Bond Insurers Become Active Participants in Chapter 9s

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Chapter 9 municipal bankruptcy cases are rare—the true option of last resort. In fact, in the 78 years since the enactment of Chapter 9 in 1934 there have been only about 600 such filings. Although some cases stem from genuine emergencies—an unanticipated judgment or calamitous investment loss, for example—most Chapter 9s involve municipalities grappling with an unhealthy mix of a deteriorating tax base, high labor costs, unfunded pension obligations, and long-term bond debt.

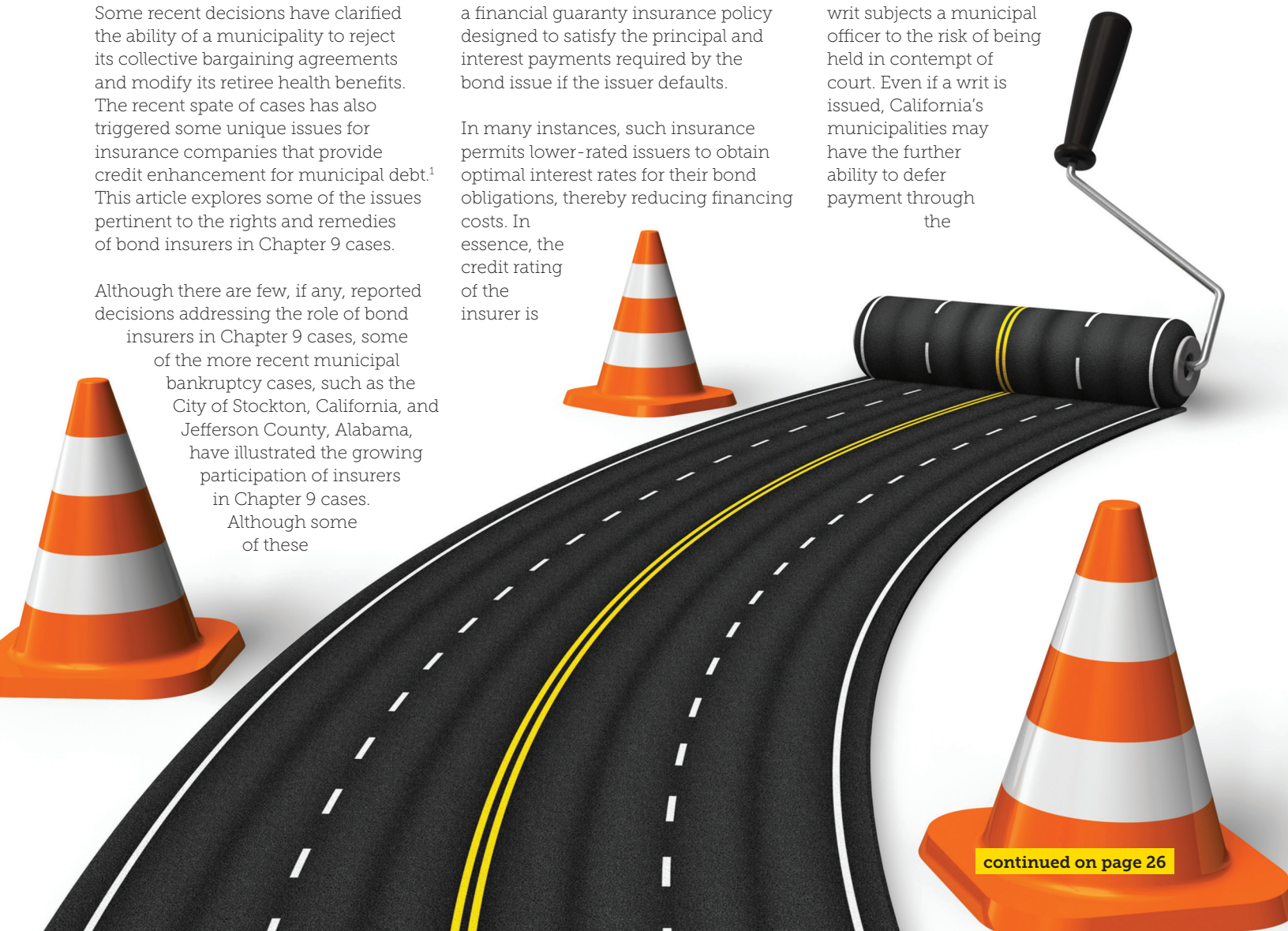
Some recent decisions have clarified the ability of a municipality to reject its collective bargaining agreements and modify its retiree health benefits. The recent spate of cases has also triggered some unique issues for insurance companies that provide credit enhancement for municipal debt.[1] This article explores some of the issues pertinent to the rights and remedies of bond insurers in Chapter 9 cases.

