Municipal Bankruptcy: Avoiding and Using Chapter 9 in Times of Fiscal Stress

THIRD EDITION

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orrick

This booklet is dedicated to the memory of

John Knox

Co-author of the first edition and a wonderful person,
partner and public finance attorney.

Published by: Orrick, Herrington & Sutcliffe LLP

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Introduction

In May 2008, the City of Vallejo, California, filed for protection under chapter 9 of the United States Bankruptcy Code, followed in 2011 by Jefferson County, Alabama, in 2012 by the City of Stockton, California, and the City of San Bernardino, California, and by Detroit, Michigan, in 2013. No significant city or county filings have occurred since then, but municipalities[1] have been increasingly squeezed between the cost of providing basic services and flat or declining revenues. While many were able to avoid severe fiscal distress or insolvency by their receipt of federal funding in connection with the COVID-19 pandemic, those grants are in the past; and some municipalities are once again experiencing the strain of increased costs while managing revenue streams that have not fully recovered. In the face of such pressures, the possibility that some may want or need to seek chapter 9[2] protection has increased.

We intend this booklet to provide an overview of chapter 9 for those who manage and govern municipalities. We offer thoughts on how to avoid filing as well as how to successfully navigate a bankruptcy case and emerge in stronger financial health. The booklet does not, nor does it attempt to, provide an exhaustive technical exposition of the law.

Due to its size and format, it only briefly summarizes, and in some cases omits entirely, areas that in particular cases might be very significant, but which we feel would not be of interest to most readers.

Accordingly, this booklet does not purport to provide legal advice to any person or serve as a template for a practitioner seeking to advise a client considering a chapter 9 filing or to prosecute any case. Rather, it provides a basic framework for those seeking to better understand chapter 9, with enough context to enable decision-makers and managers to ask informed questions of their advisors when considering the alternatives. Bankruptcy is a complex area of the law, and the adage "don't try this at home" should be heeded. Any municipality seriously considering a chapter 9 filing should obtain expert legal counsel as well as municipal advisory help.

[1] Throughout, we use the term "municipality" to refer to a local government entity that may file a chapter 9 case. The term covers a wide variety of local governments that may or may not be considered "municipalities" under state law.

[2] Note that "chapter" is not capitalized when referring to the chapters of the Bankruptcy Code. This is the standard convention.

CHAPTER 1

Avoiding Chapter 9

If the reader takes away only one thing from this booklet, it should be that filing for bankruptcy protection should be considered a last resort, to be used only after every effort has been made to avoid it. As we discuss herein, there are several significant downsides to a filing, and in the end, the problems that brought the municipality to the point of filing will have to be solved anyway; it is far better to resolve them, if possible, outside of bankruptcy.

ASSESSING THE PROBLEM(S)

The initial step in trying to avoid bankruptcy is to clearly and dispassionately assess the underlying problem or problems that are pushing the municipality in that direction. The degree of self-awareness and transparency among municipalities can vary widely, and for some, one of the main problems may be simply getting a good handle on the real drivers of emergent financial instability and threats to solvency. As we are not financial managers, we leave it to those professionals to get into the technical details, but suffice it to say that if a municipality cannot identify in clear terms the specific factors that are driving revenues down and/or expenses up, it has some serious homework to do before venturing into workout negotiations, let alone into bankruptcy court.

Municipalities that have been pushed to the brink of, or into, bankruptcy generally experienced one or both of two types of fiscal problems. The first is a large and extraordinary one-time financial hit that cannot be absorbed by the budget or covered out of reserves. This could be a sudden and catastrophic investment loss (such as that experienced by Orange County, California, leading to its chapter 9 filing in 1994) or a large judgment rendered against the municipality (such as that experienced by Cle Elum, Washington, leading to its chapter 9 filing in June 2025).

The second kind of fiscal problem is a structural operating deficit that continues long enough to burn through reserves and is not resolved by

revenue increases or spending cuts quickly enough for the municipality to avoid running out of cash as it attempts to meet necessary and fixed expenses such as debt service and payroll. Such was the case with Vallejo, Stockton, Detroit and San Bernardino. A municipality with this type of problem could be pushed over the edge by a relatively small one-time expense or drop in revenues, as it may have little or no cushion available to absorb even a modest setback. For example, the City of Vallejo, which had spent down its reserves in order to meet its obligations over a period of several years, became insolvent as a result of California's economic slowdown and the concomitant drop in real estate and sales tax revenues, combined with significant employee salary and benefit cost increases dictated by collective bargaining agreements. The City of Stockton suffered even greater losses due to the burst of the housing bubble and, in addition to unsustainable labor and legacy costs, faced public debt with payment obligations structured to escalate in the future. The COVID-19 pandemic similarly had the potential to be the straw that broke the back of municipalities already struggling with structural operating deficits; however, due substantially to increased federal funding, the pandemic did not result in significant chapter 9 filings. As noted above, the solvency issues municipalities avoided with the help of such federal funding may reappear, though, now that COVID-related funding is winding down and operating deficits continue to rise.

In general, fiscal stress related to one-time problems can be resolved by financing cure costs over a long enough period so those costs can be absorbed in the budget over time. For example, a municipality may elect to sell judgment obligation bonds – the subject of the Orrick booklet *"An Introduction to Judgment Obligation Bonds in California (Financing Tort and Other Involuntary Obligations)."* And while bankruptcy protection may be necessary to buy time to consummate a financing and delay disruptive collections efforts or the forced liquidation of collateral, all efforts, including in some cases entering mediation, should be made to convince creditors to be patient and not to cause the municipality to incur the significant costs associated with a bankruptcy filing.

Fiscal stress related to ongoing structural deficits and lack of reserves is much more difficult to tackle because a financing will have little impact on solving the underlying structural problem. In fact, this tactic will likely make things worse by "kicking the can down the road" and increasing the overall costs

to the municipality. In these circumstances, painful cuts in service levels, employee compensation and other expenses may be required, coupled with increased revenues through higher taxes or fees. Bankruptcy protection may be needed to avoid immediate sanctions for breaching contracts, including labor agreements, missing debt service payments or failing to provide required levels of service.

