Securities Law Disclosure Requirements for the Political Subdivision Threatened with Bankruptcy

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Cover Page Footnote
SECURITIES LAW DISCLOSURE REQUIREMENTS FOR THE POLITICAL SUBDIVISION THREATENED WITH BANKRUPTCY

Robert A. Fippinger*

I. Introduction

As Finance Director of City X, Mr. Jones is an *ex officio* member of the Electric Utility Board of City X. In this capacity he attends a meeting of the board to approve a bond resolution, authorized the previous evening by the City Council, providing for the issuance of $20,000,000 of City X Electric Utility Revenue Bonds to improve and repair distribution lines throughout City X. As bond counsel summarizes the bond resolution, Mr. Jones' mind wanders to a meeting he has just attended in the Mayor's office during which advisors to the Mayor discussed the necessity of City X filing a petition for municipal debt adjustment under Chapter 9 of the Bankruptcy Reform Act of 1978 (Bankruptcy Code)\(^1\) because of unexpected revenue shortfalls and legal impediments to the issuance of revenue anticipation notes. Without disclosing the possible filing of the petition, Mr. Jones votes to approve the bond resolution, and the Board executes an underwriting agreement with its investment bankers. Has Mr. Jones and City X or the investment bankers, upon a subsequent distribution of bonds to investors, violated the antifraud provisions of the Securities Act of 1933 (1933 Act)\(^2\) or the Securities Exchange Act of 1934 (1934 Act)?\(^3\)

This illustration, with a few variations and additional details, provides the basis for discussing the interplay of disclosure requirements under the 1933 Act and 1934 Act with the municipal debt adjustment procedures of the Bankruptcy Code. The presentation is made in three parts. First, the Article summarizes the application of federal secur-

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It is not the author's intention to recommend that in the ordinary course of public finance there be a standard disclosure paragraph as to the possible application of Chapter 9 of the Bankruptcy Code where there is no foreseeable filing of a petition. In most of the illustrations to be discussed, the Bankruptcy Code, properly interpreted, adequately protects the investor and, therefore, the integrity of the municipal market to the advantage of issuers. The analysis of Chapter 9 in the illustrations becomes so complex, however, that the securities lawyer, the issuer and other professionals inevitably will have to be sensitive to possible disclosure requirements.

5. 48 Stat. at 74.
6. § 17(a) of the 1933 Act is as follows:
   (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transporation or communication in interstate commerce or by the use of the mails, directly or indirectly—
      (1) to employ any device, scheme, or artifice to defraud, or
      (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
      (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.
7. 15 U.S.C. § 77e (1976). The registration provision of § 5 has three time periods:
   (1) prior to filing a registration statement complying with § 7 of the 1933 Act filed with the Securities and Exchange Commission (SEC), no offer to sell or buy a security may be made, (2) during a 20-day waiting period, no communications with respect to securities for which a registration statement has been filed with the SEC may be made except by a prospectus meeting the requirements of § 10 of the 1933 Act, and (3) no sale may be made prior to the effective date.
disclosure for many, but not all, issues of securities. Compliance with Section 5 does not ensure compliance with Section 17(a).8

The registration requirements of Section 5 may be avoided if there is no "security" to be sold within the meaning of Section 2(1),9 if the security is an exempted security under Section 310 or the transaction is exempted under Section 4.11 For public issuers the exemption from registration is set forth in Section 3(a)(2).12 The exemption in Section 3(a)(2) includes securities issued by states, territories, political subdivisions, public instrumentalities or securities qualifying as industrial development bonds under Section 103 of the Internal Revenue Code.13 The defined entities become significant whenever it is neces-

9. Section 2(1) of the 1933 Act is as follows:
   [T]he term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.
12. See note 10 supra.
13. I.R.C. § 103 (P-H 1981). Relevant provisions of §§ 103(a) and (b) of the Internal Revenue Code include:
   (a) General Rule—Gross income does not include interest on—
      (1) the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia; . .
   (b) Industrial Development Bonds—
      (1) Except as otherwise provided in this subsection, any industrial development bond shall be treated as an obligation not described in subsection (a). . .
sary to cross-reference among the 1933 Act\textsuperscript{14} and 1934 Act,\textsuperscript{15} the

(2) Industrial Development Bond—For purposes of this subsection, the term "industrial development bond" means any obligation—

(A) which is issued as part of an issue all or a major portion of the proceeds of which are to be used directly or indirectly in any trade or business carried on by any person who is not an exempt person (within the meaning of paragraph (3)), and

(B) the payment of the principal or interest on which (under the terms of such obligation or any underlying arrangement) is, in whole or in major part—

(i) secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or

(ii) to be derived from payments in respect of property, or borrowed money, used or to be used in a trade or business.

(3) Exempt person—For purposes of paragraph (2)(A), the term "exempt person" means—

(A) a governmental unit, or

(B) an organization described in section 501(c)(3) and exempt from tax under section 501(a).

(4) Certain exempt activities—Paragraph (1) shall not apply to any obligation which is issued as part of an issue substantially all of the proceeds of which are to be used to provide—

(A) projects for residential rental property,

(B) sports facilities,

(C) convention or trade show facilities,

(D) airports, docks, wharves, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing,

(E) sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy or gas,

(F) air or water pollution control facilities,

(G) facilities for the furnishing of water,

(H) qualified hydroelectric generating facilities.

(6) EXEMPTION FOR CERTAIN SMALL ISSUES—

(A) In general—Paragraph (1) shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less.

(D) $10,000,000 limit in certain cases.—At the election of the issuer, with respect to any issue this paragraph shall be applied—

(i) by substituting "$10,000,000" for "$1,000,000" in subparagraph (A), and

(ii) in determining the aggregate fact amount of such issue, by taking into account the aggregate amount of capital expenditures with respect to facilities described in subparagraph (E) [the municipality] paid or incurred during the 6-year period beginning 3 years before the date of such issue and ending 3 years after such date.

14. In the House Report accompanying the 1933 Act, H.R. REP. No. 85, 73rd Cong., 1st Sess. 14 (1933), it was explained:

Paragraph (2) exempts United States, Territorial and State obligations, or obligations of any political subdivision of these governmental units. The term "political subdivision" carries with it the exemption of such securities as county, town, or municipal obligations, as well as school district, drainage district. The line drawn by the expression "political subdivi-
INTERNAL DISCLOSURE REQUIREMENTS

... and the Bankruptcy Code.\textsuperscript{17}


\textit{Internal Revenue Code},\textsuperscript{16} and the Bankruptcy Code.\textsuperscript{17}

\section*{DISCLOSURE REQUIREMENTS}

\section*{Internal Revenue Code,\textsuperscript{16} and the Bankruptcy Code.\textsuperscript{17}}

\begin{itemize}
\item[	extsuperscript{16}] Section 3(a)(9) of the 1934 Act defines "person" to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." 15 U.S.C. § 78c(a)(9) (1976). The definition is central to § 10(b) of the 1934 Act which provides:

\begin{verbatim}
SEC. 10. It shall be unlawful for any person, directly or indirectly, by
the use of any means or instrumentality of interstate commerce or of the
mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any
security registered on a national securities exchange or any security not so
registered, any manipulative or deceptive device or contrivance in con-
tra-vention of such rules and regulations as the Commission may prescribe as
necessary or appropriate in the public interest or for the protection of
investors.

SEC Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of
any means or instrumentality of interstate commerce, or of the mails or of
any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a
material fact necessary in order to make the statements made, in the light
of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates
or would operate as a fraud or deceit upon any person, in connection with
the purchase or sale of any security.


16. The meaning of "political subdivisions" referred to in § 103(a) of the Internal Revenue Code has been the subject of litigation, rulings and proposed regulations of the Internal Revenue Service. In Commissioner of Internal Revenue v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944), \textit{cert. denied}, 323 U.S. 792 (1945), the Court of Appeals for the Second Circuit held that The New York Port Authority was a political subdivision for purposes of § 103(a). The Authority did not have the power of taxation and its members were not elected, but the Authority was created by compact between New York and New Jersey, its members were appointed by the states, it had the power of eminent domain, was imunized from suit, it had a police force with traditional police powers and was empowered to enforce regulations governing the operation of its facilities. See also Commissioner of Internal Revenue v. Whit's Estate, 144 F.2d 1019 (2d Cir. 1944), \textit{cert. denied}, 323 U.S. 792 (1945), holding that the Triborough Bridge and Tunnel Authority was a political subdivision under § 103.

In Philadelphia Nat'l Bank v. United States, 666 F.2d 834 (3rd Cir. 1981), the Court of Appeals for the Third Circuit reversed the district court's determination that
The reference in Section 3(a)(2) of the 1933 Act to Section 103 of the Internal Revenue Code did not exist prior to 1970, and exemption from registration was a simple matter of identifying the issuer as an authorized government entity. No review of the purpose for which proceeds were to be used was necessary. In the 1960's, a number of states had enacted legislation permitting political subdivisions to issue tax exempt revenue bonds for the purpose of attracting private business to locate in the issuing county or municipality. Proceeds of the bonds would be used to construct a plant which was leased or sold to a private business in amounts and installments timed to coincide with debt service on the bonds. The inducement to the company was the lower interest rate for tax exempt bonds to finance a capital improvement otherwise acquired by the issuance of corporate debentures or stock. From the perspective of the political issuer, provision for employment opportunities had equal merit for the use of bonds as the construction of roads. From the perspective of the SEC, the issue was a disguised form of corporate debt which should be subject to the same registration requirements as other corporate issues.

In 1968, the SEC took the position in proposed Rule 131, which became effective in 1969, that bonds issued to benefit private corporations involved a "separate security" apart from the bond of the political subdivision. The SEC viewed the separate security as the obligation of the corporation under the lease or installment sale agreement.

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Temple University had sufficient governmental functions and powers to qualify as a political subdivision. The Court of Appeals concluded that charges for tuition for performing a recognized public service were not akin to tolls on bridges, id. at 838, that campus police were not the equivalent of Port Authority police, id. at 840, that the power to request the Commonwealth to condemn land was not similar to the power of eminent domain, id., and that the private members of the Board of Trustees were in a majority over those appointed by the Commonwealth, id. at 838. Temple University was held not to be a political subdivision for purposes of § 103. Id. at 842.

17. Chapter 9 of the Bankruptcy Code applies to "municipalities" (Bankruptcy Code § 109(c)). "Municipality" is defined in § 101(29) to mean a "political subdivision or public agency or instrumentality of a State; . . . " The confusion inherent in this definition and the legislative history is discussed at notes 53-63 infra and accompanying text.


19. See note 11 supra.

20. A revenue bond is an obligation not payable from taxes but payable from revenues generated by the project financed with proceeds of an issue, e.g., a toll bridge. A general obligation bond is payable from taxes levied by the governmental issuer and is likely to be used when the project financed does not generate sufficient revenue to retire debt, e.g., a government office building.

to pay debt service. The obligation of the corporation was distinguished from the bond of the issuer and subject to registration.

In 1968, Congress itself took action to limit the use of public bonds for private enterprise by enacting Section 103(c) of the Internal Revenue Code, since recodified as Section 103(b).\textsuperscript{22} The term of art used in the Internal Revenue Code is "industrial development bond" because the most prolific use of the device has been to attract heavy industry. The definition, however, extends to any obligation in which a major portion of the proceeds are used in the trade or business of any person other than the government itself (or certain charitable organizations) and a major portion of the debt service is payable from such trade or business.\textsuperscript{23} Congress limited the use of industrial development bonds to certain identified purposes\textsuperscript{24} deemed to provide sufficient public benefits to justify tax exempt financing. The SEC chose not to follow the lead of Congress by repealing Rule 131. In 1970, therefore, Congress specifically provided in Section 3(a)(2) that an industrial development bond would not be subject to registration.\textsuperscript{25}

The SEC has reacted to the additional clause in Section 3(a)(2) by applying the cross reference to the Internal Revenue Code with a vengeance. The pre-1970 provision in Section 3(a)(2) granting an exemption from registration for political subdivisions and public instrumentalities remains intact. This general provision makes no reference to the Internal Revenue Code and yet in more than one hundred no-action letters rendered by the SEC since 1970 interpreting Section 3(a)(2) the SEC has included a standard phrase that its favorable interpretation is "contingent" upon the issue's achieving tax exempt status under Section 103 of the Internal Revenue Code.\textsuperscript{26} No attempt is made to determine whether the issue is an industrial development bond under Section 103(b), making the contingency with respect to the Internal Revenue Code appropriate pursuant to congressional policy in 1970. The broad language of Section 3(a)(2) is, as far as the SEC is concerned, to be interpreted by the narrow language of Section 103 of the Internal Revenue Code.\textsuperscript{27}

\textsuperscript{22} I.R.C. § 103(b) (P-H 1981).
\textsuperscript{23} See note 13 supra.
\textsuperscript{24} See I.R.C. §§ 103(b)(4)-(6) (P-H 1981), note 13 supra.
\textsuperscript{25} See note 18 supra. Rule 131 remains in effect representing the position of the SEC in situations not comprehended by Congress and continues to plague lawyers relying on § 3(a)(2) of the 1933 Act where there is any unique form of underlying security not otherwise exempt under § 3 of the 1933 Act. See Fippinger, Public Finance Law, ANN. SUR. AM. L. (Vol. 4 1980).
\textsuperscript{26} See SEC No-ACTION LETTERS INDEX AND SUMMARIES (1933 ACT), Wash. Serv. Bureau Inc. (1974).
\textsuperscript{27} The SEC has pursued its interest in the Internal Revenue Code by reviewing the tax analysis of attorneys under § 103 of the Internal Revenue Code to argue that
In the usual case where an issue of a political subdivision is exempt from the registration requirements of Section 5 by reason of Section 3(a)(2), there is no basis for civil liability under Section 11\textsuperscript{28} with respect to false statements or omissions in the registration statement. Section 12(2)\textsuperscript{29} imposing civil liability in connection with prospectuses and other communications specifically excludes securities exempt under Section 3(a)(2). What remains is Section 17(a) of the 1933 Act\textsuperscript{30} which is the general antifraud provision. Section 17(a) clearly applies to securities issued by political subdivisions by reason of Section 17(c).\textsuperscript{31} Since liability cannot be effected under the civil liability provisions of Sections 11 and 12, enforcement is accomplished by the injunctive powers of the SEC under Section 20,\textsuperscript{32} the power to conduct hearings under Section 21\textsuperscript{33} and the criminal sanctions under Section 22.\textsuperscript{34}

the tax analysis was incorrect thereby rendering an industrial development bond not tax exempt and, in turn, subjecting the issue to registration under the 1933 Act and defendants liable under the 1933 Act for failure to register. See generally SEC v. Haswell [1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,156 (W.D. Okla. Oct. 19, 1977).

