . . . may include provisions modifying or altering the rights of creditors generally, or any class of them, secured or unsecured, either through issuance of new securities of any character, or otherwise, and may contain such other provisions and agreements not inconsistent with this chapter as the parties may desire.

125. See text accompanying notes 73-76 *supra*.

pired leases.¹²⁶ Otherwise, New Chapter IX specifies no particular methods of effectuating the plan of adjustment. For example, there is no requirement that the plan provide for a balanced municipal budget at the end of the period of debt adjustment.¹²⁷

Despite the heavy publicity surrounding New York City's recent cash flow problems, New Chapter IX provides no technique for generating immediate cash to meet current expenses for essential services. Perhaps the drafters thought this might be a prohibited interference with the municipality's political or governmental powers.¹²⁸ As a practical matter, since all the municipality's creditors are permitted to file claims with the court, there should be some mechanism to generate ready cash for operating expenses incurred during the period of debt adjustment or before the municipality returns to a balanced budget fiscal condition. Perhaps the court's authority to issue certificates of indebtedness was intended to help the municipality raise operating revenues. However, it is implicit in municipal finance jurisprudence that bonded indebtedness may be issued only for a capital purpose.¹²⁹ Thus, creating new debt to supply the municipality with operating funds might be challenged as unconstitutional.

According to section 92(a) of New Chapter IX,¹³⁰ the only creditors entitled to accept or reject the plan are those whose claims are allowed and whose interests are determined to be materially and

126. See text accompanying notes 61-68 *supra*.

127. A balanced budget requirement may be inferred from the fact that the court must find the plan to be fair, equitable and feasible as a condition for confirmation. In *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943), the Supreme Court interpreted the "fair and equitable" finding to require that the municipality be able to meet obligations imposed by the plan, based on past and prospective tax revenues and operating expenses. See text accompanying notes 136-40 *infra*. Also, section 97 of New Chapter IX provides that an exchange of newly-created obligations for existing obligations under the plan may be made before the petition is filed. Such an exchange will not limit or impair the effectiveness of the plan. This provision is of considerable importance in light of the fact that creditors need not accept the plan before the petition is filed. See text accompanying notes 17-20 *supra*.

128. See text accompanying notes 84-87 *supra*.

129. The usual rule is that municipal bonds may be issued only for a public purpose. 15 McQUILLIN, MUNICIPAL CORPORATIONS § 43.29 (1970). However, such public purpose must be in the nature of a capital item rather than an expense item, since, under state law, specific public purposes often have useful lives which determine and limit the terms of the bond issue. See, e.g., N.Y. CONST. art. 8, § 2; N.Y. LOCAL FIN. LAW § 11 (McKinney 1968), as amended, (McKinney Supp. 1975). Section 43.31 of McQUILLIN, *supra*, lists no expense items as examples of public purposes.

130. New Chapter IX, Pub. L. No. 94-260, § 92(a), 90 Stat. 322 (1976).

adversely affected by the plan. Confirmation requires that two-thirds in amount of claims in every class and fifty percent in number of claims must accept the plan in writing.¹³¹ Under Old Chapter IX, only the former requirement was necessary for confirmation.¹³² The court may, in its discretion, temporarily allow claims in order to permit claimants to vote on the question of acceptance or rejection of the plan.¹³³ This provision enables the court to transmit the plan to creditors for acceptance without first determining the merits of all claims and objections. However, it also increases the total number and amount of claims needed to obtain confirmation of the plan.¹³⁴

Not all claims allowed are counted for purposes of obtaining confirmation of the plan. Excluded are claims held or controlled by the municipality, claims not affected by the plan, claims paid in cash, and claims of creditors otherwise protected in the plan. The last exclusion clause enables the court to dispense with the acceptances of belligerent, non-assenting creditors, in order to secure prompt confirmation. Although such creditors are allowed to bargain for their settlement by threatening to reject the plan, they are still bound by the terms of the plan¹³⁵ (if and when accepted). Modifications to the plan which do not materially and adversely affect the interest of a given creditor are deemed accepted if such creditor has previously accepted the plan. However, if the creditor is so affected and does not reject the modification, he is deemed to have accepted it.¹³⁶

F. Securing Confirmation of the Plan

Once the plan and modifications thereto have been accepted, the court must hold a hearing to confirm the debt adjustment scheme.¹³⁷ Several conditions must be satisfied if confirmation is to be secured.