CASH POSITION AND SPECIAL FUNDS

Most municipalities (particularly general purpose entities such as cities and counties) maintain scores of separate funds within their treasuries, each having a particular function and source of revenues, and each burdened by legal or grantor restrictions as to the use of those funds. For example, in California, revenues from municipal utilities such as water and sewer systems may be used only to pay the costs of operating and maintaining those systems or for capital improvements (including debt service) to those systems. Many states require that special funds be held in trust and not diverted for unrelated uses. Similarly, moneys received in grants and state subventions may be restricted to particular uses by the terms of the grants, or by statutes or regulations. Careful analysis must be made of the municipality's various funds to determine what diversions legally can be made and, more importantly, how such limitations on the uses of funds will affect the true available cash position of the municipality. While it is not uncommon for funds to be commingled for investment purposes into a pooled cash account, a significant positive balance in a pooled cash account can mask a serious problem in the municipality's underlying financial condition.

Typically, a municipality's general fund is the only fund completely unrestricted as to its use. It is common practice for municipalities to use their pooled cash accounts as a source of cash flow within a fiscal year to carry funds that have intra-year cash inflows that do not match their cash outflows; provided, that the budget and reserves are sufficient to ensure that at the end of the fiscal year, restricted funds are not in a position of having funded items not permitted within their restrictions. For example, the general fund may receive large infusions from property tax revenues twice a year but have a monthly cash outflow that is relatively even. Generally, it is not improper for the cash outflow deficits to be covered from pooled cash during the year so long as the general fund makes up the difference from cash inflows by the end of the fiscal year.

The trouble arises when the budgeted revenues for a general fund will not meet budgeted expenditures, and there are insufficient reserves to cover the shortfall. The Government Finance Officers Association (GFOA) recommends that agencies maintain general fund unrestricted reserves of at least two months of their annual general fund operating revenues or expenditures. Often any imbalances are not apparent until the fiscal year is well under way and it becomes increasingly clear that projections of revenue and expense will not be met. In such a case, use of restricted funds in pooled cash could be a violation of the restrictions imposed on the special funds and therefore illegal. It is important to note that while municipal financial officers generally have immunity from personal liability for official acts, that immunity does not necessarily extend to knowing violations of the law. Thus, a municipal finance officer should be very careful before permitting advances from restricted funds intra-year.

It is very important for a municipality that appears to be headed for insolvency to closely monitor its cash position, particularly in the funds that are projected to go negative by the end of the fiscal year, so that it can determine when it will run out of funds to maintain operations. A municipal official who requires or even permits employees to come to work knowing that the municipality will not be able to pay them may be violating state labor laws or committing common-law fraud. In some states, this even may constitute a criminal offense. For example, if an employee is paid from a municipality's general fund (and payment cannot be allocated to some other special restricted fund because the employee's duties do not support the special fund's activities), and the general fund budget position is such that, taking into account any available reserves, it will be unable to achieve at least a zero year-end balance without using legally restricted funds in pooled cash, the municipality could be faced with the choice of either breaking the law by using restricted funds for an impermissible purpose or by failing to pay wages after work has been performed. If either of these occurs with foreknowledge by the municipality's managers or governing body, normal governmental immunity for official acts may not protect those persons from personal liability. This issue becomes important with respect to the timing of a bankruptcy filing, as is discussed below.

ACKNOWLEDGEMENT BY STAKEHOLDERS

Once the municipality's management has identified and quantified the underlying fiscal problems, it must recognize that a key ingredient to solving them is to clearly and transparently communicate the nature and scope of

the challenges to all potentially impacted stakeholders to enable them to understand and acknowledge the problems. Managers and political leaders should insist on clear and open disclosure of the financial data and related facts, and they should make sure that stakeholders both receive all relevant information and data, and that they have an opportunity to ask questions and offer solutions. All reasonable suggestions to solve the fiscal problems should be investigated and taken seriously.

The ins and outs of labor negotiations are far beyond the scope of this booklet, but if payroll costs or benefits are a key component of the municipality's fiscal stress, it will be necessary to engage labor law advisors to assist in resolving these problems. In most states, laws applicable to public employee labor agreements place numerous restrictions on revising such agreements, even if the impact thereof is pushing the municipality toward bankruptcy. However, if all parties realize that failure to modify extant agreements likely would land the municipality in bankruptcy court, they should be willing to work very hard to achieve consensual modification of burdensome agreements. Although bankruptcy may provide more flexibility in dealing with labor agreements by enabling the municipality to reject an agreement if certain conditions are met, bankruptcy is not necessarily a "silver bullet" with respect to such matters, so every effort should be made to reach an agreement that provides a workable arrangement for the municipality prior to the decision to file. Such negotiations can and should continue after the bankruptcy filing. For example, in the City of Vallejo case, agreement was reached with one safety union after the bankruptcy filing and with another safety union even after the ruling of the bankruptcy court authorizing rejection was affirmed on appeal.

Similarly, creditors such as banks, bondholders and credit enhancers may be willing to restructure long-term debt to avoid forcing a municipality into bankruptcy. Attempts should be made to approach these stakeholders with clear and transparent information in order to reach some accommodation. Often an intermediate step in such a restructuring is a forbearance agreement under which the creditors agree not to declare a default and/or take remedial action against the municipality for a specified period while the parties attempt to reach a negotiated settlement.

Finally, the officers and elected officials of the ailing municipality must make hard decisions about ongoing projects and programs that may have to be postponed, scaled back or cancelled to free up cash. These are often painful political choices, but the looming possibility of a bankruptcy filing can serve

Advantages and Disadvantages of a Chapter 9 Filing

There are many misconceptions about the utility of a bankruptcy filing in addressing extreme financial problems for municipalities. While chapter 9 provides certain benefits for municipalities that cannot otherwise solve their fiscal problems, it is no panacea and comes with some significant downsides.

ADVANTAGES

Protection; the Automatic Stay. One of the most important and immediate advantages of a bankruptcy filing is the injunction prohibiting actions that have been or might be taken by creditors or others against the municipality, its officers and its inhabitants. This benefit to a municipality with insufficient liquidity to pay its operating costs cannot be overstated. The injunction, known as the automatic stay, is triggered by the filing of the bankruptcy petition, and the protection in chapter 9 cases to officers and inhabitants with respect to claims against the municipality goes beyond the protection afforded only to debtors in chapter 11 cases. The chapter 9 extended protection means that even if the municipality or other protected persons take or omit to take actions related to claims against the municipality that would otherwise subject them to sanctions or liability in court or before a regulatory body, those actions may not proceed without the permission of the bankruptcy court. The automatic stay protects the municipality, its officers and its inhabitants against creditor lawsuits, foreclosures, attempts to terminate leases and even collection phone calls and emails. The stay lasts during the pendency of the chapter 9 case, although the bankruptcy judge retains the right to modify or terminate the stay for cause shown.