30. See note 6 supra.
31. Section 17(c) provides that “[t]he exemptions provided in § 3 [77c] of this title shall not apply to the provisions of this section.” 15 U.S.C. § 77q(c) (1976).
33. Id. § 77u.
34. Id. § 77x. The Supreme Court has yet to decide whether there is an implied civil liability under § 17(a). In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court stated: “We express no opinion on whether § 17(a) in light of the express civil remedies of the 1933 Act gives rise to an implied cause of action.” Id. at 734 n.6. In a similar statutory provision, § 206 of the Investment Advisors Act of 1940, the Court in 1979 held there was no implied cause of action. Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979). In his concurring opinion in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971), Judge Friendly stated:

[t]here is unanimity among the commentators, including some who were in a peculiarly good position to know, that § 17(a)(2) of the 1933 Act—indeed the whole of § 17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§ 11 and 12. [citations omitted]. When the House Committee Report listed the sections that ‘define the civil liabilities imposed by the Act’ it pointed only to §§ 11 and 12 and stated that “[t]o impose a greater responsibility [than that provided by §§ 11 and 12] . . . would unnecessarily restrain the conscientious administration of honest business with no compensating advantage to the public.’ H.Rep. No. 85, 73rd Cong., 1st Sess. 9-10 (1933).

Id. at 867. For the argument that an implied cause of action should not arise under either § 17(a) of the 1933 Act or § 10(b) of the 1934 Act in the context of municipal
The standard of conduct required by Section 17(a) is the same for issues of securities by political subdivisions as for issues of private corporations. Sections 17(a)(1) refers to "devices," "schemes" and "artifices to defraud." This is language of intent and a showing of scienter is required in an enforcement action by the SEC. Scienter is defined by the courts to be a mental state embracing intent to deceive, manipulate or defraud. Sections 17(a)(2) and (3) employ language which relates to the effect of the conduct rather than the intent of the defendant. Under these provisions a negligence standard will support injunctive action by the SEC.

A better argument may be made under Section 10(b) of the 1934 Act for implied liability in issues of securities by political subdivisions, given the absence of tightly drafted civil remedies in the 1934 Act comparable to Sections 11 and 12 of the 1933 Act. Throughout Section 10(b) of the 1934 Act there is language referring to "devices," "contrivances" and conduct that is "manipulative." Accordingly, an action under Section 10(b), whether for damages or injunctive relief, requires a showing of scienter. Where there is an identifiable primary party committing the securities law fraud, peripheral persons referred to by the courts as "aiders and abettors" will be subject to Section 10(b) liability if the aider and abettor had knowledge of the violation and rendered substantial assistance in the achievement of the primary violation. The courts have interpreted this test in the form of correlative variables: where there is little showing of substantial assistance the degree of knowledge must be greater.

The concept of materiality appears throughout the antifraud provisions. It is unnecessary to disclose information for the sake of providing additional information. What is material is that which, in the
context of all information disclosed, would assume actual significance in the deliberations of a reasonable investor.\textsuperscript{45} This standard may be clarified by highlighting the elements of the definition. First, the information to be evaluated for materiality must be considered in the context of all material information, not in isolation.\textsuperscript{46} Second, it must assume actual significance in an investment decision.\textsuperscript{47} Third, it also must assume actual significance to an objectively reasonable investor, not a unique investor with a particular, specialized interest.\textsuperscript{48} If information is not material, it need not be disclosed. Conversely, if disclosure of immaterial information would confuse that which is material, it should not be disclosed.

Returning to Mr. Jones and City X, the possibility of filing a petition for municipal debt adjustment is clearly material since there would be an immediate impact on the secondary market for all City X obligations. Furthermore, the terms of repayment could be affected under the procedures of the Bankruptcy Code.\textsuperscript{49} Mr. Jones and City X would be subject to civil liability under Section 10(b) of the 1934 Act for having actual knowledge of the material omission. Mr. Jones and City X also would be subject to injunctive procedures by the SEC under Section 10(b) of the 1934 Act and Section 17(a) of the 1933 Act. The investment banker, however, lacking actual knowledge of the fraud, would not be liable under Section 10(b) of the 1934 Act.\textsuperscript{50} The investment banking firm and the responsible employee could be subject to injunctive action by the SEC under Sections 17(a)(2) or (3) of the 1933 Act where the standard of care is based on negligence and not on actual knowledge.\textsuperscript{51} The investment banker's negligence is due to his failure to analyze the financial condition of the issuer to acquire sufficient information which could cause him to question the solvency of City X.\textsuperscript{52}

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\item \textsuperscript{45} TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).
\item \textsuperscript{46} \textit{Id}.
\item \textsuperscript{47} \textit{Id}. at 448-49.
\item \textsuperscript{48} \textit{Id}. at 449.
\item \textsuperscript{49} \textit{See Part III infra}.
\item \textsuperscript{50} \textit{See IIT, An Int'l Inv. Trust v. Cornfeld, 619 F.2d 909, 923-25 (2d Cir. 1980).}
\item \textsuperscript{51} For a discussion of the negligence standard as applied to aiders and abettors under § 17(a), \textit{see SEC v. Spectrum, Ltd., 489 F.2d 535, 541-42 (2d Cir. 1973).}
\item \textsuperscript{52} For investment bankers as well as attorneys attempting to have a practical definition of "due diligence", a valuable guide is the American Bar Association's Committee on Ethics and Professional Responsibility, Formal Op. 335, 60 A.B.A.J. 488 (1974):
\end{itemize}

[t]he lawyer should, in the first instance, make inquiry of his client as to the relevant facts and receive answers. If any of the alleged facts, or the alleged facts taken as a whole, are incomplete in a material respect or are
DISCLOSURE REQUIREMENTS

III. Chapter 9 of The Bankruptcy Code

A. The Securities Law Problem of Identifying the Bankruptcy Code Debtor

The immediate reaction of Mr. Jones and City X on being informed of possible violations of the federal securities laws might well be to argue that the bondholders are unaffected not only because there was full and adequate disclosure with respect to the electric system, but also because revenues of the system are sufficient to pay debt service. In order to consider this argument, it first must be determined whether the debt is owed by City X, which is about to file a Chapter 9 petition, or by the Electric Utility Board of City X, a separate political subdivision which is not threatened by bankruptcy. If this is the debt of City X, the second issue to be considered is whether a plan of adjustment may lawfully be approved by the bankruptcy court if it impairs the security of bondholders.

Considering the first issue, a municipality entitled to file a petition under Chapter 9 is defined as a "political subdivision or public agency or instrumentality of a State."\(^5\) The legislative history\(^54\) indicates that the definition was derived from the municipal bankruptcy amendment to the Bankruptcy Act enacted in 1976.\(^55\) A 1976 House Report dealing with the municipal bankruptcy amendment provides that the definition "is not meant to be limiting language. . . ."\(^56\) The report further explains that the requirement that the state approve the filing of a petition\(^57\) is to ensure that the proceeding be a cooperative one between the state and the bankruptcy court.\(^58\) It also is clear from the legislative history that the definition of a political subdivision and a public agency or instrumentality is to be derived from state law. This conclusion was applied in In Re Fort Cobb, Oklahoma, Irrigation Fuel Authority,\(^59\) where a federal court dismissed a Chapter 9 suspect, or are inconsistent or either on their face or on the basis of other known facts are open to question, the lawyer should make further inquiry. . . . Where the lawyer concludes that further inquiry of a reasonable nature would not give him sufficient confidence as to all the relevant facts, . . . he should refuse to give an opinion.

Likewise, the investment banker should refuse to underwrite an issue. Id. at 489.

petition for failure of the petitioner to qualify as a political subdivision under state law. This principle illustrates an important distinction between the interpretation of similar language in the Bankruptcy Code and Section 103 of the Internal Revenue Code,\textsuperscript{60} where the definition of a political subdivision has been federalized and made overly simplistic.\textsuperscript{61} Whether the Bankruptcy Code debtor is City X or the Utility Board is a matter of state law.

By relying on state law definitions of political subdivisions and public agencies and instrumentalities, the Bankruptcy Code draws on two centuries of jurisprudence delineating the public and private sectors of the economy. In most jurisdictions, the term "political subdivision" refers to all government bodies below the level of the state, including counties, municipalities, districts, agencies, authorities, quasi-corporations and other "bodies politic and corporate" which have a sufficiently separate identity under state law.\textsuperscript{62} The phrase "political" in political subdivision or "body politic and corporate" and the phrase "public" in public agency or public instrumentality also have historical significance. In early American law, corporations had both the sovereign powers of what are now public corporations and the profit-oriented rights of what are now private corporations. The monopolistic use of such power for the attainment of private wealth led to the separation in the early nineteenth century of public and private functions.\textsuperscript{63} While the boundaries of legitimate activity for the two sectors have varied with the vicissitudes of political and economic philosophy, as far as Chapter 9 of the current Bankruptcy Code is concerned, the historical and functional attributes of the term "political subdivision" relate to the overriding purpose of Chapter 9, as distinguished from the operative chapters of the Bankruptcy Code which deal with private persons and corporations. In Chapter 9 there is no liquidation of the assets of the municipality as in Chapter 7, nor is there the creation of a fictional estate of the debtor overseen by a trustee as in the provisions of Chapter 11 applicable to business reorganizations. Chapter 9 contemplates the maintenance of

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  \item \textsuperscript{60} I.R.C. § 103 (P-H 1981).
  \item \textsuperscript{61} See note 16 supra. To be a § 103 political subdivision pursuant to \textit{Philadelphia Nat'l Bank v. United States}, it virtually is necessary to have the power of eminent domain and a police force with the ability to shoot to kill. The possible assignment by state legislatures of a myriad of public functions to various public entities is ignored. The only meaningful criterion mentioned in the case is state control of membership on the board of the entity.
  \item \textsuperscript{62} DILLON, MUNICIPAL CORPORATIONS § 34.
  \item \textsuperscript{63} Frug, \textit{The City As A Legal Concept}, 93 HARV. L. REV. 1059 (1980).
\end{itemize}
public property for public purposes as well as decisions made by public officials, not by private trustees.

Returning to the illustration of City X, the facts indicate that the debt is a debt of the city and not the Electric Utility Board. The bond resolution was adopted by the City Council and the bonds are revenue bonds of City X. The board appears to be an agency of the city and probably has a partially separate identity under a state statute authorizing the creation and governing the operations of electric utility boards in cities of a certain size. Although the membership and powers of the board are determined by state legislation, the board still would be an agency of City X. The debt incurred for the electric system is debt of City X and therefore necessarily within the jurisdiction of the bankruptcy court overseeing the petition and plan of City X.

An entirely different analysis would result if state law created a separate political subdivision to operate the electric system. For example, a statute could provide, “[i]n every city of the first class there hereby is established an authority to be designated the Electric Utility Authority of the City, constituting a political subdivision of the state and body politic and corporate with the following powers . . . .” In such a case, the imminent bankruptcy of City X might be wholly immaterial as a matter of securities law to the issuance of debt by the authority. The plan of debt adjustment of City X could not affect the debt of the authority which would be a separate political subdivision. In this instance, the only argument for disclosure of the peril of City X would be the possible secondary market effect on the bonds of the authority.

The legislative history and explanatory comments to the Bankruptcy Code exclude industrial development bonds from the scope of the petition and plan. Therefore, this particular form of indebtedness is beyond the jurisdiction of the court. The Senate Report states that industrial development bonds are issued to provide financing at lower tax exempt interest rates in order to construct facilities for privately owned companies. Furthermore, they are sold on the basis of the credit of the company and are payable solely from payments made by the company. The municipality is merely a financing vehicle to enable the bonds to be sold on a tax exempt basis under

65. Id.
66. Id.
Section 103 of the Internal Revenue Code. Bankruptcy Code claims in connection with industrial development bonds are claims against the company and not the municipality and, therefore, are deemed debts of the company. A municipal plan of adjustment would exclude industrial development bonds.

The congressional attempt, while motivated by good intentions, is unsuccessful in its execution. By referring specifically to an industrial development bond as defined in Section 103 of the Internal Revenue Code, the legislative history of the Bankruptcy Code adopts the meanings set forth in the Internal Revenue Code. For example, assume City X issues $20,000,000 of Electric Utility Revenue Bonds, the proceeds of which are used to provide $10,000,000 of improvements to transmission facilities which will benefit the general public and $10,000,000 of improvements to its hydro-electric generating plant which would increase the output to be sold to an investor-owned private utility serving a recently annexed area of the city. To secure the bonds, a reserve fund is established with electric system surpluses on hand in the amount of $2,000,000. Although under the Internal Revenue Code this is an industrial development bond, should the issue be deemed solely a debt of the investor-owned utility and not of City X for purposes of the Bankruptcy Code?

The problem is more clearly exposed in the following issues. On the same day, City X issues $10,000,000 of Hospital Revenue Bonds to loan money to a private hospital organized under Section 501(c)(3) of the Internal Revenue Code and $10,000,000 of Housing Development Revenue Bonds to provide funds to make ten $1,000,000 loans to developers to finance the construction of apartment buildings for occupancy by persons of low and moderate income. The first issue is not an industrial development bond and, therefore, should be subject to a Chapter 9 plan. The second issue is an industrial development bond and, therefore, should fall outside the scope of Chapter 9. But

67. Id.
68. Id. at 109-10.
69. For the provisions of I.R.C. § 103 relating to industrial development bonds, see note 13 supra.
71. The analysis under I.R.C. § 103(b) is that the second issue is the making of loans to developers for use in the trade or business of the developers in the construction business. The first issue, while a loan to a private corporation, is a loan to an "exempt person" under I.R.C. § 103(b)(3) by reason of the hospital being organized under I.R.C. § 501(c)(3). The language of I.R.C. § 103(b) provides that the Hospital Revenue Bonds are not industrial development bonds. See note 13 supra.
this result would be the very opposite of what Congress intended when it enacted Chapter 9.