Although there are few, if any, reported decisions addressing the role of bond insurers in Chapter 9 cases, some of the more recent municipal bankruptcy cases, such as the City of Stockton, California, and Jefferson County, Alabama, have illustrated the growing participation of insurers in Chapter 9 cases. Although some of these issues may be applicable to insurers generally, it is important to bear in mind that the precise terms of a particular insurance policy or bond indenture vary by jurisdiction, issuer, and insurer.

Municipal bonds and notes typically are regarded as extremely safe investments, principally because they are backed by the issuer's taxing power or, in the case of revenue bonds, by a dedicated income stream pledged to their repayment. However, it is not unusual for such debt to be accompanied by a financial guaranty insurance policy designed to satisfy the principal and interest payments required by the bond issue if the issuer defaults.

In many instances, such insurance permits lower-rated issuers to obtain optimal interest rates for their bond obligations, thereby reducing financing costs. In essence, the credit rating of the insurer is substituted for the credit rating of the issuer. Insurance is also warranted because of the relatively limited enforcement and collection mechanisms available to municipal creditors. In some states, creditors lack access to customary remedies, such as attachment, levy, and execution.

In California, for example, a creditor generally must seek a writ of mandamus compelling the municipal authorities to appropriate and pay the debt. The failure to comply with a writ subjects a municipal officer to the risk of being held in contempt of court. Even if a writ is issued, California's municipalities may have the further ability to defer payment through the



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issuance of a 10-year warrant, payable in annual installments with interest. Bond insurance thus serves to allay concerns over timely payment despite state-by-state variations in the ability to enforce municipal obligations.

Bond insurance is also sometimes used as a backstop for liquidity providers who commit to remarket variable interest rate bonds. This liquidity support is often provided to ensure that holders of adjustable debt will, from time to time, be able to sell their bonds if an unexpected or undesirable interest rate change occurs. In that event, the liquidity provider must either remarket the bonds to a new holder or acquire the bonds itself.

Hence, a liquidity provider often requires credit support for its own protection following a repurchase of the bonds. If a liquidity provider is compelled to purchase the bonds, it may be entitled to an accelerated repayment from the insurer, as opposed to repayment over the original amortization schedule of the bond, which usually is the only remedy available to the original bondholder.

Chapter 9 Concepts

The legislative history of Chapter 9 suggests that it was not necessarily intended to result in the repudiation of municipal debt. See H.R. Rep. NO. 95-595, at 263 (1977) ("[T]he term 'bankruptcy' in its strict sense is really a misnomer for a [C]hapter 9 case. ... Therefore, the primary purpose of [C]hapter 9 is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims with minimum (and in many cases, no) loss to its creditors.").

Nevertheless, spiraling claims for unfunded pension and retiree benefits have limited the ability of distressed municipalities to maneuver, forcing them to examine all options to reduce budgets and maintain essential services. Although bond debt historically was typically left unscathed in Chapter 9, recent cases suggest that this trend is unlikely to continue.

Other unique provisions of Chapter 9 may affect the treatment of bond debt and, by extension, the likelihood of insurance claims. Bankruptcy Code Section 904 prohibits a Bankruptcy Court from interfering "unless the debtor consents or the plan so provides" with any of the debtor's political or governmental powers, property or revenues, or use or enjoyment of income-producing property. In addition, Section 363, concerning the use or sale of property, is omitted from Chapter 9. Thus, a Chapter 9 debtor enjoys wide latitude to pay prepetition claims on a current basis or to defer payment until the effective date of a plan.

Further, a Bankruptcy Court cannot appoint a trustee to manage or control the debtor, except in very limited circumstances to pursue avoidance actions, or compel a liquidation of municipal assets. Moreover, only the municipality can propose a plan of adjustment; creditor plans are not permitted. The sole effective remedy for disgruntled creditors is dismissal of the case.

