The 1976 Municipal Bankruptcy Law

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After generally surveying the history of municipal bankruptcy legislation in the United States and former chapter IX in particular, an in depth analysis of the new chapter IX provisions is given. The article concludes that the new act, while having several imperfections, will well serve cities overburdened with debt.

I. LEGISLATIVE BACKGROUND
II. Former Chapter IX (1946-1976)
III. The Congressional Scene (1975-1976)
IV. Features of the New Chapter IX
V. Conclusion

In 1841 Representative Fessenden, an outstanding Congressional leader of his day, argued for expansion of the federal government’s powers in a bankruptcy bill then before Congress and visualized the unthinkable possibility

in which a whole community becomes insolvent by some stupendous accident, or by some magnificent but fallacious scheme, such as other countries have seen and felt at no distant day. Can it be pretended that a power to apply a remedy to a disorder that is paralyzing and destroying the body politic exists nowhere? Such an idea is a libel upon the very name of government.¹

The prospect of a city in bankruptcy, almost inconceivable to Congress in 1841, is a real prospect today. Bankruptcy became a reality for a number of small cities during and after the depression of the 1930’s. Now it is clear that large cities are not immune from financial default and bankruptcy.

I. LEGISLATIVE BACKGROUND

Bankruptcy legislation permitting discharge of debt is exclusively a federal power given to Congress by the framers of the Constitution.² Only since 1934 has there been federal legislation directed

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¹ C. Warren, Bankruptcy in United States History 159 (1935).
² U.S. Const. art. I, § 8.
to the adjustment of public debt. The legislation was born of problems arising from a wave of small town defaults in the early 1930's and resulted from tax collection and foreclosure difficulties precipitated by the depression era. It was apparent there was need to extend the uniform benefits of the Bankruptcy Act to political subdivisions of the states. Where total creditor accord to a deferred payment plan could not be obtained by the debtor, bankruptcy law could control the dissenting minority.\(^3\)

Prior to 1934, municipalities were expressly excluded from the scope of federal bankruptcy laws.\(^4\) Congress, pressed by the need of the times, reversed its statutory posture and supplied "Provisions for the Emergency and Temporary Aid of Public Debtors."\(^5\) Before this federal legislation, municipalities and taxing units in financial trouble resorted to debt moratoria and creditor stay laws when available by state law.\(^6\) Alternatively, they sought consent agreements from each of their creditors and, where necessary, each of their bondholders. However, creditors and bondholders were under no compulsion to accept any proposal.

The 1934 municipal bankruptcy statute lasted until tested 2 years later in the Supreme Court. It was found unconstitutional as an invasion of the sovereignty of the states. The Court considered that the law "might materially restrict respondent's control over its fiscal affairs."\(^7\) The Court compared the limits of the bankruptcy power conferred in the Constitution with limitations upon power to tax and pointed out that the federal government was prohibited from taxing state bonds. Commenting on Congress' application of the bankruptcy power to municipal debt as a potentially expanding concept, the Court cautioned:

Our special concern is with the existence of the power claimed. . . . And it is of the first importance that due consideration be given to the results which might be brought about by the exercise of such power in the future.\(^8\)

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3. 78 CONG. REC. 7641-42 (1934) (remarks of Senator Neely).
6. State moratoria laws are not obsolete. As recently as September, 1976, a New York State law permitting suspension of payment of principal on New York City's short-term notes was found to be constitutional by a federal district court. Ropico, Inc. v. City of New York, 415 F. Supp. 577 (S.D.N.Y. 1976). The same moratorium statute was found unconstitutional under the New York Constitution by the New York Court of Appeals in a case brought by the Flushing National Bank. See N.Y. Times, Nov. 20, 1976, at 1, col. 6.
8. Id.
The invalidation of the 1934 Act left distressed cities without federal relief and still in deep financial trouble. These cities were so insistent that by the next year a new statute was enacted by Congress. In 1938 the Supreme Court's apprehensions had apparently waned, and it found the new provisions governing municipal bankruptcies constitutional. The new law succeeded in meeting the Court's tests because congressional drafters of the law were careful to avoid restrictions on state control of its fiscal affairs. Jurisdiction was now limited to approving and enforcing a plan which came to court already accepted by a majority of affected creditors.

Congress believed, or perhaps hoped, that financial problems of local governments were temporary, for this early legislation was considered to be emergency legislation with a 2 year life span to expire in 1940. However, it was repeatedly extended until 1946 when it was made a permanent chapter of the Bankruptcy Act.