The purpose of Chapter 9 is to avoid liquidation of the assets of the governmental entity and to allow elected officials to continue to perform governmental services without the interposition of an appointed trustee. Claims are to be restructured in the manner of a Chapter 11 corporate reorganization rather than a Chapter 7 liquidation and there is to be government management of public affairs by those elected to office. There is no estate created to be administered by a trustee. The Hospital Revenue Bond issue is the mere lending of money to a private corporation and requires little, if any, governmental supervision but is within Chapter 9. The legislative history would make an obligation that is in reality an obligation of a private corporation within the jurisdiction of the Chapter 9 plan of debt adjustment.72 The Housing Development Revenue Bonds, theoretically outside Chapter 9, are for a purpose requiring continued government oversight to protect the interests of tenants in the construction and management of the apartments. If the developers become bankrupt, the Chapter 9 function is lost because the issue is not within the protection of Chapter 9. When a developer becomes bankrupt, the municipality is in the position of creditor making a claim, and the developer is replaced by a trustee. If both the municipality and the developer are insolvent, the municipality would be a Chapter 7, 11 or 13 claimant, as opposed to a Chapter 9 debtor, making it difficult for the municipality to act in the best interests of both the tenants and the municipality.

If a municipality faces any risk of becoming insolvent, the officials and advisors responsible for a revenue bond issue are left with the difficult problem of determining whether the issue would be within the scope of Chapter 9. The analysis is all the more difficult when the definitional reference to Section 103 of the Internal Revenue Code is added, leading to a result that is inconsistent with the underlying purpose of Chapter 9 of the Bankruptcy Code. Under the federal securities laws, the identity of a potential Bankruptcy Code debtor, which defines the scope of jurisdiction of the bankruptcy court in confirming a plan of debt adjustment, is essential to a determination of material disclosures.

B. The Circularity of Constitutional Issues

The term “bankruptcy” is a misnomer for a Chapter 9 proceeding. The purpose of Chapter 9 is to provide for federal court supervision of

72. See note 64 supra.
a settlement between the petitioner municipality and a majority of its creditors. Assets of the municipality cannot be liquidated to satisfy creditors. Therefore, the purpose of the plan must be to adjust outstanding debts to creditors by restructuring or refinancing so that the cash flow of the municipality is sufficient to pay adjusted debt as it comes due.\textsuperscript{73}

A municipal adjustment suit may be commenced by the political subdivision alone; it is a voluntary petition, not an involuntary case.\textsuperscript{74} In addition to requiring voluntary commencement by the political subdivision, the Bankruptcy Code requires as a precondition to the filing of a petition that there be affirmative authorization under state law.\textsuperscript{75} The requirement of state consent is included in the operative provisions of the Bankruptcy Code, but Section 903 further provides a general rule of interpretation 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 such municipality. . . .”\textsuperscript{76}

Section 903 was a result of the interplay between Congress and the Supreme Court during the Depression. The first municipal debt provisions included in the Bankruptcy Act were enacted in 1934 as emergency legislation for the relief of minor political subdivisions of states.\textsuperscript{77} The statute was declared unconstitutional on its face by the

\textsuperscript{73} H.R. REP. No. 686, 94th Cong., 2d Sess. 543 (1976).
\textsuperscript{74} 11 U.S.C. § 901(a) (Supp. II 1978), adopts 11 U.S.C. § 301 into Chapter 9 providing for voluntary cases, but there is no adoption of 11 U.S.C. § 303, the basis for an involuntary case. 11 U.S.C. § 109(c)(4) (Supp. II 1978), provides that to be a debtor under Chapter 9, the entity must be one which “desires to effect a plan to adjust such debts.”
\textsuperscript{75} 11 U.S.C. § 109(c)(2) (Supp. II 1978). State consent is illustrated by the following Florida statute, FLA. STAT. ANN. § 218.01 (West 1971):

> For the purpose of rendering effective the privilege and benefits of any amendments to the bankruptcy laws of the United States that may be enacted for the relief of municipalities, taxing districts and political subdivisions, the state represented by its legislative body gives its assent to, and accepts the provisions of any such bankruptcy laws that may be enacted by the congress of the United States for the benefit and relief of municipalities, taxing districts and political subdivisions and its several municipalities, taxing districts and political subdivisions, at the discretion of the governing authorities thereof, may institute and conduct and carry out, by any appropriate bankruptcy procedure that may be enacted into the laws of the United States for the purpose of conferring upon municipalities, taxing districts and political subdivisions, relief by proceedings in bankruptcy in federal courts.

\textsuperscript{77} Act of May 24, 1934, ch. 345, §§ 78-80, 48 Stat. 798.
Supreme Court. The following year Congress enacted a statute that would not impinge upon the constitutionally protected authority of the states to regulate the affairs of their political subdivisions. This statute was upheld by the Supreme Court. In upholding the legislation the Court warned that "no interference with the fiscal or governmental affairs of a political subdivision is permitted." The current legislative history explaining Section 903 retains this constitutional theme.

The following hypothetical illustrates the constitutional issues involved. The Electric Utility Authority of City X is organized under state law as an authority and a body politic and corporate separate and apart from City X. The Electric Utility Authority is, therefore, the relevant debtor for Bankruptcy Code analysis. In the statute creating the authority there is a standard provision designed to protect the security of revenue bondholders: "In consideration of the bondholders purchasing bonds of the authority the state does hereby covenant with the bondholders that it will not interfere with or permit interference with the covenants of the authority with bondholders set forth in a bond resolution or trust indenture." The bond resolution or trust indenture contains the following customary covenant of the authority: "The authority specifically covenants that it will not permit the extension of the maturity of any bond or the change in any interest rate or redemption provisions of any bond without the express consent of the bondholder." Meanwhile, the state enacts a law authorizing all of its political subdivisions to file a petition for adjustment of debt under Chapter 9 of the Bankruptcy Code.

With rising costs of fuel and declining electricity use, the authority finds itself unable to pay debt service on time and files a petition for Chapter 9 adjustment after consultation with major institutional investors. A minority bondholder intervenes, claiming that the authority has no power to file the petition.

The minority bondholder could argue that the statutory covenant of the state combined with the specific covenant of the authority is a

81. Id. at 49-51.
83. For typical statutory language, see note 75 supra.
contract that there will be no debt adjustments under the Bankruptcy Code and cite the contract clause of the United States Constitution in support of his position. 84 The authority, on the other hand, could cite the power of Congress to enact uniform laws on the subject of bankruptcy throughout the United States 85 and the supremacy clause of the Constitution 86 to support its position that the Bankruptcy Code supersedes the statutory covenant. This apparent conflict of constitutional issues is not a circularity problem incapable of resolution once the basic policy of Chapter 9 is accepted—the states have the primary power over the fiscal affairs of political subdivisions. 87

Rather than looking for problems at the constitutional level, attention should be directed toward resolving the apparent conflict between the state statutes. 88 According to the principles of statutory construction, when one statute deals with a subject in general terms and another with the same subject in a more detailed way, the latter will control the former if the two cannot be read together. 89 The statute authorizing all the state’s political subdivisions to file a petition for adjustment 90 is a general statute. 91 The statute creating the authority and containing the statutory covenant is a permitted special act. 92 The two may be harmonized by concluding that as a general principle political subdivisions in the state may file a petition for debt adjustment, but the state has determined that electric utility authorities may be outside the general consent when the authority, in order to induce investors to purchase bonds, agrees not to file a petition under Chapter 9 pursuant to its covenants with bondholders. The combination of the bond resolution or trust indenture covenant with the statutory covenant operates to take the authority out of the general

84. U.S. CONST. art. I, § 10, cl. 1: “No State shall... pass any... Law impairing the Obligation of Contracts...”
85. U.S. CONST. art I, § 8, cl. 4.
86. U.S. CONST. art. VI, cl. 2. “This Constitution, and the Laws of the United States which shall be made in Pursuance thereof... shall be the supreme Law of the Land... any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.”
88. This conforms to the abstention doctrine that if a case can be decided on either of two grounds, one involving a constitutional issue and the other an issue of statutory construction, the court will decide only the latter. Ashwander v. TVA, 297 U.S. 288, 346-48 (1936) (Brandeis, J., concurring).
89. SUTHERLAND, STATUTORY CONSTRUCTION § 51.05 (4th ed.).
90. See note 75 supra.
91. SUTHERLAND, STATUTORY CONSTRUCTION §§ 40.02, 40.08 (4th ed.).
DISCLOSURE REQUIREMENTS

consent to file a petition. Remedies on default will then be determined pursuant to the bond resolution or trust indenture, the state statute creating the authority and other relevant laws of the state.93

C. Commencement of the Action and the Automatic Stay

An action under Chapter 9 is commenced by the municipality’s filing a petition in the bankruptcy court in any district in which the municipality is located.94 The chief judge of the court of appeals for that circuit designates the bankruptcy judge to conduct the proceedings.95 In order to file the petition, the Chapter 9 debtor must be a municipality,96 have approval of the state,97 be insolvent or unable to meet debts as they mature,98 and have attempted to negotiate with creditors or determined that such negotiations are impracticable.99

The filing of the petition, evidenced by the time stamp of the court clerk, acts to invoke the automatic stay provisions of Sections 362100

93. There are other constitutional issues affecting political subdivisions that have yet to be resolved under the Bankruptcy Code. For example, Congress in § 106 gratuitously waives sovereign immunity for states and political subdivisions and the sweeping jurisdiction given to bankruptcy courts in § 105 has not gone unnoticed. See generally Note, Article III Limits on Article I Courts: The Constitutionality of the Bankruptcy Court and the 1979 Magistrate Act, 80 COLUM. L. REV. 560 (1980).
94. 11 U.S.C. §§ 901(a), 301 (Supp. II 1978). The reference to “any district” is to provide for municipalities located in more than one federal district such as New York City.
95. Id. § 921(b). The involvement of the chief judge of the court of appeals is because a municipal adjustment is likely to be comparable to a major business reorganization requiring perhaps years of time, considerable publicity, and, therefore, the possibility of bankruptcy judges attempting to manipulate the schedules to secure the assignment.
96. Id. § 109(c)(1).
97. Id. § 109(c)(2).
98. Id. § 109(c)(3). A municipality is insolvent if it is unable to pay debts as they mature. S. REP. No. 989, 95th Cong., 2d Sess. 31 (1978).
99. 11 U.S.C. § 109(c)(5) (Supp. II 1978), requires that the municipal debtor:
(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 in a case under such chapter;
(B) has negotiated in good faith with creditors and has failed to obtain 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 in a case under such chapter;
(C) is unable to negotiate with creditors because such negotiation is impracticable; or
(D) reasonably believes that a creditor may attempt to obtain a preference.
100. Id. § 362.
The stay arises by operation of law and requires no action by the bankruptcy court. It halts the collection of claims, prevents creditors from pursuing remedies against the debtor's assets to the detriment of other creditors, and precludes certain harassing techniques to which the typical bankrupt is subjected. Section 362(a) refers to eight activities which are immediately prevented by the filing of the petition:

1. judicial, administrative or other proceedings against the debtor including the serving of process;
2. enforcement of a judgment against the debtor;
3. any act to obtain property of the debtor;
4. any act to create, perfect or enforce a lien against property of the debtor;
5. any act to create, perfect or enforce a lien against the debtor's property securing a prepetition debt;
6. any act to collect, assess or recover a prepetition claim against the debtor;
7. set-off of any prepetition debt owing to the debtor against any claim of the debtor; and
8. a proceeding by the debtor before the United States Tax Court.

Under paragraphs (4) and (5) the automatic stay prohibits the creation and perfection, as well as the enforcement, of any liens even though the claim arose prior to the filing of the petition. The implications of these provisions for public finance are apparent when applied to the original illustration.

The City Council of City X adopts a bond resolution authorizing the issuance of Electric Utility Revenue Bonds of City X. The bonds are issued to finance electric transmission and distribution lines for a designated portion of the city. The city further adopts a rate ordinance providing for utility rates and charges by customers in amounts sufficient to pay operating expenses and debt service as well as providing for reserves. The bond resolution appoints a trustee and requires that all revenues (defined to be the rates and charges) will be deposited, as soon as practicable upon receipt by the trustee, in a trust fund. The bond resolution further provides: "To secure the payment of the bonds, the city hereby pledges to the bondholders all revenues held or set aside or to be held or set aside under the bond resolution. The pledge hereby made shall be valid and binding from and after the

101. Id. § 922. Congress determined that the automatic stay under § 362 is incomplete for a municipality and therefore added a stay of actions against municipal officers or inhabitants.
102. Id. § 362(a).
first delivery of bonds, and the revenues so pledged shall immediately be subject to the lien of the pledge without any physical delivery or further act." The city issues the bonds, constructs the project, and begins collecting revenues from customers when it files a petition under Chapter 9. The city immediately stops paying the fees and charges to the trustee, and the trustee telephones the Finance Director requesting payment. The Finance Director unhesitatingly informs the trustee that the trustee’s telephone call has violated the automatic stay, and that the city has no intention of making payments to the trustee because the trustee is attempting to perfect the lien of the pledge by causing delivery of the fees and charges.

A pledge is a security interest in a physical object capable of delivery, created by another party’s possession of the object. Typically, a pledge to secure a debt or performance of an act is created by the pledgor delivering the object to the pledgee. A contract to pledge, unaccompanied by delivery, does not in itself create a pledge but does create an equitable interest. At common law the idea of a perfected pledge is without meaning; the pledge either exists or it does not exist. Without using the term “pledge,” Section 9-305 of the Uniform Commercial Code (UCC) provides that a security interest in letters of credit, goods, instruments, money, negotiable documents or chattel paper may be perfected by the secured party’s taking possession of the collateral. The security interest is perfected from the time possession is taken without relation back.