131. *Id.* § 92(b), 90 Stat. 322.

132. Old Chapter IX, ch. 657, § 83(d), 50 Stat. 653 (1937), as amended, ch. 532, 60 Stat. 416 (1946). As in the new statute, claims owned, held, or controlled by the petitioner were not counted; nor did the Old Chapter IX require that the plan be accepted by creditors whose claims were to be paid in cash under the plan, or who were otherwise protected by the plan.
Id.

133. Similar provisions are found under the Chapter X and XI Rules of Bankruptcy Procedure. See BANKR. R. 10-305(a), 11-37(a).

134. New Chapter IX, Pub. L. No. 94-260, § 92(c)-(d), 90 Stat. 322 (1976).

135. *Id.* § 92(e), 90 Stat. 322.

136. *Id.*

137. *Id.* § 94(a), 90 Stat. 323.

The plan must be fair, equitable, and feasible, and must not discriminate unfairly in favor of any creditor or class of creditors.¹³⁸ These conditions are largely drawn from Old Chapter IX;¹³⁹ only the feasibility requirement, adopted from Chapter X and Chapter XI,¹⁴⁰ is new. That requirement codifies the holding of *Kelley v. Everglades Drainage District*,¹⁴¹ where the Supreme Court stated that before a plan may be confirmed, it must appear to the court that based on past and prospective tax revenues and operating expenses, the municipality will be able to meet payments under the plan.¹⁴² In other words, the municipality must convince the court that implementation of the plan will lead to an improved fiscal condition.¹⁴³ In order for the plan to be fair, equitable, and nondiscriminatory, the municipality must exercise its taxing power to the fullest extent possible for the benefit of creditors.¹⁴⁴ Senior creditors must be paid in full before junior creditors are paid,¹⁴⁵ and the plan must be arrived at openly, without special treatment for any creditors.¹⁴⁶

The plan must comply with all procedural requirements of New Chapter IX. In particular, this condition suggests that all jurisdictional provisions must be met, that the plan must be accepted pur-

138. *Id.* § 94(b)(1).

139. Old Chapter IX, ch. 657, § 83(e), 50 Stat. 653 (1937), as amended, ch. 532, 60 Stat. 414 (1946). The judge was also required to find that the plan was "for the best interests of the creditors." *Id.*

140. 11 U.S.C. § 621 (1970) (Chapter X); 11 U.S.C. § 766(2) (1970) (Chapter XI).

141. 319 U.S. 415 (1943).

142. The test for feasibility provided in *Everglades* came at a time when local taxes comprised all municipal revenues. It is probably inadequate in the current posture of municipal finance, where a substantial portion of a major municipality's operating revenues may be derived from state and federal aid, and where the continuation of such aid may be jeopardized by fiscal difficulties at the state and federal levels.

143. The Senate version of the 1976 amendments provided that "the budget of the petitioner will be in balance within a reasonable time after the adoption of the plan." S. 2597, § 817(c)(7), 94th Cong. 1st Sess. (1975). This language was deleted from section 94(b)(1) of New Chapter IX on the premise that the balanced budget requirement of the Senate version would be a factor in determining whether the plan was feasible. H.R. REP. No. 938, 94th Cong., 2d Sess. 21 (1976).

144. *Fano v. Newport Heights Irr. Dist.*, 114 F.2d 563 (9th Cir. 1940). But is it fair and equitable to earmark such taxes for the benefit of particular obligation holders or a class thereof? See *Flushing Nat'l Bank v. Municipal Assistance Corp.*, 84 Misc. 2d 976, 379 N.Y.S.2d 978 (Sup. Ct. 1975), *aff'd*, 52 App. Div. 2d 84, 382 N.Y.S.2d 764 (1st Dep't 1976), discussed briefly in note 83 *supra*.

145. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939).

146. *Town of Belleair v. Groves*, 132 F.2d 542 (5th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943); *American Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940).

suant to section 92 and that priority payments (as defined under section 89) must be made before any distributions are made to creditors.

