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Feature

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Maybe Taxes Aren't So Certain

What Is "Fair and Equitable" in a Chapter 9 Plan?



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Many U.S. cities and other municipalities are struggling under crippling financial demands. Buckling under the financial strain, a number of municipalities are considering an option that, just a few short years ago, was almost unheard of—filing for bankruptcy protection. Assuming that eligibility requirements are met, a municipality¹ may seek bankruptcy protection under chapter 9 of title 11 of the Bankruptcy Code. Historically, chapter 9 filings have been rare, with typically less than 10 such filings annually.² In recent months, however, a number of chapter 9 cases have been filed.³ In addition to the rise in the number of chapter 9 filings, the types of municipal entities seeking bankruptcy protection appear to be changing. Traditionally, the most common types of entities seeking chapter 9 protection were special-purpose districts or authorities. More recently, however, at least one county and a number of cities have opted for chapter 9 protection.

The ultimate goal of a chapter 9 filing is the confirmation of an adjustment plan that implements a feasible and comprehensive restructuring proposal. Given the scarcity of chapter 9 filings to date, many significant issues remain to be resolved by the courts. One significant question that remains unanswered is whether and, if so, under what circumstances a court will approve an adjustment plan over the objections of creditors when that plan does not pay creditors in full, despite the fact that the municipality might theoretically be able to raise sufficient taxes to satisfy those claims in their entirety.⁴

The Fair and Equitable Requirement

The standards for plan confirmation in a chapter 9 case include both the statutory requirements of 11 U.S.C. § 943(b) and those portions of 11 U.S.C. § 1129 made applicable to chapter 9 by 11 U.S.C. § 901(a). One key aspect of chapter 11 made applicable to chapter 9 is reflected in § 1129(b). Under this provision, if at least one impaired class of creditors consents to the plan, plan confirmation can be achieved where other classes of creditors object. This is the so-called “cramdown” power and, assuming that the plan otherwise meets the requirements for plan confirmation, it permits a court to approve a plan over creditor opposition if two criteria are met: the plan must (1) be “fair and equitable” and (2) not “discriminate unfairly” with respect to any class of creditors that the plan proposes to impair. This article will focus on the “fair and equitable” requirement for plan confirmation in the chapter 9 context. Specifically, it will consider when a court might find a plan to be “fair and equitable” in a setting where the municipality is not proposing as an element of its plan the adoption of new or additional taxes that are sufficient to satisfy all claims in full.⁵

The Bankruptcy Code does not comprehensively define the phrase “fair and equitable” for purposes of plan confirmation. Rather, it provides that the condition that a plan be fair and equitable “includes” certain specified requirements,⁶ thereby leaving the substance of the concept open to interpretation.⁷ The “fair and equitable” requirement specified in the Code—in its most basic form, and when applied

1 The Bankruptcy Code defines a “municipality” as a “political subdivision or public agency or instrumentality of a State.” See 11 U.S.C. § 101(40) (2006). In addition to encompassing cities and counties, the term also includes certain public agencies, special-use districts and authorities.

2 Chapter 9 Quarterly Filings (1980-2011), ABI, www.abiworld.org/statcharts/Ch9Filings1980-Current.pdf.

3 In 2011, 13 chapter 9 cases were filed. U.S. Courts, Bankruptcy Statistics, www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2011/1211_f2.pdf.

4 In the chapter 9 context, only the municipality may propose an adjustment plan.

5 Not all municipalities have the power to tax. Further, even political subdivisions that do have that power may be constitutionally or statutorily limited in imposing new forms of tax or from raising the rate of taxation.

6 11 U.S.C. § 1129(b)(2) (emphasis added).