Therefore, a Chapter 9 debtor has almost complete discretion (a) to determine whether and when to file a bankruptcy case, (b) to manage its affairs and property during the pendency of the case, and (c) to file a plan of adjustment during a virtually perpetual exclusive period.

Varieties of Municipal Debt

Municipal bond insurance is not confined to traditional general obligation (GO) bonds backed by a pledge of the full faith and credit and taxing power of the issuer. Rather, insurance may accompany numerous types of municipal financing instruments, including public enterprise revenue bonds, tax increment and redevelopment bonds, and financing leases/certificates of participation, among many others. The particular rights of a bond insurer following a default under any of these instruments may vary by the type of insured obligation.

Chapter 9 affords differing treatment to various types of municipal bond debt. This, in turn, may affect the likelihood that the bond insurer will be called upon to honor its policy. In some cases, a municipality's ability to impair municipal bond obligations is significantly limited. In other situations, the need for continued access to the capital markets, either to finance a plan of adjustment or for general operating purposes following confirmation of a plan, may counsel a more practical approach to the adjustment of bond debt. In any event, the unique features of municipal debt instruments and the corresponding provisions of Chapter 9 affect a bond insurer's risks and participation in a particular case.

At one end of the spectrum, insurance for unsecured GO bonds might have the highest likelihood of being invoked, especially if the municipal debtor faces a true fiscal emergency in which it must choose between the delivery of essential public services and payment of prepetition claims. At the other end, insurance for revenue bonds might not necessarily be triggered upon commencement of a Chapter 9 case.

Unlike GO bonds, a revenue bond is secured solely by income generated by the project financed with the proceeds of the bond. Although holders of revenue bonds face the risk of project failure and lack recourse to municipal receipts other than the specific revenue stream pledged, their rights in Chapter 9 are comparatively more favorable than the rights of a GO bondholder.

Specifically, if a revenue bond qualifies as a "special revenue" obligation under Section 902(2) of the Bankruptcy Code, the indebtedness will continue to be serviced, notwithstanding the automatic stay under Section 362. Five categories of special revenues are listed in Section 902(2): (a) receipts from the operation of water, sewage, waste, or electric systems, (b) highway or bridge tolls, (c) user fees, (d) special excise taxes, and (e) proceeds from project financing.

Bonds secured by statutory liens on tax revenues might also remain unaffected in a Chapter 9 case. Generally, a secured party may obtain a security interest (i.e., a lien created by agreement) in after-acquired property of the borrower. Section 552 of the Bankruptcy Code, however, terminates the reach of a security interest in post-petition property unless the property constitutes proceeds of the prepetition collateral.

Although Section 552 of the Bankruptcy Code is applicable under Chapter 9, it only truncates a lien created under a security agreement, not one that arises by operation of law. In many cases, liens securing bonds issued pursuant to municipal financing schemes are created automatically by state law rather than by contract. As a result, post-petition tax receipts should continue to serve as collateral for the bondholders.

Last, financing arrangements based on lease transactions enjoy certain protections under Chapter 9. Like

corporate debtors, municipalities also can reject, assume, and assign unexpired leases under Bankruptcy Code Section 365. Municipal financing leases, however, are unique instruments. For purposes of state law limitations on the issuance of debt, such instruments are usually considered true leases, not long-term indebtedness, because they bear the risks of annual "abatement" or "non-appropriation."

The municipal capital markets, on the other hand, typically view such instruments as debt obligations. For this reason, a special rule of construction has been added to Chapter 9 to prevent the potential treatment of municipal financing leases as true leases subject to potential assumption or rejection under Section 365.

Section 929 provides that "a lease to a municipality shall not be treated as an executory contract or unexpired lease for the purposes of [S]ection 365 or 502(b)(6) of this title solely by reason of its being subject to termination in the event the debtor fails to appropriate rent." This rule overrides assumption or rejection deadlines and rental claim limitations under the Bankruptcy Code and thereby preserves for the lender/lessor the right to seek full recovery on the outstanding amount of the debt.

As a result, to the extent that municipal financing leases are accompanied by insurance, the municipality's inability the reject the lease may leave the insurer gratefully on the sidelines.