All amounts to be paid by the municipality or on its behalf for services and expenses incident to the plan must be reasonable and fully disclosed.¹⁴⁷ The court may wish to examine payments to attorneys and fiscal consultants, since such fees are given priority of payment.¹⁴⁸ However, the legislative history of New Chapter IX suggests that this requirement serves primarily to prevent the municipality from making sham payments to a third party for its own benefit.¹⁴⁹ The court is not compelled to examine all payments made in connection with administration of the case, as such a procedure would hamper prompt confirmation of the plan.¹⁵⁰

The plan must be offered and accepted in good faith. Cases decided under Old Chapter IX indicate that good faith requires full disclosure of all material facts relating to the municipality's insolvency;¹⁵¹ apparent misappropriations and erroneous figures in the plan's distribution schedule may be attributed to mere bookkeeping errors and may not necessarily evidence bad faith.¹⁵² Further, if the municipality, after filing a petition, arranges to retire some of its indebtedness via a private transaction, the terms and all material facts of the transaction must be disclosed.¹⁵³

Under New Chapter IX, the Securities and Exchange Commission (SEC) may also object to confirmation;¹⁵⁴ however, the SEC does not have the right to appeal the court's ruling on the objection.¹⁵⁵ Allowing the SEC to become involved in a Chapter IX proceeding (let alone in the area of municipal finance) is a new develop-

147. New Chapter IX, Pub. L. No. 94-260, § 94(b)(4), 90 Stat. 323 (1976).

148. *Id.* § 89(1), 90 Stat. 321.

149. H.R. 10624, § 94(b), 94th Cong., 1st Sess. (1975).

150. See H.R.REP.No. 686, 94th Cong., 2d Sess. 33 (1975).

151. See *American Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138 (1940).

152. *West Coast Life Ins. Co. v. Merced Irr. Dist.*, 114 F.2d 654 (9th Cir. 1940).

153. *Ouerbacker v. Henderson County*, 126 F.2d 309 (4th Cir.), *cert. denied*, 317 U.S. 654 (1942). Thus, there may be a good faith requirement for transactions made under section 97 of New Chapter IX.

154. New Chapter IX, Pub. L. No. 94-260, § 93, 90 Stat. 322 (1976).

155. *Id.* Under Chapter X procedure, the SEC may, and *shall*, if requested by the court, intervene in a Chapter X case. Upon filing a notice of intervention, the SEC is made a party in interest, and may be heard on all matters in the case. However, it may not appeal from any order of the district court. 11 U.S.C. § 608 (1970).

ment, and confirms a growing trend that municipal finance practice will be reviewed according to the same stringent standards that govern corporate finance.¹⁵⁶ Thus, additional "good faith" issues may be raised by New Chapter IX. For example, there may be a good faith requirement that the plan project a balanced budget. This projection could be tested for misrepresentations by examining developments following the implementation of the plan. Likewise, there may be a good faith standard for filing a petition if the plan later reveals that the principal purpose for filing was to stay creditors' actions in light of a threatened but improbable default. The answers to these issues await the outcome of litigation interpreting Chapter IX's good faith provisions.

The municipality must not be prohibited by law from taking any action necessary for the execution of the plan. This condition may involve possible conflict between the action of the bankruptcy court and state law. Since states are also permitted to devise plans for the adjustment of municipal debt, this condition, too, will almost certainly be the subject of New Chapter IX litigation.¹⁵⁷

G. Discharge, Distribution and Dismissal

Once the plan is confirmed by the court and the municipality has deposited required consideration with a court-appointed disbursing agent, the municipality is discharged from all claims against it which are provided for in the plan.¹⁵⁸ However, if a creditor had "neither timely notice nor actual knowledge of neither the petition nor the plan,"¹⁵⁹ his claim is not discharged. Thus, New Chapter IX provides necessary due process protection for a creditor (such as a bearer bondholder) who was not given notice of the proceeding.