7 The Bankruptcy Code provides expressly that for purposes of statutory construction, “includes” is “not limiting.” 11 U.S.C. § 102(3). See also *Fed. Sav. & Loan Ins. Corp. v. D&F Constr.* (In re *D&F Constr.*), 865 F.2d 673, 675 (5th Cir. 1989) (“A court must consider the entire plan in the context of the rights of the creditors under state law and the particular facts and circumstances when determining whether a plan is ‘fair and equitable.’”).

to “for-profit” enterprises—means that a plan must comport with the “absolute-priority rule.” This rule dictates that a plan can be deemed “fair and equitable” with respect to a dissenting impaired class of unsecured creditors⁸ if (1) the creditors in that class receive or retain property of a value that is equal to the allowed amount of their claims, or (2) the holders of claims that are more junior do not receive or retain anything under the plan. Thus, under this rule, all creditors must be paid in full under the terms of the plan if the plan also proposes distributions to any pre-petition equityholders (including the retention of any property of the estate by pre-petition equityholders). Since municipalities, by their nature, do not have equity interestholders, the “fair and equitable” requirement must mean something different in the context of a municipal bankruptcy.⁹

How then does the “fair and equitable” requirement limit the circumstances in which a court might approve debt reduction in the chapter 9 context? The limited body of relevant case law suggests that a municipality’s compliance with the “fair and equitable” principle will require that it demonstrate that its plan is balanced and that it has taken reasonable steps to increase revenue and cut costs before proposing debt reductions and/or other contractual modifications. Thus, when applying the “fair and equitable” standard in the chapter 9 context, courts analyze whether the amount to be distributed to the objecting creditors is all that they “can reasonably expect in the circumstances.”¹⁰ Courts might also assess whether a plan is “fair and equitable” in light of the primary purpose of debt restructuring for municipalities: the continued provision of public services.¹¹

Plan Confirmation and the Power to Tax

Not all municipalities have the power to tax. For municipalities that do have that power, the ultimate “fair and equitable” question is this: Where a municipality has done all it can do to reduce expenses and increase revenue to achieve a balanced budget, must a court require it to raise taxes. Conversely, may a court approve a plan that does not include new or increased taxes sufficient to satisfy claims in a setting where the municipality’s plan does not propose to pay its creditors in full?¹²

Most would likely agree that circumstances might exist where the municipality should be expected to shoulder part or all of its financial shortfalls by raising taxes. In other settings, however, expecting the municipality to raise taxes would entirely frustrate the very reason for it seeking bankruptcy protection. Further, under some circumstances, rais-

ing taxes might be detrimental to attracting new residents or commercial enterprises and thus adversely affect its long-term revenue. As such, the future of the municipality, including its economic-development plan, should be considered.

All of this suggests that whether and, if so, to what extent a bankruptcy court ought to require a municipality to impose new or increased taxes should be determined on a case-by-case basis. Limited case law supports this conclusion and suggests that if a municipality can show that increasing taxes is likely to be counterproductive, then a court might find a proposed plan to be “fair and equitable,” even if the municipality does not propose in its plan to impose new or increased taxes sufficient to pay creditors in full.¹³

The Requisite Showing

What are the factors that a court should consider in determining whether a proposed adjustment plan satisfies the fair-and-equitable test where the municipality does not propose to raise taxes sufficient to cover that debt, despite having the legal power to do so? The municipality will likely need to make two important showings.

First, the municipality will likely need to show that it has taken action to minimize its fiscal distress by increasing revenue and decreasing costs. Among the actions that a municipality would likely need to pursue to support this showing include: (1) reviewing existing contracts to look for inefficiencies and savings; (2) terminating burdensome contracts; (3) negotiating modifications to collective-bargaining agreements and retiree benefits;¹⁴ (4) reducing work force or compensation to realize cost savings; (5) selling or leasing municipal assets; (6) outsourcing or privatizing certain services; (7) consolidating services with other municipalities; and (8) securing grants or other financial support from federal and/or state programs.