Customary Features

Municipal bond insurance policies typically provide for the unconditional and irrevocable promise of the insurer to pay the indenture trustee or other designated disbursement agent that portion of the total bond obligations that becomes due but is not paid in a timely manner. The policy term is generally coterminous with the maturity date of the bond. Generally speaking, the policies are noncancelable.

No Acceleration. One key feature of municipal bond insurance is that the policies are commonly written without an acceleration clause. That is, although the issuer's default would trigger the insurer's obligation to make the missed payment, the bondholders are not also entitled to acceleration and full payment by the insurer of the then outstanding balance due from the municipality. Rather, the insurer's sole obligation is to pay only the portion of the stream of insured payments that becomes due but remains unpaid.

Typically, the insurance therefore does not cover the loss of any prepayment premium or other acceleration payment. Moreover, many policies are expressly limited to the nonpayment of principal and interest, and do not insure against any additional amounts that may be due, such as penalties, default rate interest, indemnification, or other contractual rights. Instead, bondholders are merely entitled to an insurance payout for each missed bond installment as it occurs.

The omission of an acceleration clause from a municipal bond insurance policy can have some unintended bankruptcy consequences. For instance, although the insurer is not obligated to make any payments for default rate interest, it correspondingly will not be subrogated to a claim for such interest against the issuer. Rather, the bondholders would theoretically retain such rights to the extent permitted under the bond instrument.

Nevertheless, following a payment under the policy the insurer becomes entitled to direct the indenture trustee and the bondholders with respect to the general enforcement of the bond obligations. It is unclear, however, whether the insurer or the bondholders

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would be entitled to retain any default rate interest that may be recovered from the issuer. The same conundrum would apply to other entitlements under the bond instruments that are not covered by the insurance policy.

More importantly, perhaps, the policy terms that insure solely against the loss of payments when otherwise due may lead to disparate interests among the bondholders, insurer, and municipal issuer. Even though the insurer usually obtains upon payment under the policy the right to participate in the bankruptcy case on behalf of the indenture trustee, it is unclear whether the insurer or the trustee has the ultimate authority to negotiate (or for that matter, to vote on) any adjustments to the bond obligation that might be the subject of a plan of adjustment.

The insurer is only subrogated to the rights of the bondholders "to the extent" of the payments made under the policy. Yet, as the ultimate economic party in interest, it should have a direct role in the possible treatment of the total outstanding bond obligations.

Unlike a guarantor, whose guaranty obligations might be exonerated to the extent the primary debt is modified without its consent, an insurer's policy obligations are absolute and unconditional, and the insurer generally waives any rights and defenses that might otherwise have the effect of discharging its insurance obligations.

Thus, in plan negotiations with the issuer, bondholders may be agnostic to any proposed modifications to the indenture because the insurer would remain obligated to make the payments otherwise required by the bonds. It is unclear whether either the insurer's subrogation rights or its agency rights would entitle the insurer, as opposed to the bondholders, to vote on any amendments to the bond instrument or to permit the issuer to modify the bond obligations, among other potential treatment options available under a plan.

Control. The insurer's payment under the policy following the issuer's default usually entitles the insurer to step in and control the enforcement remedies otherwise available to the trustee and bondholders under the terms of the indenture. Thus, although the insurer is only obligated to make insurance payouts when the issuer defaults, it is entitled to direct the rights of the trustee as specified in the indenture or otherwise available under applicable law.

In many policies, the indenture trustee or other party entitled to the benefit of the payments made under the policy contractually appoints the insurer as its agent and attorney in fact in any legal proceedings related to the bonds, including bankruptcy cases. In some cases, the trust indenture makes the insurer a third-party beneficiary of all rights and remedies otherwise afforded to the indenture trustee.

The insurer, as the true economic party in interest, is thereby entitled to direct all matters arising in such proceedings or the conduct of such proceedings. Further, when the bonds may be secured by a pledge of special revenues or rents under a lease that are otherwise payable to the indenture trustee, the insurer may become entitled to collect those amounts directly.

One purpose of the appointment of the insurer as the agent for the indenture trustee is to defend against any action by a municipal debtor for the recovery of preferential payments previously

made to bondholders. Naturally, the avoidance and recovery of a preference might trigger an insurance claim under the policy; thus, the insurer's direct participation in any preference action would not be unusual. Indeed, most insurance policies will apply to the extent any payment otherwise made to a bondholder is later recovered as an avoidable preference.