At a post-confirmation date fixed by the court, the disbursing agent may begin to distribute the consideration to those creditors

156. The Securities Acts Amendments of 1975, 89 Stat. 137 (1975), amended §§ 3, 15, 15A, and 17 of the Securities Exchange Act of 1934, 15 U.S.C. 78q (1970), to make the sanctions for fraudulent acts and practices applicable to the issuing municipality and to brokers and dealers involved in the issuance of municipal securities. Section 15B was added by the 1975 Amendments in order to provide for regulation of transactions in municipal securities (whether or not such transactions involve interstate commerce). A rulemaking board is established for the purpose of proposing rules to the SEC with respect to transactions in municipal securities by brokers and dealers.

157. See *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).

158. New Chapter IX, Pub. L. No. 94-260, § 95, 90 Stat. 323 (1976).

159. *Id.*

whose claims were allowed, whether or not such claims are considered to be materially affected by the plan.¹⁶⁰ The court may also direct the municipality or other necessary parties to execute and deliver essential documents, or to perform other acts (such as satisfying a lien) which the court deems necessary for carrying out the plan.¹⁶¹

Finally, a five-year statute of limitations is imposed on creditors: any action involving the plan must be brought within five years of the entry of the order confirming the plan. If no suits are filed within the statutory period the municipality is entitled to recover any consideration remaining in the custody of the disbursing agent.¹⁶²

Section 98 of New Chapter IX¹⁶³ enlarges the grounds for permissive and mandatory dismissal of cases. Grounds for permissive dismissal include want of prosecution, failure to propose a plan, failure to secure acceptance of a plan in the time allowed, or default by the municipality during a term of the plan for which the court has retained post-confirmation jurisdiction.¹⁶⁴ If the court refuses to confirm the plan, dismissal is mandatory.¹⁶⁵ The grounds for dismissal provide a court-imposed check on the actions of interested parties throughout the proceedings; it assures that they will deal in good faith.

H. Revival

The Conference Committee Report indicates that if the 1976 amendments to Old Chapter IX are held unconstitutional, Old Chapter IX is revived and shall have full force and effect as to cases filed under New Chapter IX.¹⁶⁶ This provision guards against the possibility that pending cases may be left without a remedy in the bankruptcy court, but it should not be considered a revival of Old Chapter IX for any other purpose.

III. Conclusion

The ultimate question in evaluating New Chapter IX is "will it

160. *Id.* § 96(c), 90 Stat. 324.

161. *Id.* § 96(b), 90 Stat. 324.

162. *Id.* § 96(d).

163. *Id.* § 98, 90 Stat. 325.

164. *Id.* § 98(a).

165. *Id.* § 98(b).

166. H.R. REP. NO. 686, 94th Cong., 2d Sess. 61 (1975). *See also* 1 U.S.C. § 108 (1970).

work?" The particular facts and circumstances surrounding each case will, of course, be largely responsible for the success or failure of the reorganization process. For example, in states which have no state procedures for municipal debt adjustment,¹⁶⁷ tenth amendment questions are not likely to be troublesome. In states such as New York, where the legislature seemingly has widespread authority to suspend provisions of the state's constitution and statutes to provide relief in financial emergencies,¹⁶⁸ tenth amendment challenges may be meritorious.

Such conflicts aside, New Chapter IX provides an inviting harbor for the municipality in financial distress. The automatic stay provisions guarantee an orderly procedure for satisfying creditors' claims, whereas the alternative to filing—default on debt obligations—would generate a plethora of creditors' actions against the municipality and (if municipal service delivery should grind to a halt) endanger the well-being of the municipality's inhabitants.

The New Chapter IX procedure permits the bankruptcy court to isolate its debt adjustment functions from the municipality's political and governmental processes. This respect for the sovereignty of local government does more than merely guarantee due process of law. First, it permits the municipality to retain control over the delivery of essential services during the period of debt adjustment, albeit at reduced levels of cash flow. Second, it allays fears that a federal judge in charge of a Chapter IX case could "take over the town," supplanting the power of duly elected and appointed municipal officials. The congressional intent behind New Chapter IX, as with Chapter XI, is to allow a corporate entity to adjust its debt structure while continuing as an ongoing concern. Many business corporations have entered Chapter XI, adjusted their business routines to meet a plan of adjustment, and emerged from proceedings years later as financially healthy and viable enterprises. In like manner, the bankruptcy court, over a number of years, may encourage basic reforms in urban economies designed to balance municipal budgets by means other than sudden reductions in expenditures and the resulting economic displacement. Indeed, if a large city, such as New York, Detroit, or Newark, were forced to place its fiscal policies

167. See text accompanying notes 13-15 *supra*.

168. *Id.* See also note 71 *supra*.

in the hands of a federal court, there is reason to believe that Congress might be prompted to consider a comprehensive national plan for urban economic reform.