Breathing Space. Bankruptcy provides the debtor breathing space, enabling it to provide ongoing service to its residents while it tries to work out its creditor and cash flow problems. Raising new revenues, renegotiating contracts and restructuring debt obligations take time. If a municipality is forced to

breach contracts or face other legal claims caused by fiscal stress outside of bankruptcy, it may have to spend time fighting off creditors trying to seize assets or collateral, or be forced into regulatory or other state fora to answer for such actions and redress grievances before it is able to fashion a workable solution for the benefit of all creditors, employees and residents. The bankruptcy case serves as the vehicle for all these disputes to be addressed in one forum, and the automatic stay provides the municipality the opportunity to focus on a comprehensive solution rather than simultaneously fighting multiple brushfires.

Access to an Expert Arbiter. An often-underestimated advantage of a bankruptcy filing is the bankruptcy court bench. Bankruptcy judges are experts in financial restructuring, negotiations and arbitrating complex debtor/creditor and intercreditor disputes. While chapter 9 filings are rare, bankruptcy judges see similar issues in the private sector day in and day out and generally are very well equipped by dint of knowledge and temperament to help the parties arrive at workable compromises. Furthermore, because of the unique system of assigning bankruptcy judges to chapter 9 cases, it is very likely that a chapter 9 case will be assigned to one of the most qualified and experienced judges within the applicable federal circuit. The value of a highly qualified and experienced judge in helping the stakeholders get to a solution should not be underestimated.

Ability to Adjust Obligations. The prime benefit of a bankruptcy filing may well be the debtor's ability to adjust public debt and other obligations. A chapter 9 plan of adjustment may provide that unpaid obligations to creditors be extended or otherwise restructured. There are limitations on how these adjustments can be made, and it may be possible for creditors to block a debtor from making the adjustments it would like (or feel that it needs) to make. Nevertheless, in situations where it is not possible to fully repay all creditors absent some sort of debt relief, a plan of adjustment can provide a fresh start and the ability to achieve long-term financial stability for the municipality by deferring and/or reducing past obligations.

Rejection of Burdensome Contracts and Leases. The Bankruptcy Code enables a debtor to reject executory contracts and unexpired leases if, in the debtor's business judgment, such agreements are burdensome. Rejection is not without consequences, and the nondebtor party to a rejected agreement will have an unsecured claim for damages. However, invariably, such unsecured claims are paid at far less than one hundred cents on the dollar.

DISADVANTAGES

Credit Markets Reaction. Municipalities that seek bankruptcy relief (and even those that seriously consider filing) should expect the immediate suspension and/or downgrade of their credit ratings, and, in many cases, having their access to public capital markets cut off during the chapter 9 case (potentially including credits secured by separate revenue streams—e.g., a performing utility enterprise credit being unable to access the public capital markets during a municipality's chapter 9 case arising out of a distressed general fund credit). If bondholders are not fully repaid in connection with a municipality's chapter 9 case, this credit stigma may last for many years. However, it is certainly possible that the municipality may emerge from bankruptcy and have its credit standing restored within a few years, as was seen, for example, in the case of Orange County and with respect to certain enterprise fund financings by Stockton and Vallejo following the conclusion of their chapter 9 cases. Often overlooked by those who argue against a chapter 9 filing is that absent bankruptcy, an illiquid and insolvent municipality may have little to no access to the capital markets in any event for a potentially extended period, limiting its options even for maintaining its existing debt portfolio.

Municipalities contemplating bankruptcy should expect intense scrutiny from their capital markets creditors and rating agencies. One of the best things a municipality can do to position itself to get its credit ratings restored is to be able to provide timely and accurate information about its financial condition to the capital markets and rating agencies. Establishing a track record of providing trustworthy information, even if it is not favorable, is an absolute necessity if a municipality expects to emerge from bankruptcy and access the credit markets. In connection with this process, as is discussed below, municipalities must be mindful of applicable securities law requirements governing disclosure to investors, an area in which the guidance of competent disclosure counsel will be essential. This effort also takes time and resources from the municipality's finance staff at a time when the staff will be under tremendous stress, and decision-makers must take this burden into account when they contemplate a filing.

Cost and Distraction. Filing and pursuing a chapter 9 case is very expensive. Legal and financial consulting fees easily can range into seven figures (or even more for very large and complex entities). Every dollar spent on these costs is a dollar that cannot go toward solving the underlying financial issues. It is therefore in the interest of all stakeholders to realize that, unless they can come

to a negotiated settlement that avoids bankruptcy, these costs ultimately will consume funds that otherwise could be more productively used.

Another component of cost is the opportunity cost that will be expended by taking valuable senior staff time away from solving core problems and directing it to managing and responding to the demands of the case itself. Most municipalities that take the drastic step of filing a bankruptcy petition already will have cut staff to the bone prior to the bankruptcy filing to save costs to try and avoid insolvency.

The distraction of dealing with a bankruptcy case—preparing for and attending hearings and depositions, responding to potentially voluminous requests for information and documents from creditors, rating agencies, collective bargaining units, elected officials, the media and the public—can be a major distraction from the core work the staff must do to enable the municipality to continue to serve its residents. A municipality contemplating a bankruptcy filing should have a clear plan of how to address these issues going in, lest the demands of the case simply overwhelm the ability of the organization to continue to function.

Stigma on the Community. Bankruptcy likely will be viewed by residents, workers, and creditors as a stigma, and that perception can affect the self-esteem of inhabitants and have an adverse impact on the overall business climate in the community. New businesses may be reluctant to locate there, real estate sales may be affected, and general economic conditions may be depressed. This stigma could even linger for a period after the municipality emerges from the bankruptcy in the legal sense. Of course, the bankruptcy filing is not the cause of the municipality's problems, but rather the result of not being able to solve them any other way. It is the underlying financial health of the municipality, including its ability to deliver services and promote a strong community, that really matters.