After 1946, the municipal bankruptcy chapter was not amended again until April of 1976. The statute apparently met the needs of the debtors who resorted to it, and improving economic conditions lessened those needs. But, with recognition of New York's recent problems, the interest in municipal bankruptcy law revived. It became apparent that the Act, untouched for 3 decades, was inadequate. The intensity of New York's financial crisis, and its potential effect upon the municipal bond market, paralleled the crisis of the 1930's in the way it focused and renewed Congressional attention on the statute.

Examination of the Act, with New York in mind, showed it to be unworkable for large cities needing pervasive treatment of their financial problems. The Act appeared deficient for several reasons: it did not provide ready access to the court; it did not provide a mechanism for raising funds to pay ongoing expenses after filing the petition; and it did not provide for court supervision to assuage compliance with a confirmed plan. The Act was workable for a local taxing unit or a small city with a narrow range of financial problems, but the focus needed widening to meet the needs of a large city.

13. Sixty-four cases were filed under chapter IX in the last 30 years. Tables of Bankruptcy Statistics, Administrative Office of U.S. Courts, Washington, D.C.
II. Former Chapter IX (1946-1976)

The title of the Chapter succinctly indicated its objective—to permit "Composition of Indebtedness of Certain Taxing Agencies or Instrumentalities." The agencies or instrumentalities included drainage and improvement districts, school districts, counties, and municipalities. The chapter followed the basic concept of providing a means to enforce a voluntary composition agreement with "coercion . . . against the one-third who are not willing to come in [with the majority on the agreement]."

Under the chapter, the plan extending or composing the debt was to be filed with the petition initiating the case. In addition, the plan must have been accepted by 51 percent of affected creditors. Further, the petitioner must have filed with the petition a list detailing creditors by name, address, and a description of the type of securities or claim held.

A means was provided for the debtor to obtain a stay of specific creditor proceedings preliminary to filing the petition; however, the stay was for a limited period no longer than 120 days. To obtain this limited stay the petitioner was obligated to demonstrate to the court that efforts were being made in good faith to obtain the requisite acceptances of the plan and, further, that there was a prospect of creditor acceptance within a reasonable period of time.

In view of the voluntary nature of the proceeding and the required pre-petition agreements, the court basically had an after-the-fact supervisory rather than an adjudicatory role. The Commission on the Bankruptcy Laws of the United States in its 1973 report characterized the requirement for pre-petition creditor approval of the plan as the submission of a "fait accompli to the judge, thereby creating substantial pressure on the judge to confirm the plan."

Once the case was filed, all that was needed was an additional 15 2/3 percent affirmative vote on the plan to set the stage for confirmation. But obtaining that minor percentage could be a lengthy and tedious task, particularly where a few creditors with a substantial block of claims decide to hold out. A single creditor could block the 51 percent creditor acceptance needed for the filing of a

15. 77 Cong. Rec. 5482 (1933) (remarks of Congressman Sumner).
chapter IX petition and plan.\textsuperscript{20}

Although the requirements of a pre-petition plan and acceptance seemed to provide a degree of protection for the petitioner and its creditors and was thought necessary to support constitutionality,\textsuperscript{21} these requirements were now seen as procedural obstacles to a large city. Additional problems were created by the need to file a list of creditors. When a city's creditors include a large number of bondholders and the bonds are held in bearer form, the holders are unknown and widely dispersed. Even if creditors are known, compiling lists of thousands of creditors places a demanding clerical burden on a petitioner at the time of filing the case.

The other rehabilitation chapters of the Bankruptcy Act do not have these demanding strictures. When chapter XI was first enacted, it too required a plan to be filed with the petition. However, petitioners filed pro forma plans knowing full well that the "real" plan would be submitted later.\textsuperscript{22} The law was subsequently amended to permit the filing of a plan after the filing of the petition. Experience has indicated that meaningful plans often take time to formulate and mature after the initial turbulence of case filing has passed.

Another weakness of the former chapter IX was that it did not provide for automatic stay of proceedings against the debtor. Entry of a stay order was discretionary with the court. Automatic stays, triggered by filing of a petition, are now common in cases filed under other chapters of the Bankruptcy Act.\textsuperscript{23} In both business and personal bankruptcies, court action is generally required to terminate the stay, not impose it.