The Finance Director appears to have a firm basis for diverting revenues to purposes other than the payment of debt service while the stay is in effect. If he were correct, however, securities lawyers might

103. A telephone call is an “act” which 11 U.S.C. § 362 (Supp. II 1978), is designed to prevent since many of the harassing techniques of collection agencies are conducted by telephone.
104. Restatement of Security § 1 (1941).
105. Id. § 5.
106. Id. § 101(2).
108. Id. § 9-305.
109. Official Uniform Comment 3 to UCC § 9-305 states:
   [t]he Section rejects the ‘equitable pledge’ theory of relation back, under which the taking possession was deemed to relate back to the date of the original security agreement. The relation back theory has had little vitality since the 1938 revision of the Federal Bankruptcy Act, which introduced in Section 60(a) provisions designed to make such interests voidable as preferences in bankruptcy proceedings. This Section now brings state law into conformity with the overriding federal policy: where a pledge transaction is contemplated, perfection dates only from the time possession is taken, although a security interest may attach, unperfected, before that under the rules stated in Section 9-204.
feel obligated to make a disclosure of law even where insolvency of the issuer is not imminent. There are several bases for concluding that the Finance Director was incorrect.

First, Section 9-104(e) of the official text of Article 9 of the UCC provides that Article 9 has no application to a transfer by a government, a governmental subdivision or agency. The official comments explain that "certain governmental borrowings include collateral in the form of assignments of . . . electricity . . . charges . . ." which are governed by "special provisions of law."\(^{110}\) The term "special provisions of law" primarily refers to the statute establishing the authority and any references therein to the creation of security interests. While every organic law must be reviewed individually such statutes typically provide that "any bond resolution may contain provisions, which shall be part of the contract with bondholders . . . pledging all or any part of the moneys and revenues derived from the project to secure payment of the bonds." This clause alone might be sufficient to allow the creation of an immediately perfected security interest at the time of first delivery of the bonds or execution and delivery of a trust indenture. Careful legislative drafting, however, would ensure that the pledge is immediately effective without an infinite series of perfections each time money is delivered to the trustee by the city.\(^{111}\) Thus, the common law is modified by legislation only to the extent of determining that the relevant object of delivery is the bond resolution or trust indenture which incorporates within it the concept of a stream of revenues.

A second approach is to analyze the statutory language of Section 362 of the Bankruptcy Code, particularly Section 362(b)(3),\(^{112}\) which removes from the operation of the stay any act to perfect an interest in property to the extent that such perfection would be upheld under the substantive provisions of Section 546(b).\(^{113}\) If perfection of the lien is

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111. Typical legislation is illustrated by the following New York statute, N.Y. Pub. Auth. Law § 561 (4-c) (McKinney 1982):

   "It is the intention hereof that any pledge of tolls or other revenues or other moneys made by the authority shall be valid and binding from the time when the pledge is made; that the tolls or other revenues or other moneys so pledged and thereafter received by the authority shall immediately be subject to the lien of such pledge without any physical delivery thereof or further act, and that the lien of any such pledge shall be valid and binding as against all parties having claims of any kind in tort, contract or otherwise against the authority irrespective of whether such parties have notice thereof. Neither the resolution nor any other instrument by which a pledge is created need be recorded."

113. Id. § 546(b).
inevitable, nothing is gained by invoking a stay to temporarily prevent the perfection.\textsuperscript{114} Section 546(b) provides that the right of the municipality to avoid liens under Sections 544,\textsuperscript{115} 545\textsuperscript{116} and 549\textsuperscript{117} is subject to the superior right of a creditor having power under any generally applicable law to enforce the perfection of a lien against an entity that acquires pre-petition rights. For example, assume that the Electric Utility Authority of City X has just lost a lawsuit for damages to a frozen food warehouse resulting from the negligent failure to supply electricity. The plaintiff obtains a judicial lien to secure his judgment. Under the laws of priority of the state, the bondholders’ trustee would probably have a superior lien to assure the availability of revenues to pay debt service prior to the payment of the award for damages. In the context of a petition for debt adjustment under Chapter 9, the authority would have the power to avoid the judicial lien of the warehouse,\textsuperscript{118} but because the bondholders’ trustee has the power to supersede the judicial lien of the warehouse, nothing would be gained by a stay to temporarily prevent the bondholder trustee from perfecting its lien. The purpose of Sections 362(b)(3) and 546(b) is to aid creditors’ efforts to enforce their liens under Section 362(a) when their ultimate success is assured under applicable law. The importance of this analysis becomes clear when revenue bond issues are involved and a contrary result could cause the authority to miss an interest payment date, thereby damaging the secondary market for bonds.

A third approach is to consider the constitutional policy considerations implicit in Section 904.\textsuperscript{119} Section 904 prohibits the bankruptcy court, without the consent of the municipality, from interfering with the political or government powers of the municipality or any of its property or “revenues.” In response to the Supreme Court’s decision in National League of Cities v. Usery,\textsuperscript{120} the legislative history to Section 904 makes clear the courts may not interfere with a municipality’s choice of essential services. Implicit in this policy is the notion

\begin{itemize}
  \item \textsuperscript{114} The purpose of a stay is to allow the debtor time to proceed without creditors competing to gain relative advantage in the ultimate disposition of the property. H.R. REP. No. 595, 95th Cong., 1st Sess. 340-42 (1977).
  \item \textsuperscript{115} 11 U.S.C. §§ 901(a), 544 (Supp. II 1978).
  \item \textsuperscript{116} Id. §§ 901(a), 545.
  \item \textsuperscript{117} Id. §§ 901(a), 549.
  \item \textsuperscript{118} Id. § 362(2).
  \item \textsuperscript{119} 11 U.S.C. § 904 (Supp. II 1978), provides that “notwithstanding any power of the court... the court may not, by any stay... interfere with
    \begin{enumerate}
      \item any of the political or governmental powers of the debtor;
      \item any of the property or revenues of the debtor; or
      \item the debtor’s use or enjoyment of any income-producing property.”
  \item \textsuperscript{120} 426 U.S. 833 (1976).
\end{itemize}
that courts may not set aside contracts which municipalities have
executed in order to provide those services. If a court lacks the
power to interfere with such a contract, then it cannot stay the
enforcement of the contract with the bondholders.

A fourth approach is to examine the trustee's judicial relief under
Section 362(d). After notice and a hearing, the bankruptcy judge
may grant relief from the stay either if the effect of the stay is to deny
the creditor adequate protection of an interest in property or if the
debtor does not have an equity in such property. The policy of
Chapter 9 is to recognize and give effect to those liens that are not
subject to avoidance. If the stay operates effectively to destroy a
valid lien, then the stay should be lifted with respect to the credi-
tors.

The effect of the stay as interpreted by Mr. Jones, the Finance
Director, is to free pledged revenues for general use by City X. The
diversion of revenues is perhaps the clearest example of a creditor being denied adequate protection where those revenues are the creditor's collateral. Likewise, if the bond resolution controls the flow of funds of the revenues for specified purposes, City X has no equity in the revenues. The counter argument of the Finance Director is that until the revenues are delivered to the trustee, the trustee has no security interest in the revenues under the common law requirement that a pledge must be delivered to be effective. The Finance Director further argues that Section 552(a) allows the municipality to avoid the claim of the bond trustee; therefore, the claim is not one entitled to be given effect under Section 506. Section 552(a) provides that property acquired by the debtor after the commencement of the action is not subject to any lien resulting from a security agreement entered into by the debtor before the commencement of the action. Section 552(a) was drafted in response to a UCC provision which permits a security agreement allowing a creditor a lien on after-acquired property. The policy of the Bankruptcy Code is to limit the effect of "floating liens" by making them inoperative to post-petition property of the debtor. For example, the lender who has a floating lien on inventory may not assert a lien in any inventory purchased by the debtor after the petition is filed.

The argument of the Finance Director is still incomplete. Section 552(b) provides that if a security agreement entered into before the commencement of the case creates a security interest in proceeds, then such security interest extends to proceeds acquired by the debtor after commencement of the action. Assuming the bond resolution or trust indenture does not create a mortgage in the physical property constructed with the bond proceeds, the property in which a security interest attaches prior to the commencement of the action is the system of accounts established by the bond resolution or trust indenture. The revenues received by City X are proceeds of the accounts

127. If the flow of funds allows a payment of excesses to the city after operating expenses, debt service and reserves are funded, the best way to protect the city's equity is to flow the funds in accordance with the resolution and make the payment to the city free and clear of the resolution as provided therein.

128. See note 107 supra and accompanying text.


130. U.C.C. § 9-204.


132. Section 552(b) refers to "proceeds, product, offspring, rents or profits of such property" acquired before the commencement of the case. For example, a real estate mortgage could be secured by the first rents received in any month up to the amount of the monthly mortgage payment. The rents would, upon receipt, not be subject to the avoidance powers under § 552(a).
receivable which may not be diverted by the city if the revenues are subject to the pledge upon receipt by the city. The security interest of the trustee is valid upon receipt of the proceeds of revenue by the city. The bond resolution or trust indenture makes the city an agent of the trustee to collect the fees and charges and Section 552 does not empower the city to avoid the trustee's liens.

Each of the illustrations considered thus far has involved revenue bonds either of an authority or a city. Transmission and distribution of electricity also could be financed by the issuance of general obligation bonds of a city payable not from a pledge of revenues but from the taxing powers of the city. For purposes of the Bankruptcy Code, a general obligation bond is a form of unsecured debt, and much of the analysis of the relief provisions from the automatic stay applicable to secured creditors, including the revenue bondholder, would not apply to general obligation bondholders. This difficulty is compounded by the absence of a trustee to take immediate action because general obligation bonds typically are not issued with the appointment of a trustee. The security for the general obligation bondholder is the "full faith and credit" of the municipality under the state constitutional provision which gives substance to that phrase.

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133. As discussed above, the law of the state would probably subject the revenues to the pledge immediately even if the state has taken government transfers out of Article 9 of the U.C.C. and the analysis of "proceeds" made in Article 9.

134. While the present Bankruptcy Code protects the pledge of revenues, there has been sufficient concern raised with respect to this issue for it to be addressed in the technical amendments to the Bankruptcy Code, S. 658, 96th Cong., 1st Sess. (1979), now pending before the Committee on the Judiciary of the House of Representatives. The proposed amendment would add a new § 928(c) as follows:

(c) If the debtor and a secured party enter into a security agreement before the commencement of the case and the obligation of the debtor is secured by a security interest in and is payable solely from specifically identified revenues including tax revenues, proceeds, rents, profits, or other similar moneys of the debtor, then such security interest shall extend to such revenues including specified tax revenues, proceeds, rents, profits, or other similar moneys acquired by the state after the commencement of the case to the extent provided by such security agreement and by applicable bankruptcy law.


the constitutional scheme gives priority to payment of employee expenses over debt service and such expenses are the cause of insolvency, then there may well be circumstances under which a revenue bond is a more secure obligation than a general obligation bond of the same issuer.

D. Payment of Debt Service as a Voidable Preference

One of the purposes of Chapter 9 is to allow the insolvent municipality to formulate a plan for the orderly adjustment of debts. The automatic stay is not intended to have substantive consequences but is meant to provide extra time while the plan is being formulated, although in the context of revenue bonds, the automatic stay has significant substantive consequences and is likely to trigger litigation by the bond trustee. A plan of adjustment under the Bankruptcy Code is conducted much like a business reorganization. Accordingly, the Chapter 11 reorganization provisions are incorporated into Chapter 9, except for those sections which imply the existence of a trustee administering a hypothetical estate. To facilitate the operation of the reorganization sections, Chapter 9 incorporates the early sections of Chapter 5 relating to the allowance and priorities of claims. Chapter 9 also incorporates certain of the later sections of Chapter 5 relating to the avoidance of claims as well as appropriate sections of Chapter 3 relating to case administration.

Unless the bond trustee successfully opposes the termination of the bondholders’ liens in after-acquired revenues by operation of Section 552, the application of the preference avoidance powers of the municipality under Section 547 could result in a revenue bond becoming an unsecured debt as of ninety days prior to the filing of the petition. A preference is defined in Section 547 as any transfer of the municipality’s property to or for the benefit of a creditor, for or on account of an antecedent debt of the municipality, made while the municipality is insolvent and within ninety days before the filing of the petition. Such a transfer allows the transferee to receive more than it would receive in a liquidation action if the transfer had not been made. The theory of the preference section is to provide equality of treatment among creditors, thereby avoiding transfers made shortly before bankruptcy which gives one creditor unfair advantage over others.

138. Id. § 547(b).
139. Id.
Assume the Electric Utility Bonds have a principal and interest payment date on June 1 and ninety days later the issuer files a Chapter 9 petition. Would Section 547 operate to annul the payments by the trustee to the bondholders on June 1 or merely the transfers of revenues to the trustee after June 1? If the June 1 payment of debt service is voided, the effect is to treat both the payments of revenues for the accumulation of principal during the prior year and the accumulation of interest since February 1 as preferential. A supposed ninety day problem is suddenly a 450 day problem. The answer depends on the language of the bond resolution or trust indenture. Section 547 refers to “any transfer of property of the debtor.” If the transfers prior to June 1 are held by the trustee in trust for the bondholders, the revenues are property of the trustee and not the debtor. A different outcome could result if the issuer accumulated the revenues in its own commercial banking accounts and transferred required debt service on June 1.

There are several arguments for the non-application of the preference section to revenue bonds. First, there is no preference unless the transfer enables the creditor to receive more than the creditor would receive in a Chapter 7 liquidation in which no transfers were made. For Chapter 9 municipal debt adjustments, there is no possibility of liquidation and no incorporation of any sections of Chapter 7. The reference to Chapter 7 in Section 547, therefore, is meaningless in a Chapter 9 case, although the reference is central to the concept of a preference. If Chapter 7 did operate, the liquidation analysis would first necessitate determining the allowability of the claim under Section 502 and its priority under Section 507. Since these sections are incorporated into Chapter 9 the analysis could proceed, without disservice to Section 547, to a determination whether in the reorganization provisions applicable to Chapter 9 the transfer results in an overpayment. If the plan of adjustment under the reorganization sections would necessitate protection of the revenue bondholders, then

140. This assumes a typical revenue bond resolution under which revenues are accumulated for principal during the course of the year between principal payment dates (which are at yearly intervals) and revenues are accumulated for interest during the six months between interest payment dates (which are at semi-annual intervals).
141. It also would disadvantage the holders of registered bonds, who can be traced, relative to the holders of bearer bonds, who cannot be traced.
142. 11 U.S.C. §§ 901(a), 547(b) (Supp. II 1978).
143. BOGERT, TRUSTS AND TRUSTEES § 1 (2d ed. 1965).
145. Id. §§ 901(a), 507.
Section 547 should not apply to transfers of revenues from the city to the bond trustee during the ninety day period.