CHAPTER 3

Preparing for Chapter 9

THE IMPORTANCE OF NEGOTIATIONS

It is crucial that, once the magnitude of a financial crisis is established, the municipality attempt to commence negotiations with creditors and stakeholders to avoid insolvency. In fact, such negotiations, undertaken in good faith, are a legal prerequisite to filing a chapter 9 case in some jurisdictions, including, for example, California. Even if the municipality has determined that it likely will be forced to file for bankruptcy protection, it should continue to try to negotiate with key creditors to avoid that result. It also should carefully document the steps it took to reach agreement. It is not necessary or even prudent that a municipality accept a short-term fix that only briefly defers an inevitable insolvency. But when a solution is offered, the municipality must analyze it carefully to determine whether it will resolve the municipality's problems sufficiently to avoid both short-term and long-term insolvency. For example, it makes no sense to renegotiate a long-term debt obligation by deferring interest or other payments for a year if, on the first anniversary of the deferral, the municipality will be unable to satisfy the revised obligation absent extraordinary intervention. Similarly, a municipality should not accept one-time concessions from labor that would avoid insolvency only in the short term while extending unsustainable labor agreements such that insolvency will become inevitable and the deficit facing the municipality will be even larger and more difficult to resolve as a result. Indeed, labor made such a proposal at the outset of the Vallejo chapter 9 case, and the City's rejection of the proposal was approved by the bankruptcy court.

AUTHORIZATION TO FILE

A municipality may not validly seek chapter 9 relief unless its governing body specifically authorizes the filing. Local law determines what form this authorization must take, but a typical approach would include a resolution adopted by the municipality's governing board in an open meeting.

In many states, while discussions with counsel leading up to and after a filing usually are conducted in closed or executive sessions under the litigation exception to most open meeting laws, the actual vote on whether to file typically must take place in an open meeting or at least be reported out in an open meeting immediately after the vote.

Authorization to file could take the form of an immediate direction to file, or, as is more common in both chapter 9 and chapter 11 cases, a delegation to the executive officer of the municipality to file in the event that certain conditions are not satisfied (such as approval by creditors or bargaining units of offers made by the municipality pursuant to authorizations from the governing body).

Taking a vote to initiate a bankruptcy case obviously is a consequential step; the municipality should expect significant public and media attention and should be prepared to respond fully and accurately to inquiries, providing relevant details and information regarding the process. While media strategy is beyond the scope of this booklet, municipalities should carefully consider how they will provide timely responses to media inquiries and should have a clear plan in place including identification of one or more spokespersons. Also, legal counsel should be consulted about public statements and press releases so as not to inadvertently waive important privileges concerning confidential negotiations and strategy, breach confidentiality provisions in discussions with potential financing sources or violate applicable securities laws.

FEDERAL SECURITIES LAW CONSIDERATIONS

If a municipality has outstanding capital market debt, competent bond and disclosure counsel should be consulted regarding the municipality's obligations under federal securities laws well in advance of any bankruptcy filing and before any public statements or deliberations regarding a potential filing. Securities Exchange Commission ("SEC") Rule 15c2-12 requires underwriters in most primary offerings of municipal securities to reasonably determine that municipal issuers and other obligated persons involved in such an offering have undertaken to provide annual and material event disclosure to purchasers of the obligations. Filing for bankruptcy protection is a material event that triggers disclosure in connection with such an undertaking. In addition, deteriorating finances and public discussion of the potential for insolvency leading up to a chapter 9 filing are likely to trigger rating agency

actions, which may constitute material events, and in any event will be relevant to the investment decisions of holders and potential purchasers of such obligations.

To protect a municipality, its governing body, and its executive officers from liability and other potential enforcement consequences under federal securities laws in this type of situation, executive officers of the municipality need to have a clear and comprehensive understanding of the municipality's disclosure obligations and should work with counsel to develop a plan for communicating material facts consistently to the market at the requisite and appropriate times. Any statement to the market by an issuer, including, for example, a material event notice, must comply with applicable securities laws. The SEC's Office of Municipal Securities has stated that information provided to the public by municipalities and reasonably expected to reach investors and the trading markets must comply with applicable antifraud provisions of the Securities and Exchange Act of 1934, including Rule 10b-5 promulgated by the SEC, meaning such statements may not make an untrue statement of material fact nor omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading. The omission portion of Rule 10b-5 almost always is the most difficult with which to comply in the context of municipal bankruptcy. In general, saying that a credit rating has been downgraded or that a bankruptcy petition has been filed by itself will not be enough. Experienced counsel should be consulted to assist in crafting public statements that provide the relevant facts and materials to satisfy the broader standard of Rule 10b-5.

The SEC also has taken the position that statements made by municipal officials during public meetings and in other contexts may constitute statements to the market by the municipality. Special consideration should be given promptly, for example, if the municipality's financial condition or even a potential insolvency or bankruptcy is discussed in public by members of the municipality's governing board, its officers or staff, particularly in the absence of official continuing disclosure disseminated by the municipality addressing such topics. For example, the SEC pursued an enforcement action against the City of Harrisburg, Pennsylvania, in connection with similar facts and the absence of continuing disclosure that the City had contractually undertaken to provide.

Finally, in addition to liability and enforcement considerations, establishing a pattern of complete and accurate information dissemination to the market also will be important in helping a municipality maintain credibility with the market and reestablish a good credit rating after it emerges from bankruptcy. Bad news is made worse by late discovery, much more so if it appears that suppression or obfuscation was involved.

TIMING FOR CHAPTER 9 FILING

As noted earlier, it is important to monitor the municipality's cash position during the period leading up to a potential bankruptcy filing so as not to knowingly violate the law—for example by permitting employees to work when the municipality lacks the ability to pay them, disregarding legal restrictions on special funds, or entering into essential contracts knowing that there will be a lack of sufficient funds to meet the contract terms. Having an idea of when this crossover point may occur is crucial in determining when a petition must be filed in order to protect the municipality and its officers. While there will be tremendous pressure from many quarters to delay the ultimate step of filing a chapter 9 petition until the last possible moment, it is prudent to leave at least some room between the time that management would be compelled to shut the doors of the municipality and the date of filing the petition. The precise amount of time will depend on the circumstances of each municipality, but in general, 60 to 90 days would be prudent. The reason is to allow the bankruptcy court time to conduct an orderly process of considering the petition and any objections to it before drastic actions that potentially affect public health and safety (such as forced furloughs of essential service personnel) must be taken.