When New York City's financial problems became apparent, these deficiencies and others appeared so serious in the light of possible needs of a major city that Congress concluded that the impracticability of existing federal bankruptcy remedies for use by municipalities increases the likelihood of their default and will aggravate the adverse affects thereof. . . .\textsuperscript{24}
When Congress finally recognized that the municipal bankruptcy laws were impractical for present needs, it had before it the testimony of numerous witnesses and a study by the Commission on the Bankruptcy Laws of the United States, created to analyze the current bankruptcy statute. Legislation drafted by the Commission and by a committee of Bankruptcy Judges proposed revisions to all chapters of the Bankruptcy Act, including chapter IX. In addition, a number of bills dealing solely with chapter IX were introduced because of the critical nature of New York City's financial problems.

The Ford Administration also suggested a unique approach to New York's problems with the Bankruptcy Act. The Administration proposed to add another chapter, chapter XVI, to the Bankruptcy Act, designed solely for "major municipalities"—cities with a population "in excess of 1,000,000 inhabitants." The Administration bill was significant for several reasons. It was the first time the Administration openly recognized that chapter IX was inadequate for use by New York City. In addition, the bill marked the approach the Administration would support in regard to new bankruptcy legislation. Prior to presentment of this bill, the Administration and many in Congress had opposed any accommodation of New York.

Chapter XVI was intended to be an alternative to chapter IX. While it eliminated creditor approval for filing a case, it required specific state authorization to file a petition under the chapter. A city still had to present a plan with its petition. Further the petition had to file a budget projection—"a statement of petitioner's current and projected revenues and expenditures adequate to establish that the budget of petitioner will be in balance within a reasonable time after adoption of the plan." The chapter XVI proposal

29. In the Senate, two bills were introduced by Mr. Buckley of New York: S. 2579 and S. 2586. In the House, Mr. Badillo of New York introduced H.R. 9926, 9998, and 10455; and Mr. Rodino of New Jersey and Mr. Edwards of California introduced H.R. 10454. All were in the 94th Cong., 1st Sess. (1975).
32. S. 2597, § 803(a), supra note 30.
also authorized rejection of executory contracts, but only as a provision of the plan. Thus, rejection could only come about after confirmation of the plan. The city was thereby deprived of flexibility and bargaining power to negotiate modification of executory contracts early in the proceeding.

Chapter XVI incorporated many proposals recommended by earlier legislation and witnesses. It provided for issuance of certificates of indebtedness to be authorized by the court where good cause was shown. Filing a petition automatically stayed creditor collection efforts. Chapter XVI also contained a “cram down” provision, providing that a dissenting class of creditors “is to be paid in cash the value of its claims or is to be afforded such method of protection as will, consistent with the circumstances of the particular case, equitably and fairly provide for the realization of the value of its claims.” However, payment of “value” generally is not the full dollar amount due. The “cram down” provision was modeled on similar provisions in corporate and railroad reorganizations of the Bankruptcy Act. The purpose of the “cram down” provision is to preclude frustration of the entire plan by a class of creditors which has voted against the plan.

The Senate accepted the philosophy of a separate chapter for major municipalities; the House, however, opted for a revised chapter IX applicable to public debtors of any size. Members of the House were apparently concerned that the applicability of chapter XVI was too limited. The problem of a medium or small city with major financial problems would not be resolved by chapter XVI. In addition, a question of the constitutionality of such a limited chapter was raised in view of the requirement that bankruptcy laws be “uniform . . . throughout the United States.” Many other problems of the former chapter IX, such as access to the court, were not fully resolved by the chapter XVI proposal.

The most important contribution of chapter XVI was to generate Congressional movement on municipal bankruptcy legislation, for it was presented with emphasis on “the President’s strong personal interest in this legislation as the responsible way for the Federal Government to assist New York City in overcoming its financial difficulties.”

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36. Six cities have a population in excess of 1,000,000: New York, Chicago, Los Angeles, Houston, Detroit, and Philadelphia. STATISTICAL ABSTRACT OF THE UNITED STATES 23 (1975).
The differences in the House and Senate bills were resolved by a Conference Committee. The Committee adopted the House approach providing for a revision of chapter IX with some of the provisions from the Senate bill. Emerging from the Conference Committee was a new chapter IX entitled, “Adjustment of Debts of Political Subdivisions and Public Agencies and Instrumentalities.”

IV. FEATURES OF THE NEW CHAPTER IX

The new chapter IX resolves many of the procedural difficulties of the former chapter. Although its purpose, to aid financially distressed public instrumentalities, is the same as the prior statute, the court now has a greater degree of involvement and greater discretionary powers than before.