Second, the preference section serves to prevent the extraordinary payment or transfer which unfairly benefits a creditor. Section 547 was never intended, however, to interrupt the ordinary course of business affairs. Under Section 547(c)(2), there is no voidable payment if (i) a debt is incurred in the ordinary course of business affairs, (ii) payment is made not later than forty-five days after the debt is incurred, (iii) payment is made in the ordinary course of business affairs of the debtor and transferee, and (iv) payment is made according to ordinary business terms. The difficult issue is the meaning of the requirement that payment be made not later than forty-five days after the debt is incurred. The reference to “debt” in the requirement that revenues be transferred to the trustee upon receipt by the city could only refer to the obligation of the city to make payment to the trustee within forty-five days of receipt by the city of the fees paid by consumers of electricity. The word “debt” should not mean the original issuance of bonds because there is no obligation to pay revenues to the trustee at that time. Debt can only mean the time at which the city is obligated to make a transfer of revenues to the trustee. On that date a debt is incurred, and if payment is made within forty-five days, the statute should be satisfied.

Third, Section 547(e) provides that a transfer is not made until the debtor has acquired rights in the property transferred. This provision makes it difficult to argue that the transfer has taken place at the time the bonds are issued, as opposed to the time of billing or receipt.

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146. Id. § 547(c)(2).
147. In the typical case, a seller delivers goods to a buyer, and if the payment obligation is within 45 days of delivery, normal trade practices are being followed and the preference rules do not apply. In the case of Weill v. Southern Credit Union (In re Bowen), 3 Bankr. 617 (E.D. Tenn. 1980), the court held that § 547(c)(2) was intended to protect a special class of contemporaneous exchanges and had no application to loan repayments. Id. at 619. See also Belfance v. Bancohiol Nat’l Bank (In re McCormick), 5 Bankr. 726 (N.D. Ohio 1980), holding that “45 days after such debt was incurred” refers only to the date on which the debtor originally assumed legal obligation to pay and debt is not considered to be incurred every month when an installment comes due. Id. at 730-31. Unlike the seller-buyer situations where the seller must perform by delivering the goods to the buyer, in a loan transaction, such as a bond issue, the lender has fully performed on the date the loan is made.
148. The counter-argument to Bowen and McCormick is that under § 547(a)(4), a debt is incurred when due. For the argument that “incurred” means “due” in § 547(c)(2), see Tait and Williams, Bankruptcy Preference Laws: The Scope of Section 547(c)(2), 99 BANKING L.J. 55, 59 (1982).
of revenues by the city from customers.\textsuperscript{150} Depending upon the drafting of rate ordinances and the statutory framework authorizing the municipal imposition of fees and charges, the city may have acquired rights to revenues at a much earlier date than the date of payment to the trustee. If the city's rights have been assigned to the bond trustee, the transfer may be complete at an earlier date for purposes of tolling the ninety days prior to the petition.\textsuperscript{151} The statute creating the authority or the rights of the city to collect rates and charges also should be carefully considered to determine whether there is a statutory lien.\textsuperscript{152} A statutory lien would be protected from the application of the preference provisions\textsuperscript{153} unless it came into effect with the filing of the petition,\textsuperscript{154} an unlikely event with respect to a statutory lien for rates and charges.

Fourth, as stated above, Section 547(e) was specifically drafted to make certain floating liens subject to the preference rules. If a creditor with an outstanding loan of $50,000 has a floating lien on the equipment of the debtor worth $10,000 ninety days prior to the petition, but worth $30,000 on the date of the petition because the debtor has acquired new equipment, the creditor would have a preference of $20,000, representing the amount by which the unsecured portion of the loan has been reduced. Section 547(c)(5)\textsuperscript{155} creates an exception for perfected floating liens in inventory or accounts receivable and their proceeds. The bond trustee has accounts receivable with the authority or the city (which in turn has accounts with customers) and the revenues derived from payments by customers are proceeds. Section 547(c)(5), therefore, may be a valuable means of avoiding the preference rules.\textsuperscript{156} To take advantage of Section 547(c)(5), it is necessary to compare the value of the collateral ninety days prior to the petition.

\textsuperscript{150} The purpose of § 547(e)(3) is to overrule DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), and Grain Merchants of Indiana, Inc. v. Union Bank & Sav. Co., 408 F.2d 209 (7th Cir.), cert. denied sub. nom. France v. Union Bank & Sav. Co., 396 U.S. 827 (1969), which had protected floating liens against preference attack.

\textsuperscript{151} The effect of this may be to subject payments to the bond trustees after the petition is filed to preference attack on the theory that the transfer took place before the petition.

\textsuperscript{152} 11 U.S.C. § 101(38) (Supp. II 1978), defines a statutory lien as a lien arising solely by force of a statute or specified circumstances or conditions. It is because many revenue bond statutes provide statutory liens on the revenues providing the security for the bonds that the 1972 version of the U.C.C. removed government transfers from Article 9.


\textsuperscript{154} Id. §§ 901(a), 545(2).

\textsuperscript{155} Id. § 547(c)(5).

\textsuperscript{156} Compare § 547(c)(5) with § 552(b); see notes 131-32 supra and accompanying text.
with the value on the date of filing the petition to make certain that unsecured creditors are not prejudiced. If the value of the collateral increases because of new acquisitions during the ninety day period, as in the case above, there is a preference. Similarly, if the authority or the city expends moneys to provide electricity to more customers, thereby gaining new accounts as collateral, there is a preference. If the value of the collateral increases without new purchases, however, there is no prejudice to the unsecured creditors and no preference. Fluctuations in value of the bond trustee's accounts and the accounts with customers are of the latter type. Their value rises and falls according to variations in the payment cycle. Section 547(c)(5), therefore, should insulate most revenue bond situations from the application of the preference rules.\textsuperscript{157}

E. Standby Letter of Credit Payments as Preferences

With high interest rates during the past two years, an increasing number of standby letters of credit have been used in public finance to improve security and obtain more favorable interest rates.\textsuperscript{158} A letter of credit is a commitment undertaken by a commercial bank (issuer) issued pursuant to instructions from the applicant (customer) in favor of a third party (beneficiary).\textsuperscript{159} In public finance, the customer is likely to be the political subdivision and the beneficiary the bond trustee. The standby letter of credit differs from a conventional commercial letter of credit which contemplates payment by the issuer to the beneficiary upon the beneficiary's performance of the acts specified in the customer's instructions. The standby letter of credit conditions payment to the beneficiary on the occurrence of some event of default by the customer, thereby functioning much like a guarantee. The standby letter of credit creates an independent obligation between the issuer and the beneficiary apart from the underlying transaction between the beneficiary and the customer. This independent quality of the letter of credit has allowed the courts to distinguish between letters of credit and guarantees which few national and state banks have the power to issue.\textsuperscript{160}

\textsuperscript{158} For general discussions of the increasing use of letters of credit for domestic use, see Harfield, The Increasing Domestic Use of the Letter of Credit, 4 U.C.C.L.J. 251 (1972); Joseph, Letters of Credit: The Developing Concepts and Financing Functions, 94 Banking L.J. 816 (1977).
\textsuperscript{159} U.C.C. § 5-103(1).
The Bankruptcy Code contemplates that payment on a standby letter of credit is likely to occur near the time that a petition by the bank customer is filed. There is an apparent preference to the beneficiaries of the letters of credit if a step transaction analysis is applied. For example, the authority issues its Utility Revenue Bonds on January 1, 1983. To improve the marketability of its bonds, which would be poorly rated, the authority obtains from a commercial bank a standby letter of credit in an amount equal to the outstanding principal amount of bonds plus one year's interest. The letter of credit provides that the bond trustee, as beneficiary, is authorized to draw down on the letter of credit any shortfalls in revenues on any principal or interest payment date relative to debt service as certified by the bond trustee. On January 1, 1986, the authority is unable to meet debt service, and the bond trustee calls upon the letter of credit. The bond resolution provides for an immediate redemption of bonds in an amount equal to the principal outstanding and interest accrued to the redemption date. Typically, the redemption date is the following interest payment date, or July 1, 1986 in this instance. Because the amount of the standby letter of credit is equal to the amount necessary to redeem all outstanding bonds if necessary, the authority's bonds are fully secured and the bank rating will be substituted for the authority's rating. Furthermore, the lower interest rates usually obtained more than compensate for the fees associated with the letter of credit. The bondholders are fully paid on July 1, 1986. On August 1, 1986, the authority files a Chapter 9 petition.

Any doubt that this transaction will be sustained under the Bankruptcy Code creates a serious disclosure problem under the 1933 Act and the 1934 Act. If it may be necessary to file a petition under the Bankruptcy Code, and if the letter of credit would then be ineffective, the lack of protection should be disclosed and the rating should not be that of the bank. Applying a two step analysis to the transaction, it becomes apparent that to the extent the bondholders are not paid from revenues (the security for the bonds), the bondholders are unsecured creditors. By receiving payment during the ninety day period prior to the filing of the petition, the second step is to conclude that there is a preference given to these unsecured creditors relative to

Reserve Board and the FDIC have each issued regulations to distinguish standby letters of credit from unlawful guarantees: 12 C.F.R. § 7.1160 (1980); 12 C.F.R. § 208.8(d)(1) (1980); and 12 C.F.R. § 337.2(a)(1980).

161. 11 U.S.C. § 506(a) (Supp. II 1978), provides that to the extent the value of the collateral is less than the total allowed claim, the creditor is deemed to have an unsecured claim.
other unsecured creditors. Alternatively, the effect of the payment under the letter of credit is to substitute for the unsecured bondholders a secured commercial bank. The bank is secure to the extent it has a right of set-off, but the set-off occurs during the preference period in violation of Section 547 or Section 553(a)(2)(B).

The weakness of the two step analysis is that the bondholder is not unsecured to the extent of the revenue shortfall, but is fully secured by reason of the letter of credit. Therefore, the bondholder is protected by Section 547(c)(5). Furthermore, there is no transfer "of property of the debtor," the very essence of a preference. To apply the Bankruptcy Code, it is important to remember that the letter of credit creates an independent relationship between the bank issuer and the beneficiary. Payment by the bank issuer to the beneficiary is not a transfer of the customer's property. The issue was discussed in the context of a case concerning a standby letter of credit. In *In Matter of Marine Distributors, Inc.*, the Ninth Circuit held that the bankrupt had no property interest in either the moneys distributed by the bank to the beneficiaries or the documents held by the beneficiaries necessary to effect payment. The letters of credit represented an obligation of the bank independent of the bankruptcy proceedings and the bankruptcy court did not have jurisdiction with respect to the letter of credit.

162. If the bank issuing the letter of credit is a depository of the customer there is a right to set-off the bank account against the debt arising upon the occurrence of payment under the letter of credit. New York County Nat'l Bank v. Massey, 192 U.S. 138 (1904). 11 U.S.C. § 506(a) (Supp. II 1978), provides that an allowed claim that has an interest on property subject to set-off is a secured claim.

163. The argument is that the creation of the security interest in the set-off is a "transfer" of an interest in property under the definition of "transfer" in 11 U.S.C. § 101(40), even though a set-off itself is not a transfer. 124 Cong. Rec. H.11,090 (Sept. 28, 1978); S17,407 (Oct. 6, 1978).

164. 11 U.S.C. §§ 901(a), 553(a)(2)(B) (Supp. II 1978), provides that the right of a creditor (the bank) to offset a mutual debt owing by such creditor to the debtor (the political subdivision's bank account) will not be permitted if the claim was transferred by an entity other than the debtor to such creditor during the 90 day period prior to the filing of the petition.

165. 11 U.S.C. § 101(37) (Supp. II 1978), defines "security interest" to mean a lien created by an agreement. 11 U.S.C. § 101(28) (Supp. II 1978), defines a lien to be a charge against or interest in property to secure payment of a debt or performance of an obligation. The letter of credit creates a lien in the beneficiary against the issuer bank by reason of the agreement of the issuer and its customer. There is a charge against the bank by reason of bank regulations. See 12 C.F.R. § 7.1160 (1979).

166. See notes 155-56 *supra* and accompanying text.


168. 522 F.2d 791 (9th Cir. 1975).

169. *Id.* at 795.
The right of the beneficiary to receive payment on a letter of credit should not be affected by any bank accounts of the debtor to which the bank might attempt to apply a set-off. The right of the bank to set-off has no bearing on the right of the beneficiary to payment.\(^1\) Under Section 553(a)(2), no set-off is allowed when the claim to be set-off against the bank account has been transferred to the bank during the preference period.\(^1\) Set-offs have been permitted, however, where the claimant was compelled to acquire the claim through contractual obligation.\(^1\) The right of set-off should be of concern to banks in the standby letter of credit context,\(^2\) but should not impair the rights of beneficiaries using a letter of credit from a third party as an independent source of security.\(^3\)

### F. Executory Contracts

Section 554\(^4\) of the Bankruptcy Code allows the trustee in bankruptcy to abandon property of the estate that is "burdensome."\(^5\) Section 554 is not incorporated into Chapter 9\(^6\) because municipal property is held in trust for the public and cannot be abandoned.\(^7\)

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1. Id. at 794-95.
2. The purpose of § 553(a)(2) is to prevent the bank from purposefully acquiring claims prior to the petition in order to take advantage of prepetition set-off avoiding the stay of set-off upon the filing of the petition under § 362(a)(7) and the right of the trustee in bankruptcy to the use of cash collateral under § 363.
5. The issue has been thoroughly confused by the inexplicable reasoning of Twist Cap, Inc. v. Southeast Bank (In re Twist Cap, Inc.), 1 Bankr. 284 (1979).
6. Without any consideration of the independent nature of the letter of credit, the court distinguished Marine Distributions, Inc. where property had been placed with the bank as security for any payments on letters of credit and reasoned that payment to the beneficiary would be payment from the debtor's property which gave the court jurisdiction to enjoin payment by the bank. Id. at 285. The Twist Cap approach recently has been rejected in favor of the position taken in this Article: In re Page, D.C., 18 Bankr. 713 (Mar. 30, 1982), holding that the cashing of the letter of credit had no bearing on the property of the debtor under § 362, regardless of the security held by the bank, since the letter of credit is an independent contractual obligation. The analysis of the bank's security under the Bankruptcy Code is a separate inquiry.
8. In the typical nonmunicipal bankruptcy case, the Bankruptcy Code severs the debtor from most of the property acquired by the debtor prior to the filing of the petition, requires that most prepetition rights and interests be satisfied from this hypothetical "property of the estate" and grants the debtor a discharge from many obligations incurred prior to the petition. In municipal debt adjustments under Chapter 9 there is no hypothetical "property of the estate," but the importance of the date of filing the petition is retained for the analysis of many rights and interests.
9. Section 554 is not cross-referenced in § 901(a).
Chapter 9 does, however, incorporate a very similar provision, Section 365,\textsuperscript{179} which allows the debtor to assume or reject executory contracts which are burdensome\textsuperscript{180} to the reorganization efforts of the debtor municipality.