DEALING WITH VENDORS AND TRADE CREDITORS

Most local government agencies have significant commercial relationships with vendors and trade creditors, including specialized service providers and suppliers. A municipality preparing to file a chapter 9 petition should expect that these providers will stop extending credit in the form of delayed billing arrangements once they become aware of the filing or potential filing. They very well may require COD or prepayment terms for future transactions, and the municipality should be prepared to implement these arrangements for critical services and supplies. Moreover, payments made within 90 days

of the filing of the bankruptcy case on account of prior unpaid invoices may be recoverable as preferences even though preference claims belong to the chapter 9 debtor and thus may not be prosecuted. To protect favored vendors that have not put the municipality on COD terms, the municipality should pay such vendors during the normal payment cycle—a defense to preference actions—rather than to fall behind and then make catch-up payments. Unlike in chapter 11 bankruptcy cases, payments on account of a note or bond are not avoidable as preferences.

CHAPTER 4

Seeking Bankruptcy Protection

PREFILING REQUIREMENTS

The Bankruptcy Code includes specific threshold requirements that the court must conclude have been satisfied for a municipality to be eligible for relief under chapter 9:

1. The entity must be a municipality within the broad Bankruptcy Code definition, which includes cities, counties and other instrumentalities of the state. Section 109(c) defines municipality to mean *"a political subdivision or public municipality or instrumentality of a state."* It does not include states themselves.
2. Applicable state law must authorize the municipality to seek chapter 9 protection. Some have adopted very broad statutes granting blanket filing authority to all municipalities. However, many states limit which entities can file and under what circumstances or require special approval of state authorities to permit a filing. For example, in California, unless it is facing a fiscal emergency, a municipality must complete a mediation process with its key creditors that takes at least 60-90 days. In Connecticut, the governor must approve all chapter 9 filings. There are no relevant laws about chapter 9 eligibility in approximately half of the states, meaning that in those states a municipality in need of bankruptcy relief must seek enactment of a specific statute particular to it authorizing the filing. It goes without saying that a floundering municipality faces an uphill timing battle in such states.
3. The municipality must be insolvent as defined in the Bankruptcy Code, which means that the municipality either must not be paying its undisputed debts as they come due at the time of filing or be unable to pay such debts when they become due in the near future. The latter test is prospective but must be based on a projection of the current or immediately ensuing fiscal year. Notably, a projection that the municipality will not be able to meet its obligations in subsequent years is insufficient to establish insolvency.

4. The municipality must "desire to effect a plan to adjust its debts." It is important to note that the plan of adjustment does not have to be in existence as a precondition to filing, but there must be evidence that the municipality wants to effect a plan through the vehicle of a bankruptcy case.
5. The municipality must demonstrate that it has attempted to avoid bankruptcy or that the bankruptcy filing was necessary by proving at least one of the following:
    a. It has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that the municipality intends to impair under a plan of adjustment;
    b. It has negotiated a term sheet or the outline of a chapter 9 plan in good faith and is unable to reach an agreement;
    c. Negotiations are impracticable (for example, because there are a multitude of claimants and no practical way to negotiate with all of them individually or to identify a representative with authority to negotiate); or
    d. A creditor is attempting to gain a preference (basically a payment that would unfairly disadvantage other creditors because it disproportionately favors the creditor that seeks to receive the payment).
6. The bankruptcy petition must have been filed in good faith.

ASSIGNMENT OF THE BANKRUPTCY JUDGE

In all bankruptcy cases other than chapter 9 cases, a bankruptcy judge is assigned by lot as each case is filed. Due to the importance and rarity of municipal bankruptcies, the Bankruptcy Code assigns to the Chief Judge of the Circuit in which the case is filed the task of selecting a judge to each chapter 9 case. While it is probable that a judge from the District in which the case is filed will be assigned, the Chief Judge may assign it to any bankruptcy judge in the Circuit. For example, a Boston bankruptcy judge presided over the Central Falls, Rhode Island, chapter 9 case. This is an important feature because it means it is very likely that a chapter 9 case will be assigned to a highly competent and experienced judge, which is a benefit to all parties. Moreover, the Chief Judge can consider whether a judge who resides in or near the debtor municipality ought to play a role in the case filed by that municipality.

Judges of the U.S. Supreme Court, the various Circuit Courts of Appeal and the numerous U.S. District Courts are appointed for life pursuant to Article III of the United States Constitution. Bankruptcy judges are appointed under Article I of the Constitution and serve for terms of 14 years. Any party to a chapter 9 case has the right to petition the District Court to remove the case to the District Court so that it can be heard by an Article III judge. It is up to the District Court to decide whether to take the case away from the bankruptcy court or to leave it there. In either case, all rulings by the bankruptcy court are appealable to the Article III court system.

CHAPTER 5

The Tenth Amendment and Limitations on the Role of the Court

TENTH AMENDMENT LIMITATIONS

The Tenth Amendment to the United States Constitution reserves certain powers to the states regarding the management of their internal affairs. In chapter 11 cases (for which municipalities are ineligible), the bankruptcy judge wields significant power to control what the debtor may and may not do. For example, without court approval, any proposed action by the debtor outside the ordinary course of its business must be approved by the court after creditors and other parties in interest have been provided with the time and the opportunity to object. Nor may the debtor borrow funds outside of the ordinary course of business, grant collateral for a new loan or settle a significant claim against it absent court approval. However, due to the Tenth Amendment and the provisions of the Bankruptcy Code that implement it, the court plays a significantly more limited role in a chapter 9 case, and state law restrictions on the activities of municipalities and their uses of funds must continue to be observed.

Thus, for example, the court cannot take over the operation of the municipality, remove governing board members, direct the actions of the governing board or appoint a receiver or trustee to run the municipality's affairs. Similarly, the court cannot permit the municipality to override state laws such as those requiring voter approval for new taxes or limiting the use of restricted funds for particular purposes. Obviously, the court lacks the power to require the sale or lease of a park or a sewage facility to satisfy the municipality's obligations to creditors.