Section 926(b) of the Bankruptcy Code, however, renders immune from preference attack any transfer that is made by the municipality to or for the benefit of "any holder of a bond or note." Thus, despite the protections afforded under a policy, it is rather unlikely that a bond insurer will be called upon to honor a payment under a bond that has been returned to the debtor by the bondholder.

It is somewhat unclear whether the appointment of the insurer as the bondholders' attorney in fact would be effective for all purposes in a Chapter 9 case. As noted, an insurer's policy obligations are typically limited to the payment of missed principal and interest installments. Although the policy language may be framed broadly to permit an insurer to control all matters in a case, there may be some uncertainty regarding the insurer's ability to agree to amendments to the indenture, modify the terms of the bonds, or vote to accept or reject a plan on behalf of bondholders, who technically remain creditors for the outstanding amounts due under the bonds.

Bankruptcy Rule 9010 sets forth important procedural rules regarding the appearance of a party in interest in the case. The interplay of these requirements and the terms of a prepetition proxy under a bond insurance policy have yet to be thoroughly addressed.

Subrogation. As noted, most bond insurance policies make explicit what is otherwise implicit under applicable law: upon payment, the insurer is subrogated to the claims of the bondholders "to the extent" of each missed payment. As a result, the insurer becomes entitled to receive payments under the bond from the issuer and holds a corresponding claim in the Chapter 9 case.

One issue, however, that seems to have received scant attention by courts is the impact of Section 509 of the Bankruptcy Code on the rights of the bond insurer following the satisfaction of a missed payment under the bond. (Section 509 is incorporated into Chapter 9 under Section 901(a) of the Bankruptcy Code.) Section 509 addresses the rights of an entity that (a) is co-liable with the debtor on the claim of a creditor, and (b) pays such claim after the petition date. Such a co-debtor (or co-obligor) is deemed subrogated to the rights to the creditor to the extent of such payment.

Most municipal bond insurance policies expressly confirm that the insurer will be fully subrogated (to the extent of its disbursement on account of a missed payment) to all of the bondholders' rights, title, and interest under the bond obligations. Thus, there is little doubt that the bond insurer steps into the shoes of the bondholder for purposes of a missed payment. The debtor and other creditors are not harmed by the allowance of a subrogation claim because the aggregate distributions to the creditor and its subrogee should equal the amount of the original obligation.

Section 509(c) of the Bankruptcy Code, however, subordinates the subrogation claim until the creditor's claim "is paid in full, either through payments under this title or otherwise." In other words, until the combination of distributions from the debtor plus distributions from the co-debtor equals payment in full, the holder of the subrogation claim must await any distributions from the debtor on account of its subrogation claim. This subordination also applies to any alternate claims for contribution or reimbursement. Thus, the co-obligor cannot recast its subrogation claim as a direct reimbursement claim against the debtor and evade the effects of subordination.

The anomaly that arises from the non-acceleration provisions of the insurance policy, however, is whether "payment in full" refers to each particular bond payment that is unpaid when due (and hence satisfied by insurance) or to the outstanding principal amount of the entire bond obligation. Although the non-acceleration clause may protect the insurer from being forced to prepay the bonds upon the issuer's default, it may also result in the insurer's subordination to the prior "payment in full" of the entire bond before the insurer may share in distributions from the debtor.

If the plan proposes to make significant adjustments to the original bond obligation and bondholders are only paid a reduced dividend, it is theoretically possible that the insurer, as a subrogee, may not immediately share in any distributions from the debtor. As a practical matter, however, there may be little risk of competition between the subrogee and the creditor insofar as the insurer may have the ability to file a single claim on behalf of the bondholders.

Awaiting Resolution

Municipal bond insurers are becoming increasingly active participants in Chapter 9 bankruptcy cases. Many issues affecting the rights and obligations of municipal debtors, especially the relative claims and priorities of retirees, bondholders, and pension creditors, will likely be addressed in various current high-profile cases. The resolution of these issues undoubtedly will also impact both the rights of bond insurers under existing policies as well as the future contours of the monoline insurance industry. J

[1] These companies are often referred to as monoline insurers because they do not offer other types of insurance, such as health, casualty, or general liability.

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