While the Bankruptcy Code does not define the term "executory contract," the legislative history and comments\textsuperscript{181} utilize the "Countryman definition"\textsuperscript{182} that an executory contract is one in which both parties have not performed to the extent that failure by either to complete performance would constitute a material breach.\textsuperscript{183} A revenue bond is not an executory contract because the bondholder has fully performed when he pays for the bonds upon their delivery.\textsuperscript{184}

If the Electric Utility Board has entered into a contract to purchase 1000 yards of no. 3 wire which the supplier has delivered prior to the petition, there is no executory contract to assume or reject. The same result occurs if the wire has been paid for but has not yet been delivered. If neither has performed by delivery or payment, there is an executory contract, and the decision of the debtor to assume or reject usually will be a simple matter of comparing the market price of the wire at the time of contract with the price at the time a decision is being made to reject or accept. If the debtor rejects, the supplier has an allowable claim\textsuperscript{185} for the difference in market price,\textsuperscript{186} but he will receive no preferential treatment if his claim is not secured or entitled to priority under Section 507.\textsuperscript{187} The decision to assume or reject becomes more difficult if the current market price is higher so that assumption would be profitable, but the debtor determines the repair work would be burdensome because the expenses incurred in connection with the repairs would not be in the best interests of rehabilitating the debtor. The problem is complicated if the repair work is necessary to preserve the revenue-producing capability of a portion of the system providing revenues securing bonds. The test for determining a burdensome contract is the "business judgment text,"\textsuperscript{188} and its

\textsuperscript{180} The common law power of a trustee in bankruptcy to reject executory contracts grew out of the common law power to abandon burdensome property. See Note, Abandonment of Assets by a Trustee, 53 Colum. L. Rev. 415, 416 (1953).
\textsuperscript{182} Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439 (1972-73).
\textsuperscript{183} Id. at 460.
\textsuperscript{186} Id. § 365(g).
\textsuperscript{187} Id. § 507.
application requires that the debtor look at all the consequences of rejection including the impact on creditors.\footnote{189}

From the perspective of the securities lawyer concerned with disclosure, the right to assume or reject executory contracts is of concern not only with respect to the issuer, but also as to entities with whom the issuer is entering into agreements. If a major contractor or supplier of the issuer is financially weak, and the application of Section 365 by such person’s trustee in bankruptcy would materially affect the security of the bonds, there may be a disclosure problem. There is no obligation, however, to use due diligence to determine the financial strength of all contracting parties with the issuer. For example, a bond issue for the financing of apartment buildings usually involves agreements with many developers, depending on the number of developments being financed. The relevant disclosure is the underwriting standards applied by the issuer in selecting developers and managing projects. The primary concern of the investor is in the capability of the issuer to exercise care in its business affairs.\footnote{190}

G. Preparation of the Plan of Adjustment

A Chapter 9 debt adjustment and a Chapter 11 reorganization are essentially contracts between the debtor and its creditors,\footnote{191} and both chapters encourage contractual negotiations prior to the filing of a petition.\footnote{192} While much of Chapter 9 is based on the incorporation by reference of Chapter 11, there are differences resulting from the state’s power to oversee its political subdivisions and the inapplicability of reorganization of ownership and management in the Chapter 9 context.

\footnote{189. Id.}

\footnote{190. Since this would be an industrial development bond, the Bankruptcy Code is applied if a developer is in Chapter 7, 11 or 13 proceedings. The municipality or its bond trustee is in the position of a claimant and, therefore, further relevant disclosure is the nature of the security with the developer.}

\footnote{191. Chapter 9 is not entitled “municipal reorganizations” although many of its operative provisions are derived by cross-references to Chapter 11. The theory of Chapter 9 is that management of the municipality’s operations will remain unchanged while Chapter 11 has the possibility of extensive changes in the ownership and management of the business organization, i.e., reorganization. In practice, there may be significant changes in management under Chapter 9. The work-out agreement with creditors may, by contract, require changes in the conduct of the financial affairs of the municipality. 11 U.S.C. § 926 (Supp. II 1978), provides for the appointment of a trustee if the debtor itself is refusing to enforce its avoidance powers. Nonbankruptcy law may require that there be a receiver appointed.}

\footnote{192. 11 U.S.C. §§ 901(a), 1126(b) (Supp. II 1978). Section 941 also contemplates the possible filing of a plan at the time of the petition. A primary purpose of the Chapter 9 amendments in 1976 was to bring an end to the requirement that a plan be approved by 51% in amount of the creditors prior to the filing of a petition. H.R. REP. No. 686, 94th Cong., 2d Sess. 544 (1976).}
For example, to retain state control, Chapter 9 allows only the debtor to file a plan.\textsuperscript{193} The Chapter 11 provisions\textsuperscript{194} permitting other parties in interest, including indenture trustees, to file a plan are not incorporated into Chapter 9.\textsuperscript{195} There are also distinctions for the management of operating expenses to maintain the entity as a going concern. Chapter 9 assumes that the application of the stay to the payment of debt service on general obligation bonds will automatically provide sufficient relief to enable the municipality to pay for essential services.\textsuperscript{196} Chapter 11, in contrast, assumes that the debtor will need access to collateral securing the debt in order for the corporation to pay operating expenses. Thus, provision is made for the debtor to use both cash\textsuperscript{197} and non-cash\textsuperscript{198} collateral to maintain the viability of the corporation.

Upon the filing of a petition, the debtor is required to submit a list of creditors\textsuperscript{199} who have claims\textsuperscript{200} against the debtor. If a creditor or indenture trustee does not appear on the list, a proof of claim may be filed.\textsuperscript{201} When the list of claims is complete, negotiation and voting on a plan is based upon the classification of claims.\textsuperscript{202} Under Section 1122, claims may be included in the same class only if the claims are

\begin{footnotesize}
\textsuperscript{194} Id. § 1121.
\textsuperscript{195} Id. §§ 901(a), 903, 904.
\textsuperscript{196} H.R. REP. No. 686, 94th Cong., 2d Sess. 566 (1976): “With the petitioner relieved of the burden of debt service by the filing of the petition, in most cases the petitioner will be able to pay all operating expenses currently, or under credit terms which obtained prior to the filing of the petition.”
\textsuperscript{197} 11 U.S.C. § 363(c)(2) (Supp. II 1978). Cash collateral, including cash, bank accounts, negotiable instruments and securities may not be used by the debtor unless the secured party consents or there is a court order finding adequate protection under § 361. Id.
\textsuperscript{198} Id. § 363(c)(1). Inventory, accounts receivable and other non-cash collateral may be used to operate the business without notice of a court order.
\textsuperscript{199} Id. § 924.
\textsuperscript{200} 11 U.S.C. § 101(4) (Supp. II 1978), defines “claim” as follows:

“claim” means-

(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or

(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured; . . .

\textsuperscript{201} Id. §§ 901, 925.
\textsuperscript{202} Id. §§ 901(a), 1122:

(a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

(b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the
substantially similar. While Section 1122 distinguishes “claims” and “interests,” there is little or no likelihood that there will be an interest in a municipality.

Under the Bankruptcy Code, unsecured claims must be classed separately from administrative expenses. General obligation bonds also should be placed in a separate class because they are entitled to unique constitutional and statutory protection, and general obligation bondholders are entitled to enforce full faith and credit provisions by proceedings in mandamus.

Secured claims will be placed in separate classes if they involve different property or are of different kinds or ranks. Bondholders with a first mortgage on the same property may be placed in the same class if they are entitled to parity of treatment under the trust indenture, even if the bonds contain varying maturities or are issued in one or more series. If the property which provides the security is not the same, separate classes must be created.

court approves as reasonable and necessary for administrative convenience.

204. See note 192 supra.
205. The term “interest” is not defined but is used to describe proprietary rights which (in the sense of ownership interests) are unlikely in municipal law. The distinction is confused, however, by the definition of a secured claim as one in which there is an interest in property, 11 U.S.C. § 506(a) (Supp. II 1978).
206. Chapter 9 contemplates this result by requiring a list of “creditors” which is defined as those who have “claims,” not “interests,” 11 U.S.C. §§ 924, 101(9) (Supp. II 1978), but since a secured claim is one in which there is an interest in property, the term “interest” is used in two contexts under the Bankruptcy Code, 11 U.S.C. § 506(a) (Supp. II 1978). While Chapter 9 does not contemplate ownership interests in the municipality, it does contemplate interests in property of the municipality as security.
207. 11 U.S.C. §§ 901(a)(1), 1123 (Supp. II 1978). In business reorganizations, the § 507 categories of expenses for purposes of priority in payment of operating expenses must be separately classified. Chapter 9 does not have a similar requirement. Chapter 9 does not have a similar requirement.
211. Jordan v. Palo Verde Irrigation Dist., 114 F.2d 691 (9th Cir. 1940), cert. denied, 312 U.S. 693 (1941).
212. Mokava Corp. v. Dolan, 147 F.2d 340 (2d Cir. 1945); Kyser v. MacAdam, 117 F.2d 232 (2d Cir. 1941).
The Bankruptcy Code defines broad categories of clearly distinguishable classes of secured claims. A secured claim is one in which there is a lien on property.\textsuperscript{212} Liens\textsuperscript{214} are subdivided into judicial liens,\textsuperscript{215} statutory liens,\textsuperscript{216} and liens created by agreement.\textsuperscript{217} Each type of lien provides a basis for a class and classes are further separated to the extent the liens are on different properties.\textsuperscript{218}

If separate trust indentures pledge separate sources of revenues, there will be separate classes for each lien created by agreement having a different source of security. For example, on January 1, 1983, the Electric Utility Authority of City X issues revenue bonds secured by rates and charges collected in established industrial, commercial and residential areas of the city. On January 1, 1984, the Electric Utility Authority of City X issues revenue bonds under a separate trust indenture secured by rates and charges in lightly developed areas of the city where future growth is expected. When the Authority files a petition under Chapter 9 on January 1, 1985, it cannot place the two bond issues in the same class.\textsuperscript{219}

The plan typically involves negotiations with committees of creditors\textsuperscript{220} which may be formed to represent each of the major classes of creditors, or the classes might be represented by an indenture trustee.

\begin{itemize}
\item 214. 11 U.S.C. § 101(28) (Supp. II 1978), defines lien as a “[c]harge against or interest in property to secure payment of a debt or performance of an obligation; . . .”
\item 215. 11 U.S.C. § 101(27) (Supp. II 1978), defines judicial lien as a lien “[o]btained by judgment, levy, sequestration, or other legal or equitable process or proceeding; . . .”
\item 216. 11 U.S.C. § 101(38) (Supp. II 1978), defines statutory lien as a lien: [a]rising solely by force of a statute on specified circumstances or conditions or lien of distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute; . . .
\item 217. 11 U.S.C. § 101(37) (Supp. II 1978), defines security interest as a lien “[c]reated by an agreement; . . .”
\item 218. See note 203 supra.
\item 219. See generally Evergreen Farms Co. v. Willacy County Water Control & Improvement Dist. No. 1, 124 F.2d 1 (5th Cir. 1941), cert. denied, 316 U.S. 687 (1942); Vallette v. Vero Beach, 104 F.2d 59, 62 (5th Cir.), cert. denied, 308 U.S. 586 (1939).
\item 220. 11 U.S.C. § 923 (Supp. II 1978), requires three notices to creditors: the commencement of the case; the order for relief; or the dismissal of a case. With the difficulty of identifying creditors based on a capitalization largely dominated by bearer bonds, notice is by publication in a newspaper in the district and newspaper in general circulation among bond dealers. \textit{Id.}
or similar representative. Labor unions are likely to use their own labor organizations for purposes of negotiations.\textsuperscript{221}

When the plan is formulated it must identify each class and disclose the method by which that class is to be satisfied.\textsuperscript{222} The first step is to identify the classes that are not "impaired" under the plan.\textsuperscript{223} Determinations of impairment are of critical importance because a class that is not impaired will not be entitled to vote on the plan.\textsuperscript{224} A class of claims is not impaired if the plan (i) leaves unaltered the legal, equitable and contractual rights to which such claim entitles the holder of the claim, (ii) cures defaults that led to the acceleration of the debt and does not otherwise alter the legal, equitable or contractual rights of the claim, or (iii) provides that on the effective date of the plan the holder of the claim receives cash equal to the allowed amount of the claim.\textsuperscript{225}

Returning to the hypothetical, let us assume that the reason the Electric Utility Authority of City X has filed a Chapter 9 petition is that the projected development of the outlying areas of the city did not take place and there were insufficient revenues to pay debt service on the bonds issued in 1984. The plan filed by the Authority reduces the coverage of debt service on the bonds issued in 1983 by changing the rate covenant from 125\% of debt service to 105\%. The balance of 20\% will be diverted to the funds under the 1984 trust indenture. The theory of the plan is that the 1983 bondholders are unimpaired because they are still receiving revenues 5\% in excess of the amount necessary to pay debt service. An impairment clearly exists, however, because the rate covenant has been reduced exposing the 1983 bondholders to a greater risk than when they purchased bonds at a stated interest rate. In addition to the increased risk, the 1983 bondholders are losing the benefits of the 20\% coverage set forth in the trust indenture for such purposes as the maintenance of the system or the redemption of bonds.