One important effect of the Tenth Amendment on municipal bankruptcies, distinguishing them from nongovernmental entity bankruptcies, is that there can be no forced liquidation of a municipality under the Bankruptcy Code. If a corporation files a chapter 11 case seeking to reorganize and thus

continue to operate, but it fails to achieve that objective, the case likely will be converted to a liquidation case under chapter 7 of the Bankruptcy Code. In chapter 7, a trustee is appointed and is charged with liquidating all assets for the benefit of creditors, who then receive a distribution according to the Bankruptcy Code waterfall scheme. Assets are sold or foreclosed upon, the entity no longer operates, and it ceases to conduct business. For obvious practical reasons, and due to the Tenth Amendment's limitations on the powers of the federal courts, there is no chapter 7 analogue for municipalities other than those that may be provided by applicable state law outside of the bankruptcy court system.[3] Thus, if the chapter 9 case fails to produce a plan of adjustment enabling the municipality to exit bankruptcy, unless the judge gives the debtor a second chance at negotiating and confirming a new plan of adjustment, the case will be dismissed and the municipality will continue to face all of the problems bedeviling it before bankruptcy, with whatever remedies are available to the municipality and its creditors under state law.

ROLE OF THE BANKRUPTCY JUDGE IN CHAPTER 9

The primary responsibilities of the bankruptcy judge are to determine whether the municipality is eligible for chapter 9 relief, to oversee the assumption or rejection of executory contracts and unexpired leases, to decide avoidable transfer actions (i.e., preferences and fraudulent transfers) and to confirm or decline to confirm a plan of adjustment. The municipality may, in its sole discretion, consent to the judge's exercise of jurisdiction in many of the more traditional areas of bankruptcy court oversight in bankruptcy to obtain the protection of court orders and eliminate the need for multiple fora to decide issues. Indeed, these latter features reflect some of the benefits of filing for bankruptcy in the first place.

Despite their more limited role, the judge in a chapter 9 case does exert considerable influence over the parties and can be a very helpful neutral arbiter of difficult disputes. While the only real "hammer" the judge ultimately has is to dismiss the case and throw the municipality out of court, the judge nevertheless is likely to be very helpful in bringing the parties to the point where a plan can be approved.

[3] The rules governing the ability of municipalities to disincorporate or otherwise be dissolved vary greatly by jurisdiction and type of entity and are beyond the scope of this booklet.

CHAPTER 6

The Chapter 9 Case

The following sections discuss specific aspects of filing and prosecuting the chapter 9 case that are of key import to municipalities.

INITIATING THE CHAPTER 9 CASE

In addition to filing the chapter 9 petition itself, the municipality must file several pleadings and documents to initiate the bankruptcy case. These include the following:

Creditors List. This is a list of all persons who may assert a claim against the municipality. The Bankruptcy Code defines the term "claim" very broadly, and the list should include each and every person that may assert a claim, even if the municipality believes that a given claim is specious.

List of Creditors Holding the 20 Largest Unsecured Claims. This list contains more detail than the general list of creditors, including the requirement that contact persons and phone numbers be provided. The list is used by the United States Trustee to solicit creditors to join an official committee or committees.[4]

Pleadings Establishing Eligibility. As discussed above, the Bankruptcy Code contains several eligibility requirements, and the municipality must prove that it satisfies each one. It does so by submitting a memorandum of law and supporting declarations and exhibits thereto. If the municipality anticipates that one or more creditors or parties in interest will object to the claim of eligibility, the pleadings and declarations will need to be more extensive than in a case in which eligibility is unquestioned.

Notice by Publication. The municipality must publish a notice once a week for three weeks in both a local newspaper and a national publication read by bondholders. The notice must provide details about the filing of the

[4] The Office of the United States Trustee is an arm of the United States Department of Justice, and the various regional offices assist the court system in administering bankruptcy cases. The U.S. Trustee's role in a chapter 9 case is much more limited than it is in cases under chapters 7 or 11.

chapter 9 case and provide the date by which objections to eligibility must be filed. The form of notice and the eligibility objection date must be approved by the bankruptcy judge in advance of publication.

OFFICIAL COMMITTEES

Following the entry of the order for relief—in other words, after the court determines that the municipality is eligible to be a chapter 9 debtor—the United States Trustee for the relevant district may appoint a committee or committees to represent the interests of creditors holding similar classes of claims. For example, in each of the Vallejo and Stockton cases, there was a committee that represented the interests of retirees. Unlike in the case of a chapter 11 debtor, a municipality is not obligated to fund the costs of counsel or financial advisors employed by such a committee, but prudence may dictate that the municipality should pay reasonable costs because an informed and organized creditor body will expedite the resolution of the bankruptcy case. Both Stockton and Vallejo agreed to fund the counsel for the retiree committees for that reason, among others.

EFFECT ON LITIGATION

As discussed in more detail above, the automatic stay that becomes effective the moment the chapter 9 petition is filed serves to enjoin litigation against the debtor, its officers and its inhabitants. The stay also prevents all other forms of creditor enforcement remedies such as seeking a judgment lien or foreclosing on an asset (excepting, potentially, special revenues as described in detail below). The stay continues throughout the chapter 9 case, although a claimant may seek permission to terminate or modify it by filing pleadings that attempt to convince the bankruptcy judge that cause exists for the litigation to proceed in court or for an enforcement action to commence or resume.

ASSUMPTION AND REJECTION OF CONTRACTS AND LEASES

As mentioned briefly earlier, the Bankruptcy Code provides a chapter 9 debtor with the ability to assume its favorable contracts and real and personal property leases and to reject its burdensome ones. Neither is automatic, though. To assume a contract or lease, absent consent by the nondebtor party, the municipality must cure all monetary defaults

and provide adequate assurance that it will be able to perform under the agreement in the future. So-called ipso facto clauses in contracts or leases (which provide that the contract or lease terminates on account of insolvency or a bankruptcy filing by one of the parties) are not enforceable in a chapter 9 case or any other bankruptcy case. In the event a lease or contract is rejected, the nondebtor party will have a general unsecured claim against the municipality for the damages it has suffered on account of the rejection. The damage claim will have to be addressed in the plan of adjustment along with the other general unsecured claims against the municipality.

Labor agreements are subject to assumption and rejection as well. However, due to the importance and the widespread impact rejection of such an agreement could have, the U.S. Supreme Court has placed extra restrictions on debtors seeking to reject labor agreements. These include mandating that the bankruptcy court balance the hardships employees would suffer because of rejection of the agreements against the benefits to the municipality for rejecting those agreements. The court also must conclude that the municipality employed reasonable efforts to resolve contract issues short of rejection, and that a prompt resolution would not be forthcoming. A special Bankruptcy Code provision makes it even more difficult to reject a collective bargaining agreement in a chapter 11 case, but Congress has not extended the sweep of that provision to chapter 9 cases.

