Municipal Debt Investors May Be on Uneven Footing in Chapter 9

Investors in municipal securities may face a greater risk of recovery than certain other similarly situated creditors in a municipal bankruptcy. Why? Because it may be politically or otherwise advantageous for the municipal debtor to favor other creditors (such as, chiefly, current and former government employees) and recent bankruptcy court decisions lend support to this favoritism. So, while municipal bankruptcies are rare compared to chapter 11 bankruptcies, municipal investors should carefully evaluate (price) the risks associated with a municipality's potential bankruptcy before investing in its securities.

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To set the stage, chapter 11 bankruptcy law largely governs in chapter 9. But courts may apply the Bankruptcy Code more liberally in chapter 9. In part, this is because section 904 of the Bankruptcy Code limits bankruptcy courts' supervisory authority over the municipal debtor's decision making during the case. Section 904 provides that a bankruptcy court may not interfere with a municipal debtor's political or governmental powers, property or revenue, or use or enjoyment of income-producing property without the municipal debtor's consent. So, municipal debtors have an arguably heightened level of autonomy and control in bankruptcy compared to chapter 11 debtors.

Let's take an example. Chapter 9 incorporates chapter 11's unfair discrimination rules — the bankruptcy court may confirm a plan despite a dissenting class if the plan does not "discriminate unfairly." Unfair discrimination may be present when similarly situated creditors unjustifiably receive different recoveries, including when the difference in recovery is too large (think greater than 50 percent). The bankruptcy court determines whether the disparate treatment is legitimate. But there are no absolute rules here and, with the section 904 overhang, grey area abounds.

Consider Detroit, Michigan's chapter 9 case — the largest chapter 9 case in history. Detroit's plan provided pensioners significantly greater recoveries than other unsecured creditors including bondholders (some argued at least 90 percent greater). Applying "the Court's conscience" to determine fairness, the bankruptcy court held that the disparate treatment in favor of pensioners was not discriminatory: Detroit has a "strong interest in preserving its relationship with its employees and in enhancing their motivation," Michigan state law gives notice to all unsecured creditors that pensions are distinct and entitled to special protections (a heavily controversial point), and Detroit's "recovery will turn in large part on its ability to marshal the support of its residents in general and its retirees, and employees and their labor unions in particular."

Stockton, California's chapter 9 plan also provided disparate treatment in favor of pensioners. Under the plan, general unsecured claims, including certain municipal bond claims, were to recover approximately 0.9 percent. In contrast, pension claims were to recover 100 percent. And this was despite the bankruptcy court having previously held that Stockton could limit pension recoveries by rejecting its pension agreement with the California Public Employees' Retirement System. Although the bankruptcy court did not need to consider unfair discrimination because there were no dissenting classes, it provided reasons anyway for the higher recoveries to pensioners. The court said pensions are unique to the employees, arise from a contract between Stockton and its employees, and, as Stockton asserted, paying pension claims in full was necessary to retain employees, primarily those in public safety positions, who could move to other municipalities that would provide pensions.

Both Detroit and Stockton's chapter 9 cases show that municipalities may seek to provide bondholders diminished recoveries compared to other *pari passu* creditors, namely pensioners, and provide precedential support for favoritism. Unlike current and former employees, bondholders may carry less political sway and it's easy to craft a story around the day-to-day value employees (and citizens) contribute. Of course, the risks of a chapter 9 bankruptcy occurring are minimal in general. Still, municipal investors should invest with their eyes wide open, and price municipal securities accordingly.

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