This plan, however, is not necessarily an improper one. A plan may alter the rights of any creditors whether secured or unsecured.\textsuperscript{226} What is required is that the 1983 bonds be designated as an impaired

\textsuperscript{221} 11 U.S.C. §§ 901(a), 1102 (Supp. II 1978), requires that the unsecured creditors be represented by a committee ordinarily consisting of the persons holding the seven largest claims.
\textsuperscript{222} 11 U.S.C. §§ 901(a), 1123(a) (Supp. II 1978).
\textsuperscript{223} Id. § 1123(2).
\textsuperscript{224} Id. §§ 901(a), 1126(f).
\textsuperscript{225} Id. §§ 901(a), 1124.
\textsuperscript{226} Id. § 1123(b).
class and that the plan adequately disclose the effect of the alteration on the security for the 1983 bonds.

The impairment provision focuses attention on the amount of the claim. The amount of a claim that may be allowed will be determined as of the date the municipality files its petition. Therefore, if the class of revenue bondholders is paid the full amount of principal outstanding together with interest accrued to the date of filing, the class is not impaired. If the plan does not provide for payment in full but leaves the principal outstanding, the ability of the 1983 bondholders to claim unmatured interest depends on the value of the collateral, which in turn depends on the perfection of the lien in after-acquired proceeds. If it is determined that the lien is perfected in the future revenues, then the 1983 bondholders will have a secured claim for interest. Post-petition interest is an allowable claim under Section 506 to the extent of the value of the collateral.

The allowability of post-petition interest under Section 506 requires a different analysis for a municipality's general obligation bonds if the bonds share the characteristics of general unsecured debt. An unsecured claim is not entitled to post-petition interest. The typical general obligation bond, however, "secured by" full faith and credit has the benefit of constitutional and statutory mandates which require that the municipality exercise its taxing power to the fullest extent possible to pay the principal of and interest on general obligation bonds. In order to analyze the Bankruptcy Code consistently with the state constitutional structure, the general obligation bond should be viewed as having a statutory lien on municipal property, and the

227. Id. § 1123(a)(3).
228. Id.
229. Id. §§ 901(a), 502(b).
230. Id. § 502(b)(2).
231. Id. § 1124(3)(A).
232. Id. § 506(a).
233. Id. § 552.
234. See notes 149-54 supra and accompanying text.
236. See In re Black Ranches, Inc., 362 F.2d 8 (8th Cir.), cert. denied, 385 U.S. 990 (1966); Textile Banking Co. v. Widener, 265 F.2d 446 (4th Cir. 1959).
239. See notes 152-54 supra and accompanying text.
value of the collateral necessary to allow post-petition interest depends on the economic limit of the taxing power. 241

H. Confirmation of the Plan

After a plan is prepared, it may be confirmed by voting within classes. A class of creditors has accepted a plan when a majority in number, and two-thirds of creditors actually voting, approve the plan. 242 Except in limited circumstances, each class must either vote on the plan or be grouped in a class which is not impaired and, therefore, not required to vote. 243

If agreement with each cannot be achieved and the plan is subject to the dissenting vote of an impaired class, confirmation may still result under the “cram down” rules. These rules require a court to confirm a plan 244 if the petitioner so requests 245 and “if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.” 246 The nondiscrimination portion of the test allows the court to consider the interrelation of priorities of claims where one claim is subordinate to another. 247 If the legal rights of one class are dependent upon those of another there should be consistent treatment. 248

The requirement that the plan be “fair and equitable” is the more substantive element of the test. Section 1129 has separate tests for a dissenting impaired secured claim and a dissenting impaired unsecured claim. 249 Cram down may be applied to a dissenting impaired unsecured class of claims if (i) the plan provides for members of the

242. 11 U.S.C. §§ 901(a), 1129(b)(8).
245. Id. §§ 901(a), 1129(b)(1).
247. For example, if there is a subordinate debt under a trust indenture which provides that the subordinated bonds will be payable from the flow of funds after debt service and reserve requirements for the senior debt, the court could prevent a plan that lowered the rate covenant from 125% to 105% and increased a reserve requirement so that none of the 5% excess could flow down to the subordinated bondholders.
248. 11 U.S.C. § 1129(b)(2)(C) (Supp. II 1978), providing a fair and equitable test for cram down of dissenting impaired ownership interests, such as stockholders, is inapplicable to Chapter 9.
class to receive or retain property that has a present value equal to the allowed amount of their unsecured claims, or (ii) the plan may provide any treatment of the class as long as no class representing a relatively junior claim to the dissenting class will retain or receive any property. The requirement is, in essence, the "absolute priority rule" and provides that a plan is "fair and equitable" when the impaired class receives full compensation for its allowed claims before any junior class receives partial compensation.

Application of the fair and equitable doctrine to secured claims requires modifying the concept of "allowed claims" to the extent that the class elects the option set forth in Section 1111(b)(2). This section permits a class to be treated as fully secured even if the market value of the collateral has fallen below the allowed amount of the claim. In the cram down context, the election serves the purpose of preventing a plan from satisfying a secured claim by taking advantage of the depressed value of collateral that would ordinarily define the extent of the secured claim under Section 506(a). For a plan to be cramped down, however, one of three options must first be met. The first alternative is for the class to retain the lien securing the claims of the class to the extent of the allowed amount of such claims. Furthermore, the plan must provide for the class to receive deferred cash payments aggregating at least the allowed amount of the claims and such payments must have a present value equal to the value of the collateral.

Returning to the illustration, assume the Electric Utility Authority of City X files a petition listing the following claims:

<table>
<thead>
<tr>
<th></th>
<th>Outstanding Principal</th>
<th>Interest Rate</th>
<th>Sec. 502 or 1111(b) Allowed Claim</th>
<th>Sec. 506 Secured Claim</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983 Revenue Bonds</td>
<td>$30,000,000</td>
<td>11%</td>
<td>$30,000,000</td>
<td>Revenues equal to 125% of debt service</td>
</tr>
<tr>
<td>1984 Revenue Bonds</td>
<td>$20,000,000</td>
<td>13%</td>
<td>$20,000,000</td>
<td>Revenues equal to 40% of debt service</td>
</tr>
<tr>
<td>Unsecured claims</td>
<td>$1,000,000</td>
<td>-</td>
<td>$1,000,000</td>
<td>-</td>
</tr>
</tbody>
</table>

250. The present value calculation is as of the effective date of the plan.
254. Id. § 1111(b)(2).
The Authority files a plan which diverts a portion of the revenues securing the 1983 bonds from the funds under the 1983 trust indenture to the funds under the 1984 trust indenture. The purpose of the plan is for both the 1983 bondholders and the 1984 bondholders to receive, during the period of scheduled amortization (assuming level debt service over 25 years), all of the outstanding principal amount plus an average interest rate of 10% per year. The effect of the plan is to allow both issues to be secured by revenues in an amount equal to debt service, with the 1983 bonds losing their 25% coverage. The unsecured claims would not be paid anything. The class of 1983 bonds is impaired and votes against the plan. The class of 1984 bonds is impaired but votes for the plan. The class of unsecured claims votes against the plan.

In order for a plan to be confirmed at least one class must have accepted the plan. A class that is not impaired is deemed to have accepted the plan; therefore, if the 1984 bond claims were not considered impaired they could be counted as voting for the plan. Under the absolute priority rule, the plan may be crammed down the unsecured creditors because there are no more junior claims prior to them. In compliance with the “fair and equitable” test, the 1983 bonds retain a lien on revenues to the extent of the allowed amount of the claim because the allowed amount does not include unmatured interest. The principal of the 1983 bonds remains fully secured by revenues. The plan also provides for cash payments totalling at least the allowed amount of the claims, which is the principal amount. The last part of the test is that the present value of the payments be equal to the value of the collateral. This criterion is not satisfied because the payout schedule coincides with the previously scheduled payments of principal. The present value of the payout is at least equal to the principal portion of the revenues, but because it is not equal to 125% of debt service, the plan is not fair and equitable.

From the point of view of the securities lawyer, this result under the Bankruptcy Code is the only reasonable conclusion. If the 1983 bonds

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256. While it may not appear that the 1984 Bonds are impaired, the requirements of § 1124 are not satisfied. For example, under § 1124(3), the allowed amount of the claim is to be received, but not on the effective date of the plan. Id. § 1124(3).
257. Id. §§ 901(a), 1129(a)(10).
258. Id. §§ 901(a), 1126(f).
259. Id. §§ 1129(b)(2)(B)(ii).
260. Id. § 502(b)(2).
261. Id. § 1129(b)(2)(A)(i)(II).
262. If the payout of principal were over a shorter period of time than the scheduled amortization, it is possible for the present value of the payout to equal the present value of the collateral over the scheduled period.
were subject to a plan destroying their collateral to benefit the claims of other classes, the lawyer would be responsible for discussing in a disclosure document the financial health of all outstanding classes of secured claims no matter how irrelevant to the purposes and security of the bonds being issued.

Two other options permit a plan to be crammed down to a secured class of dissenting impaired creditors. One allows the sale of the collateral with the lien being attached to the proceeds of the sale; in all other respects, the tests in the first option apply. The final option is to have the plan provide for the class of secured claims by the "realization by such holders of the indubitable equivalent of such claims." Again there is no functional change from the first option. The collateral may be sold free and clear of any liens provided the bondholder is given security and a plan which fully satisfies the fair and equitable doctrine.

IV. Disclosure Requirements Under the Bankruptcy Code

A. Disclosing the Plan

When the debtor files the plan with the court, the court gives notice to all creditors of the date for the confirmation hearing. Notice is given as well to the SEC which may be heard on any issue in a debt adjustment case but is not empowered to appeal any decision made by the Bankruptcy Court. Congress considered requiring an SEC report to creditors but chose instead to impose an obligation on the debtor to make adequate disclosure to creditors of the context and effect of the plan.

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263. Id. § 1129(b)(2)(A)(ii). This test is a companion to 11 U.S.C. § 363 providing for the disposition of collateral which is not incorporated into Chapter 9.
264. Id. § 1129(b)(2)(A)(iii).
265. In re Muriel Holding Corp. 75 F.2d 941, 942 (2d Cir. 1935).
267. Id. §§ 901(a), 1128.
268. "In this time of nationwide trading in municipal bonds, the committee feels that the S.E.C. has a legitimate public investor role when the rights of security holders are sought to be altered, even though the S.E.C. does not currently have any role at the time of issue of the securities." H.R. Rep. No. 686, 94 Cong., 2d Sess. 551 (1976).
270. "The premise underlying the consolidated chapter 11 of this bill is the same as the premise of the securities law. If adequate disclosure is provided to all creditors and stockholders whose rights are to be affected, then they should be able to make an informed judgment of their own, rather than having the court or the Securities and Exchange Commission inform them in advance of whether the proposed plan is a good plan. Therefore, the key to the consolidated chapter is the disclosure section." H.R. Rep. No. 595, 95th Cong., 1st Sess. 226 (1977).
When the court approves the disclosure statement, it sets a time limit within which creditors may accept or reject the plan. The clerk then mails to the creditors a copy of the plan, the disclosure statement, the court opinion approving the disclosure statement, and notice of the date for confirmation hearing.\textsuperscript{271} The purpose of the disclosure requirement is to strike a balance between the form of disclosure that would be required under Section 17(a) of the 1933 Act and the desirability of avoiding expensive, time-consuming procedures.\textsuperscript{272} Congress assumed that the disclosure statement would be the product of negotiation among committees of sophisticated investors\textsuperscript{273} and indenture trustees legally obligated to protect the interests of bondholders.\textsuperscript{274}

The relatively informal disclosure requirement is buttressed by the substantive safeguards of the Bankruptcy Code in delineating the boundaries of a negotiated plan. For example, the institutional investors could not negotiate a plan which allowed bondholders with more than $100,000 invested to be paid in full while smaller investors were paid 80\% of their claims.\textsuperscript{275} Similarly, the court must find the plan to be in the best interests of creditors.\textsuperscript{276} In corporate reorganizations, a Chapter 11 plan cannot give a creditor less than the creditor would receive in a Chapter 7 liquidation.\textsuperscript{277} The test in municipal debt adjustments requires a similar analysis as though a liquidation were actually possible.\textsuperscript{278}

Under the Bankruptcy Code, neither an acceptance nor a rejection of a plan may be solicited after the commencement of an action unless at the time of solicitation the creditor is sent a copy of the plan, or a

\textsuperscript{271} Sugg. Int. B. Rule 3006.
\textsuperscript{273} "[M]ost public debenture holders are neither weak nor unsophisticated investors. In most cases, a significant position of the holders of publicly issued debentures are sophisticated institutions, acting for their own account or as trustees for investment funds, pension funds, or private trusts." 124 Cong. Rec. H11,101 (daily ed. Sept. 28, 1978) (remarks of Cong. Edwards).
\textsuperscript{275} Creditors in the same class must be treated equally. 11 U.S.C. § 901(a), 1123(a)(4) (Supp. II 1978).
\textsuperscript{276} Id. § 943(b)(6).
\textsuperscript{277} 11 U.S.C. § 1129(a)(7) (Supp. II 1978), is not incorporated into Chapter 9 since there cannot be a municipal liquidation.
summary of the plan, and a written disclosure statement. The disclosure statement must be approved by the court as containing adequate information after notice and a hearing. Adequate information is defined to be "of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan." The test is the reverse of what is required for adequate disclosure under the securities laws. The Bankruptcy Code does not require an objective test of materiality based on the need for an informed investment decision. Under the Bankruptcy Code, the standard is the ability of the debtor to provide information: the worse the books and records, the less the disclosure.

Section 1125 stresses this point by providing that "whether a disclosure statement contains adequate information is not governed by any otherwise applicable nonbankruptcy law . . . ." Section 17(a) of the 1933 Act and Rule 10b-5 under the 1934 Act may not be invoked. In soliciting the plan the debtor and professional are protected from fraud liability by a statutory "safe harbor" provision which states that as long as the person acts in good faith and in compliance with the Bankruptcy Code, such person will not be responsible for federal securities laws violations.

The difficulty with this form of disclosure is its almost private nature. If the class members have obtained adequate disclosure during the negotiating process, the disclosure statement need not duplicate the information. When the class, in turn, sells its bonds to other members of the public, there is no disclosure document adequately describing the restructuring of the debt.