SPECIAL REVENUES

As discussed above, many agencies have separate governmental enterprises that are owned and operated by the municipality but are not separate legal entities. For example, a city may own and operate a system that provides potable water to its inhabitants and businesses. Typically, such systems are treated as separate accounting units and are paid for from revenues received from the users of the system in the form of fees and charges for service. Often, new users that desire to connect to the system and receive service must pay a capital charge or assessment to contribute their share of the capital cost of the system. These systems often are financed through debt obligations secured by a pledge of a lien on the system revenues, and the capital, operations and maintenance costs of the system are similarly supported only by the system revenues. In most cases, this is the sole source of security and payment for the obligations of the

system, but in some cases, the municipality also is obligated to pay such amounts from the general fund if revenues alone are insufficient.

Chapter 9 includes a detailed definition of the term, "special revenues." And while the following discussion summarizes the key aspects of that definition, ultimately the bankruptcy judge will make the determination of whether a stream of payments qualifies as special revenues. There are few published cases that address the issue, but one arising out of the Puerto Rico debt restructuring cases (under a separate statute that incorporates the Bankruptcy Code definition and most provisions of chapter 9) read "special revenues" very narrowly.

Once a stream of payments is determined by the court to constitute special revenues, such funds may not be diverted to pay the debts of the municipality that are unrelated to the system or enterprise that generated them. As noted above, in many jurisdictions, this also is the result under state law, which restricts the use of such revenues to the enterprise itself.

The Bankruptcy Code provides that a lien on special revenues is subject to the necessary operating costs of the relevant project or system. Such a carveout is typical in financing documents that include "net revenue" pledges.

Another class of special revenues obligation is special assessment or special tax financing, which is commonly used to construct infrastructure to serve new development or to improve infrastructure of special benefit to the assessed property. In these situations, the special assessments or taxes levied and pledged to support the bonds issued to provide such financing are treated as special revenues and cannot be used to pay any other obligations of the municipality in bankruptcy. This also is generally consistent with most state laws restricting the use of these types of revenues solely to the purposes for which the special assessment or special tax financing was levied.

Notwithstanding the automatic stay that otherwise prohibits certain post-bankruptcy actions by creditors, the automatic stay in chapter 9 permits the holder of a lien on special revenues to apply such revenues to the obligation secured by the lien. However, according to the one Circuit Court of Appeal decision on the subject—which arose in the Puerto Rico cases—that provision does not require the debtor to make payments during the case.

The same court also ruled that a lender seeking to compel the payment of special revenues during the case must obtain relief from the automatic stay from the federal trial court and then seek to enforce the payment obligation in state court.

Operating costs

Obligations payable from special revenues are treated as secured obligations for bankruptcy purposes, and as such, the plan of adjustment may not impair those obligations—at least to the extent they can be paid from the special revenues. However, if the special revenues are insufficient to pay those obligations, the municipality's obligation, if any, to backfill from general revenues, could be impaired by the plan.

FINANCING LEASES

Municipalities in many states use lease financing for capital projects and equipment. Although styled as leases (usually to avoid limitations on the incurrence of debt under state statutory or constitutional provisions), these instruments typically bear tax-exempt interest payable to the investors who fund the projects or equipment (which require that they be treated as debt for federal tax purposes), and also are treated as debt for accounting purposes. Although the matter is not entirely free from doubt and will depend on the facts and circumstances of each case, these instruments should in general be treated as debt obligations under the Bankruptcy Code and not as true leases. The significance of such characterization might be that the municipality would not be required to assume or reject a real property lease within a relatively short period of time after the court's having ruled that the debtor is eligible for chapter 9 relief, and that the creditor (lessor) might be unable to evict the municipality from the "leased" property (or to require return of the "leased" equipment) in the event of a payment default.

CHAPTER 7

Emerging From Bankruptcy

DISMISSAL OF THE CASE

The bankruptcy court may dismiss the chapter 9 case for cause, including unreasonable delay by the municipality or denial of confirmation of a plan of adjustment. Conversely, the case may be voluntarily dismissed by the municipality at any time, as the judge cannot force it to remain in bankruptcy against its will due to Tenth Amendment considerations. Thus, if the municipality and its key creditors (such as indenture trustees, major vendors and unions) reach agreements during the case and such agreements are binding on the parties under applicable nonbankruptcy law, the municipality can and should dismiss the case not only because confirming a plan of adjustment is no longer necessary, but also because there is no need to incur the significant cost and delay of drafting, confirming and consummating a plan of adjustment and related pleadings.

THE PLAN OF ADJUSTMENT

A Plan Should Be the Product of Negotiation Among All Constituencies. A plan of adjustment, like a chapter 11 plan of reorganization, is little more than a contract among various parties that provides for the treatment of the various claims against the municipality. One of the benefits of chapters 9 and 11, other than preserving assets by way of the automatic stay during the negotiation period, is that the bankruptcy court has the power to approve a plan over the objection of dissenting creditors so long as the requisite majorities of creditors holding similar claims have approved the plan and so long as the plan does not discriminate unfairly among holders of similar claims.

As described above, the municipality is not eligible for chapter 9 unless it has, among other things, negotiated with its creditors prior to filing the case in an attempt to avoid the filing. Once the case is filed, the negotiations should resume as soon as possible with the goal of either reaching agreement and dismissing the case or reaching agreement with the

requisite majorities and confirming a plan of adjustment. Unfortunately, if one or more creditors mount an eligibility challenge (as was the case in the Stockton, Vallejo, Detroit and San Bernardino cases), there is less room for negotiation during the several month period that will be devoted to litigating whether the debtor is eligible for chapter 9 relief.

The Role of Committees in the Plan Process. Committees serve and speak for all similarly situated creditors, and the members of and professionals employed by a committee have a fiduciary duty to the class they represent. An energetic and informed committee, particularly one that is both proactive and constructive during the process of negotiating a plan of adjustment, will be beneficial for all parties to the bankruptcy case.