Second, assuming that the municipality has taken reasonable steps to increase revenues and reduce costs, it should then show why it should not be required to impose new or additional taxes sufficient to satisfy claims in full. A court would likely find a plan to be “fair and equitable” if the municipality were to show that imposing the requisite taxes would essentially render the plan infeasible.¹⁵ To make such a showing, many factors would need to be assessed. These factors might include: (1) the tax rates of neighboring municipalities; (2) the job market and current level of employment in the locale; (3) prospects for growing the local population and the potential impact of additional taxes; (4) prospects for attracting new businesses and the potential impact of additional taxes; (5) the current level of real estate property values in the community relative to historic levels; (6) any

8 An important distinction between the treatment of secured creditors in chapter 9 (typically special revenue bond claimants) as compared to chapter 11 is worth noting. Under chapter 11, if the value of collateral securing a debt is less than the debt owed, the creditor has an unsecured claim against the debtor for the undersecured portion of its debt, and the creditor is entitled to receive distributions under a plan equal in percentage to that being paid to other general unsecured creditors. See 11 U.S.C. § 1111(b)(1)(A). This results even where the creditor has no contractual recourse against the debtor for the unsecured portion of its debt. In contrast, under chapter 9, a creditor is not given recourse against the municipality for the undersecured portion of the claim, absent a contractual agreement, or perhaps a statutory obligation, that establishes recourse. See 11 U.S.C. § 927.

9 Courts have similarly struggled with the application of the fair and equitable requirement to the reorganization of nonprofit enterprises. See, e.g., *In re Gen. Teamsters, Warehousemen & Helpers Union, Local 890*, 225 B.R. 719, 722 (Bankr. N.D. Cal. 1998) (noting difficulty with trying to apply “traditional bankruptcy analysis” to nonprofit reorganizations).

10 *Lorber v. Vista Irrigation District*, 127 F.2d 628, 639 (9th Cir. 1942) (considering plan confirmation under predecessor to current chapter 9).

11 *In re Mount Carbon Metropolitan District*, 242 B.R. 18, 34 (Bankr. D. Colo. 1999).

12 This article does not examine all arguments raised by creditors, including, for example, arguments raised by some bondholders, who have asserted that payment of debts owed to them cannot be compromised even in bankruptcy because they are guaranteed by the full faith and credit of the municipality.

13 *In re Corcoran Hospital District*, 233 B.R. 449, 459 (Bankr. E.D. Cal. 1999), provides an example of such an analysis. In that case, the committee of unsecured creditors argued that the debtor hospital district’s plan had not been proposed in good faith and was not fair and equitable because the debtor did not propose raising taxes in order to attempt to pay unsecured creditors in full. In response, the debtor presented testimony from the chief financial officer of the hospital district, who testified about the debtor’s past unsuccessful attempts to increase taxes. The city manager also testified about the city’s demographics and various economic challenges to raising taxes. Based on the evidence presented, the court held that the hospital district was not obligated to raise taxes or to even attempt to raise taxes to pay its unsecured creditors in full because the evidence indicated it would be a “futile exercise.”

14 Many municipalities are struggling with rising pension costs and other unfunded post-employment benefits. The question of whether and to what extent these obligations may be modified raises a host of complex issues and has yet to be resolved by the courts.

15 *Cf.*, *In re Mount Carbon Metropolitan District*, 242 B.R. at 34 (observing that “it would make little sense to confirm a reorganization plan which does not remedy the problem. Stated differently—there is no purpose in confirming a Chapter 9 plan if the municipality will be unable to provide future governmental services”); see also *Lorber v. Vista Irrigation District*, 127 F.2d at 639 (asking whether amount to be distributed to objecting creditors “is all that they can reasonably expect in the circumstances”).

anticipated new or additional financial needs of the municipality; and (7) the potential reaction by residents, businesses and other constituencies to the imposition of additional taxes. Based on an assessment of these factors, the municipality might show that additional taxes would not make sense as a rational and long-term approach to fixing the municipality's financial difficulties.

Conclusion

If chapter 9 is to provide any real benefit, it must be that under some circumstances, debt relief can be accomplished without imposing greater taxes. Without that ability, the benefits of chapter 9 for distressed municipalities would be largely illusory, offering the distressed municipality not much more than the opportunity to experience a slow demise. The key question is what showing is to be required to confirm a plan over the objection of creditors where the plan does not propose to increase taxes to pay creditors in full. The fact that this issue is unsettled is perhaps disconcerting. This uncertainty may motivate a municipality and its creditors to reach agreement on debt relief, rather than turning to a court to decide the issue. **abi**

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