281. Id. § 1125(a).
282. "The section also permits a certain amount of flexibility based on the condition of the debtor and of his books and records. Frequently, the debtor's books will be in a shambles at the time of bankruptcy, and reconstruction could be a long and costly process." H.R. REP. No. 595, 95th Cong., 1st Sess. 226-27 (1977).
284. Id. § 1125(e).
285. Id. § 1125(a)(2).
B. The Issuance of Notes and Bonds under the Plan

There are four types of securities that a municipality is likely to issue as part of a plan of debt adjustment: (i) short term obligations payable on a priority basis as administrative expenses for the purpose of funding immediate operating needs; (ii) notes or bonds to be exchanged for outstanding notes or bonds to evidence the adjustment of debt; (iii) bonds issued to refund existing bonds in accordance with their terms or the terms of the plan; and (iv) bonds issued to raise new capital. The first security mentioned allows the municipality to issue unsecured debt which is payable on the same priority as the expenses of administering the debt adjustment proceedings. If the municipality is unable to borrow on that basis, the court may authorize a priority for the debt over all other administrative expenses or provide a lien on property which is not otherwise subject to a lien. In extraordinary circumstances, the court may impose a lien senior to existing liens, provided that adequate protection is given to the existing lienholders.

In each type of indebtedness a question arises as to the form of disclosure that is required to accompany the underwriting of the issues. With respect to obligations not entitled to an exemption, there is the further problem that the 1933 Act requires securities to be registered under Section 5 if they are offered or sold in a non-

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287. Id. §§ 901(a), 507(a)(1), 503(b)(1).
289. For example, the plan might provide that bonds of a class, with principal payments being made annually, be exchanged for bonds with principal payments postponed for five years, but bearing a slightly higher interest rate.
290. The refunding bonds are sold to new creditors and the proceeds used to retire the debt of existing bondholders.
291. For example, the plan might call for the electric utility authority to embark on a new profitable project to improve its ability to pay existing creditors. As an inducement, the existing creditors transfer certain security to the new bondholders.
293. Id. §§ 901(a), 364(c)(1).
294. Id. § 364(c)(2).
295. Id. § 364(d). Adequate protection is defined in 11 U.S.C. § 361 to provide substitute cash or security on the theory that there is a taking of property within the due process clause requiring compensation. Wright v. Union Cent. Life Ins. Co., 311 U.S. 273 (1940); cf. Regional Rail Reorganization Act Cases, 419 U.S. 102 (1974), where the Court reasoned that facilitating borrowing to meet current expenses was preserving secured creditors' collateral and therefore there was no taking.
296. See note 10 supra.
297. See note 9 supra.
298. See note 7 supra.
exempt offering involving an issuer, underwriter or dealer. Prior to the enactment of the Bankruptcy Code, exemption from registration was based on both Section 3(a)(7), which provides an exemption from registration for certificates issued by a receiver or by a trustee in bankruptcy with the approval of the court, and Section 3(a)(10), which provides for the issuance of securities in a reorganization in exchange for existing claims. The person reselling a security issued in a plan of reorganization also would rely on Section 4(1), which exempts from registration transactions by any person other than an issuer, underwriter or dealer. Typically the person receiving the securities was not an issuer or a dealer but an underwriter operating pursuant to Section 2(11), a section which requires a subjective evaluation of a person’s intention to resell a security. The problem for investors was that as soon as there was a market, the typical investor would expect to resell.

If the security is exempt under either Section 3(a)(7) or Section 3(a)(10), the determination of underwriter status is immaterial because no registration is required regardless of the transaction. If, however, the primary issue is based on a “private placement” transaction under Section 4(2), then the resale transaction of an unregis-

299. The term issuer is defined as “every person who issues or proposes to issue any security. . . .” 15 U.S.C. § 77(b)(4) (1976).
300. The term “underwriter” is defined in § 2(11) of the 1933 Act, 15 U.S.C. § 77(b)(11) (1976), as follows:

[T]he term “underwriter” means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors’ or sellers’ commission. As used in this paragraph the term ‘issuer’ shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

301. The term ‘dealer’ is defined in § 2(12) of the 1933 Act, 15 U.S.C. § 77(b)(12) (1976), as follows:

[T]he term ‘dealer’ means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.

303. Id. § 77(d).
304. See note 300 supra.
tered security by the investor must qualify under Section 4(1) as a transaction by a person other than an underwriter, as defined by Section 2(11).

In 1978, the SEC attempted to ameliorate the problem by promulgating Rule 148. Rule 148 provides that a person who acquires securities under a plan shall not be deemed an underwriter if (i) the volume of securities sold in any three month period is within a limit generally not in excess of 1% of the outstanding units; (ii) there is adequate current public information made available by the issuer; and (iii) the transaction is conducted through "brokers" or "market makers."

The Bankruptcy Code specifically exempts from the registration requirements of Section 5 of the 1933 Act, except for sales by an underwriter, the first two types of securities: securities issued for administrative expenses and securities issued in exchange for allowed claims. Section 1145(b) defines the resale to be by an underwriter for purposes of Section 2(11) of the 1933 Act if the purchase by such person is with "a view to distribution." The Bankruptcy Code rejects the efforts of the SEC in Rule 148 to establish an objective safe harbor (or the more appropriate approach of simply declaring such a person not to be an underwriter under Section 4(1) of the 1933 Act) for the subjective test of intent.

The third and fourth types of securities are not exempted from registration by reason of Section 1145. For those securities, exemption

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308. Rule 148 permits sale of the greater of 1% of the outstanding shares on other units or the average weekly trading volume during the preceding four weeks.

309. The public information test is satisfied if the issuer is subject to the registration requirements of §12 of the 1934 Act and either of the periodic reporting requirements of §13 or §15(d) of the 1934 Act and is current with its filings. If the issuer is not a reporting company the requirement is met if there is publicly available the Rule 15c 2-11 information. See Sec. Exch. Act Rel. No. 9310 (1971). Rule 15c 2-11 makes it a fraudulent, manipulative and deceptive practice under §15(c)(2) of the 1934 Act for a broker-dealer to effect transactions in securities unless it has on file specified current information on the above reporting requirements. Rule 15c 2-11 is not directly relevant to political subdivisions but it should be noted that § 15(c)(2) of the 1934 Act after referring to broker-dealers provides that "no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or to attempt to induce the purchase or sale of, any municipal security in connection with which such municipal securities dealer engages in any fraudulent, deceptive or manipulative act or practices, or makes any fictitious quotation." See Rules G-11, G-15, G-17, G-19 and G-32 of the Municipal Securities Rulemaking Board, CCH MSRB Manual, promulgated under the authority of § 15B of the 1934 Act, for rules with respect to public information.

DISCLOSURE REQUIREMENTS

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from registration is dependent upon Section 3(a)(2), which in most cases will provide an exemption for all four types of obligations incurred by political subdivisions. There may be situations, however, in which the political subdivision intentionally issues taxable bonds in violation of Section 103 of the Internal Revenue Code to take advantage of short term profit potential on the reinvestment of proceeds not otherwise permitted by Section 103. If the bonds are not tax-exempt, they may not be exempt from registration under Section 3(a)(2) of the 1933 Act either. Attempts to issue will create problems similar to those facing corporate issues, particularly with regard to resales by statutory underwriters who consider themselves investors.

There remains the question of the type of disclosure required in connection with the sale of securities pursuant to a plan of reorganization or debt adjustment. In the corporate context, securities may not be issued to the public to raise new capital necessary to finance a plan without registration. The exemption from registration under Section 1145(a) is only for the limited purpose of exchanging new securities for existing claims or administrative expenses where a Section 1125 disclosure statement is deemed adequate. Public issues require registration in the ordinary course under Section 5 of the 1933 Act.

In the limited context of a Section 1145(a) transaction, where a plan calls for the issuance of securities in exchange for existing claims, the only disclosure requirement is the delivery of a Section 1125 disclosure statement. If the purpose of the issue is to raise new money from outside sources, the securities laws apply with their traditional disclosure standards. In the context of public finance, the pattern is similar. The Section 1125 flexible disclosure statement may be used only with the issuance of securities to persons being solicited for the acceptance of the plan of debt adjustment. The limited purpose of the Section 1125 disclosure statement is evidenced by the authorization of different disclosure statements for different classes. Where cram down procedures are being invoked under Section 1129(b), no disclosure

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312. See note 10 supra.
314. The reference is to the arbitrage restrictions set forth in I.R.C. § 103(c) (P-H 1981).
315. See text accompanying notes 18-27 supra.
317. See notes 6-8 supra and accompanying text.
319. Id. § 1125(b). In re Northwest Recreational Activities, 4 Bankr. 43 (N.D. Ga. 1980).
statement is necessary because the creditor is not in a position to make a choice.\textsuperscript{321} Accordingly, when the Bankruptcy Code provides that the adequacy of a disclosure statement will not be determined under nonbankruptcy law,\textsuperscript{322} the exemption from the disclosure requirements of the securities laws extends only to the limited purposes for which a Section 1125 disclosure statement is prepared.

Disclosure under Section 1125 will be substantively developed by the bankruptcy court,\textsuperscript{323} and decisions there may inevitably reflect the jurisprudence of disclosure under the securities laws.\textsuperscript{324} Where an issue is being offered to the public by a political subdivision for purposes of raising capital, however, the securities law standards of disclosure under Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act will be fully applicable.

The only gap in the interaction of the federal securities laws and the Bankruptcy Code is in the instance where an adjustment of the debt structure of an existing class of bonds approved by the class pursuant to the lower disclosure standards of Section 1125 is involved. Immediately after approval the class begins selling the bonds to new investors free from the restraints of underwriter status imposed by Section 2(11) because of the Section 3(a)(2) exemption. The bonds are then sold to investors inappropriate for Section 1125 disclosure who should have the benefits of disclosure under Rule 10b-5 of the 1934 Act. In this resale context, the control of disclosure will be made by the SEC and the Municipal Securities Rulemaking Board pursuant to their ability to regulate the conduct of municipal securities dealers under Section 15 of the 1934 Act.\textsuperscript{325}

\begin{itemize}
  \item \textsuperscript{321} In the Matter of Union County Wholesale Tobacco and Candy Co., 8 Bankr. 442 (D. N. J. 1981).
  \item \textsuperscript{322} 11 U.S.C. § 1125(d) (Supp. II 1978).
  \item \textsuperscript{323} In a Second Circuit decision the court emphasized the jurisdictional implications of § 1125(d) which “clearly establishes substantive preemption for the Bankruptcy Court as against the Securities Exchange Act . . . but also requires that Court to approve the disclosure statement as containing adequate information.” In re Guardian Mortgage Investors, 607 F.2d 1020 (2d Cir. 1979).
  \item \textsuperscript{325} See note 309 supra.
\end{itemize}
V. Conclusion

There are in excess of 20,000 political subdivisions with more than 50,000 separate issues of debt outstanding in the United States.\textsuperscript{326} The annual issuance of long term bonds of political subdivisions increased from $17 billion in 1970 to $45 billion in 1980.\textsuperscript{327} In the period after the New York fiscal crisis, short term indebtedness decreased from $29 billion in 1974 to $21 billion in each of the years 1976 through 1979 when it began to spiral upward to $34 billion in 1981.\textsuperscript{328}

During the 1970's the proportion of new issues in the long term market which were revenue bonds, as opposed to general obligation bonds, rose from one-fourth to three-fourths of the bond market.\textsuperscript{329} The revenue bond derives its security from the capability of the limited source of revenue to cover debt service, the statutory framework that protects the lien on revenues, and the skill of attorneys to assure that the intended security provisions are properly drafted.\textsuperscript{330}

Despite the present quantity of indebtedness, the ratio of short term to long term indebtedness, and the limited sources of repayment characteristics of revenue bonds, the debt of political subdivisions generally is perceived to be among the safe investments.\textsuperscript{331} For the securities lawyer this suggests that the investor in securities of political subdivisions is relying upon the integrity of the market as well as the disclosures made with respect to a specific issue.

Reliance upon the integrity of the securities market suggests that the market performs a substantial part of the valuation of a new security.\textsuperscript{332} Market prices respond to information disseminated, assumptions made in the market, and information withheld.\textsuperscript{333} If an issuer has reason to believe that the market price of its securities is being favorably influenced by assumptions made about the quality or safety of the security being issued that are known to be absent for the

\textsuperscript{326} D. Darst, The Complete Bond Book 190 (1975).
\textsuperscript{327} Moody's Municipal & Government Manual a7 (1982).
\textsuperscript{328} Id.
\textsuperscript{329} Id.
\textsuperscript{330} A general obligation bond derives its security from constitutional restrictions on the amount and form of indebtedness and full faith and credit requirements that the taxing power of the issuer be imposed to the extent necessary to raise sufficient amounts for debt service.
\textsuperscript{331} Darst, supra note 326, at 195.
\textsuperscript{332} Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); In re LTV Sec. Litigation, 88 F.R.D. 134 (N.D. Tex. 1980).
\textsuperscript{333} Note, Fraud on the Market, 95 Harv. L. Rev. 1143, 1154 (1982).
particular offering, the nondisclosure of appropriate correcting information could be a violation of the federal securities laws.\textsuperscript{334}

In this Article there has been a discussion of a number of the problems under Chapter 9 of the Bankruptcy Code which bear upon federal securities law disclosure analysis. The following are the conclusions to be inferred:

(1) In the ordinary issuance of debt by political subdivisions where no threat of insolvency is reasonably perceived there need be no standard disclosure of Bankruptcy Code consequences in the remote event of the filing of a Chapter 9 petition.\textsuperscript{335}

(2) The conclusion set forth above is possible because there are sufficient arguments under the Bankruptcy Code as developed in this Article to reasonably conclude that the perceived integrity of public finance will be maintained where the Bankruptcy Code is applied.

(3) If, as a result of decisions of the bankruptcy courts or other federal courts, particular statutory schemes, or drafting decisions unique to a particular issue, the arguments favoring the security of bondholders in this Article are not applicable, disclosure of Bankruptcy Code consequences is necessary if the market price is likely to reflect false assumptions about the integrity of the issue.

(4) As the potential threat of bankruptcy increases, the attention to Bankruptcy Code disclosures should increase, and those responsible for disclosure will be required to consider the materiality of discussion in the disclosure documents of the problems under Chapter 9.


\textsuperscript{335} If a financing is designed to achieve specific results in a bankruptcy context, even where there is no potential threat, an explanation of those purposes and anticipated consequences is appropriate.