The Role of the Court in Approval of the Plan of Adjustment. The bankruptcy court must confirm the plan of adjustment if it finds that the various chapter 9 confirmation requirements have been satisfied. These include, among others, that at least one class of impaired creditors has voted to accept the plan; that post-bankruptcy claims will be paid in full on the plan's effective date (unless an impacted creditor agrees to different treatment); that any necessary approval by regulators or voters (in the case of most tax increases) has been obtained; and that creditors will receive at least as much under the plan as they would under applicable nonbankruptcy law were the case dismissed. Broadly stated, the court should find that the debtor municipality has used all reasonable efforts to pay its creditors as much and as quickly as possible, recognizing that application of state law (such as state tax limitation initiatives or other restrictions) may dramatically limit the ability of municipality to raise revenues. The court also must find that the plan is feasible, which means that terms of the plan indicate that the municipality will not need further debt restructuring or another chapter 9 case in the relatively near future.

Failure to Approve a Plan of Adjustment. In the event the bankruptcy judge does not approve the plan, he or she has the discretion to send the parties back to the drawing board to craft a better plan, or to dismiss the chapter 9 case. Due to the Tenth Amendment and the applicable Bankruptcy Code provisions, the judge has no ability to craft a plan of adjustment and compel the municipality or creditors to accept it. Dismissal of the case, of course, is a nightmare scenario because the municipality, which a judge earlier concluded (during the eligibility phase of the case) was unable to pay its debts, would then be out of court, without the protection of the automatic

stay, and still would be unable to pay its debts. Such a result benefits neither the municipality nor its residents nor its creditors and should provide a compelling incentive for the parties to reach agreement on a plan of adjustment.

Confirmation of a Plan When an Impaired Class Has Not Consented — Cramdown. While proposing a plan of adjustment that is supported by all impaired classes is the goal of any chapter 9 debtor, the Bankruptcy Code provides bankruptcy judges the discretion to confirm a plan despite the rejection thereof by a class of impaired creditors. Such a process, which is known as a cramdown, should be avoided if possible because it will mean litigation (including discovery), and it will increase the professional fees that the debtor as well as those of the objector(s) will incur—and in cases where the debtor is paying the professional fees of the objector, that can be doubly punitive to the debtor.

CHAPTER 8

Yes, There Is Life After Bankruptcy

CAPITAL MARKETS ISSUES

The capital markets may punish a municipality for having sought chapter 9 relief, and perhaps for having confirmed a plan of adjustment that negatively impacts debt obligations. The degree and length of that punishment will depend in large part on several factors:

- The strength and viability of the negotiated settlement or plan of adjustment.
- The degree to which capital market debt holders and guarantors are made whole.
- The degree of cooperation and "buy in" among stakeholders
- The economic vitality of the municipality following its exit from bankruptcy.
- Whether voters and/or elected officials have contributed to the settlement or plan by approving new taxes, fees or other revenue sources.
- Whether the municipality can demonstrate that it has stable and effective management in place.
- How well the municipality communicates with the market and the timeliness and transparency of the financial information presented.
- How well the settlement or plan of adjustment is implemented and monitored.

A plan of adjustment developed by a municipality generally should assume that the municipality will be unable to access the public capital markets immediately following its approval, excepting enterprise and other special revenue credits unimpaired by the plan (which might nevertheless suffer some level of pricing penalty for a period due to a variety of reasons, including general association or rating agency scrutiny or wariness). While

it is unavoidable that a municipality's access to the capital markets will be more expensive and limited for some period after a bankruptcy, it is not certain that the fact of a chapter 9 bankruptcy itself will be a permanent or even a very long-term problem. Focus on the factors listed above will help municipalities mitigate the adverse effects of a bankruptcy and emerge stronger and in a better financial position than before they filed the case.

AVOIDING A "CHAPTER 18"

When a private company successfully navigates through a chapter 11 case with a confirmed plan of reorganization, but either cannot perform its obligations under the plan or the plan is flawed because it failed to adequately resolve all of the company's financial problems, the company may be forced back into bankruptcy court to seek yet another reorganization. This is euphemistically referred to as seeking "chapter 22" relief. Several commercial airlines and retailers have taken this route, including Spirit Airlines, which filed its second chapter 11 case in August 2025, six months after its confirmed chapter 11 plan went effective. If this were to happen to a municipality after a chapter 9 case, we assume that the second round would be deemed a "chapter 18" case. However, given the cost, disruption and pain of going through a bankruptcy case, chapter 18 is to be avoided at all costs. Also, and particularly if the need for new bankruptcy relief occurs soon after the completion of the original case, the bankruptcy court may be very skeptical of the municipality's eligibility to file again—remember that one of the unique chapter 9 criteria is that the municipality "desires to effect a plan of adjustment."

Avoidance of a "chapter 18" scenario will be best achieved by driving the hard bargains required to achieve a settlement or plan of adjustment that not only works, but that can weather contingencies and uncertainties. The successful arrangement must:

- Provide for adequate rainy-day reserves.
- Leave the municipality with flexibility to adjust costs and service levels to account for future unforeseen downturns.
- Limit exposure to undue risks in the debt markets (by for example, relying on too much variable rate debt without appropriate hedges or cushions against rising rates).

- Avoid reliance on uncertain future revenue streams, particularly if they require voter approval or are otherwise outside the direct control of the municipality.
- Be supported by a consensus of at least a majority of the affected stakeholders and backed by a meaningful commitment to implement the plan.

Finally, the municipality's management and governing board must have the discipline to stick to any settlement or plan and make it work. Remember that the bankruptcy court has limited oversight powers due to the Tenth Amendment. It may be tempting in light of the heartfelt and legitimate desires of the citizens and the politicians who represent them to spend more or tax less than the plan contemplates. Perhaps a review of the costs of going through the first bankruptcy—in money, time, energy and reputation—would be warranted if such temptations arise.

CHAPTER 9

Conclusion

For the overwhelming majority of municipalities, even severe economic downturns will not result in a need to seek chapter 9 relief. Municipalities feeling financial stress should work as hard as possible, accepting as much pain as they and their residents, creditors and employees can endure, to avoid that path. However, for some municipalities, the challenges will be too great, the avenues of solution too limited, and the window of opportunity for corrective action too small, to avoid using chapter 9 as a tool to help right the ship. For those entrusted to manage and govern municipalities, we hope this booklet provides helpful context and promotes a disciplined and thoughtful approach to avoiding or using chapter 9 in times of fiscal stress.

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