New Chapter IX is not without shortcomings. The issuance of "certificates of indebtedness" might give rise to numerous problems. It is not clear that such certificates would be legally binding obligations of the issuing municipality.¹⁶⁹ Their super-priority over other municipal obligations would likely freeze any market for other such obligations. A second problem is the extent to which the bankruptcy court may interfere with political and governmental operations of the municipality. Any plan of adjustment would seem to require expense reductions on a significant scale; but ordering a municipality to reduce its labor force or to trim welfare costs may infringe on its sovereignty as a political subdivision of the state. Since New Chapter IX adds a "feasibility" test as a prerequisite for confirmation of the plan, it is possible to argue that the plan must be fiscally sound as well as "fair and equitable" in settling creditors' claims. Thus, the bankruptcy court would become more than a mere arbiter of competing creditors' claims; it would act as an impartial "financial advisor," striving to insure that the plan provides for a balanced budget and other fiscal reforms. Another area of concern involves the classification of claims. If as recent case law suggests,¹⁷⁰ various contractual obligations of the municipality may be classified with debt obligations and secured by the municipality's "faith and credit" pledge, the bankruptcy court may be forced to observe this classification.

Municipal bankruptcy has been widely criticized as an unwise policy for dealing with the financial problems of large municipalities. As an instrument of fiscal reform, New Chapter IX does not seek to accomplish anything more than did its predecessor; it works out a plan for composition of existing debt while keeping the municipality in operation for the benefit of its inhabitants. But it does simplify the process, protecting the municipality from creditors and increasing the chances of a successful reorganization of debt. Perhaps that result, in itself, justifies placing a federal judge in control

169. See text accompanying notes 73-83 *supra*.

170. See *Board of Educ. v. Yonkers Fed'n of Teachers*, 40 N.Y.2d 268, 353 N.E.2d 569, 386 N.Y.S.2d 657 (1976). See also note 114 *supra*.

of a municipality's debt structure when the alternative of a breakdown in operations is contemplated.¹⁷¹

171. As this Article went to press, the New York Court of Appeals declared unconstitutional the New York City Emergency Moratorium Act of 1975. *Flushing Nat'l Bank v. Municipal Assistance Corp.*, 176 N.Y.L.J. 5 (Nov. 23, 1976). The implications of this decision deserve comment with regard to New Chapter IX.

The Moratorium Act postponed for at least three years payment of certain short-term obligations of the City of New York. Of approximately 5.0 billion dollars in such obligations, the holders or owners of about 1.0 billion dollars in no way agreed to the postponement. The court's decision requires the City to make payments to these holders and owners. Neither the City nor the State of New York has known funds currently available to satisfy these obligations. State options to resolve the situation are limited, and resort to federal remedies seems more likely.

State solutions seem unsatisfactory. First, MAC could issue enough bonds to fund payment of the short-term obligations, but market conditions might make this impractical. Second, the state might make an emergency appropriation to the City; however, this might deprive other municipalities within the state of needed operating revenues, perhaps triggering numerous Chapter IX filings. Finally, the City might seek a settlement with the bondholders, but failure to reach a satisfactory agreement could trigger creditors' suits against the City, leaving the City no choice but to seek federal remedies, including New Chapter IX.

Filing a Chapter IX petition might produce desirable financial consequences. The City would receive the benefit of the automatic stay provisions, *see* notes 38-52 *supra*, and all City debt obligations would be placed on equal ground with respect to a plan of adjustment. *See* notes 110-14 *supra*. Finally, filing a Chapter IX proceeding would limit the power of the federal courts to interfere with the city's political and governmental operations. "First revenues" would remain untouched, and the delivery of essential services would not be interrupted, thus permitting current revenues to be applied to such services, insuring continued maintenance of the city's well-being.