A unique feature in the new law is the requirement that, upon filing of a petition in district court, the chief judge of the district is immediately to notify the chief judge of that circuit. The chief judge of the circuit then designates “the judge of the district court to conduct the proceedings . . . .” The stated purpose of this method of assigning a judge to the case is to allow “greater flexibility in selection of a judge, for the chief judge of a circuit may appoint a judge that is retired, or does not sit in the district in which the petition was filed.” Although unexpressed, the provision for flexibility in selecting the judge removes the possibility of “judge shopping.”

One of the fundamental changes contained in the new chapter is the removal of the obligation to formulate a plan and obtain creditor consent before filing the petition; however, the plan may be filed with the petition as well as at a later time. Prior to enactment of these provisions, the financial community had expressed concern that removal of these hurdles would make use of chapter IX too easy, thereby adversely affecting the market for public securities. On the other hand, the Bankruptcy Commission concluded that the pre-petition requirement “also gives those who would seek to depress the market price of these securities of an eligible petitioner for improper purposes an excuse for doing so.” These same concerns were expressed by municipal bond dealers in 1933 when the first public debt chapter was being considered. They anticipated that its

44. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, supra note 18.
enactment would have a "suicidal effect" on the market which included "funds for widows and orphans . . . invested in municipal bonds." This prophesy of doom was heeded by neither the 73rd nor the 94th Congress.

Another feature of the new chapter is the provision for an automatic stay. As in other chapters of the Bankruptcy Act, the filing of a petition now automatically stays the commencement or continuation of all actions against the petitioner. Unless terminated or modified by the court, the stay remains in effect until the property subject to the lien or the case is disposed of. Although the stay is automatically applied at the filing of the petition and relief therefrom must be specifically requested, the party who wants the stay to continue has the burden of showing why it should be continued.

Congress apparently wanted to be quite specific in regard to the matter of stay. It extended the stay beyond the normal enforcement of claims and proceedings against the petitioner to the "commencement or continuation of any other act or proceeding . . . ." The generality of this provision is intended to apply to actions against independent entities of the petitioner although these entities are not themselves liable for the petitioner's obligations. Accordingly, actions or proceedings against a city-owned college, a municipal light plant, or a city airport operated as an independent corporation would be stayed. In these instances, the stay is not automatic; it must be requested. Apparently the stay is to be granted as long as the proceeding to be stayed would be "detrimental to the purposes of Chapter IX."

The new automatic stay provisions are quite broad. They serve to stay not only all actions and proceedings by creditors, but also preclude set-offs and counterclaims asserted after the filing of the petition. For example, bank account set-offs are prohibited so that funds on deposit will be available for the petitioner's ongoing expenses. While post-petition set-offs are stayed, pre-petition set-offs made within 4 months of filing are voidable and may be recovered by the petitioner. On the matter of set-offs, Congress analogized the public interest in railroad reorganization cases with the public interest apparent in cases of public debtors. In railroad reorganiza-

45. 77 Cong. Rec. 5731 (1933) (remarks of Senator Van Nuys).
48. Bankruptcy Rule 9-4(c).
tion cases it was recognized that bank set-offs threaten rehabilitation.\textsuperscript{52} Similarly, bank set-offs could impair rehabilitation of a public debtor.\textsuperscript{53}

The notice requirements of chapter IX were left relatively unchanged. At the various Congressional hearings, witnesses pointed out the difficulties a large city would face in meeting notice requirements of the former chapter IX. It would be cheaper and less onerous to provide for publication as the primary method of giving notice, with mail notice used to supplement publication. However, sensitivity to constitutional due process requirements constrained Congress to leave the notice requirements substantially as they were. The House Committee was concerned by the expressions of the Supreme Court in \textit{Mullane v. Central Hanover Bank & Trust Co.}\textsuperscript{54} and \textit{Eisen v. Carlisle-Jacquelin},\textsuperscript{55} which relied heavily upon direct notice for satisfaction of due process requirements.\textsuperscript{56} Although the \textit{Mullane} and \textit{Eisen} cases involved commercial entities and might not be truly comparable to the situation of a public debtor, Congress apparently felt that adherence to the strictures of notice in those cases would be prudent.

Heretofore, publication notice was permitted, but the Act also mandated mailing of notice of filing to each creditor. Now the Act provides that “if no address is given in the list for a creditor and the address of such creditor cannot with reasonable diligence be ascertained, then a copy of the notice may, if the court so determines, be mailed, postage prepaid, to such creditor, addressed as the court may prescribe.”\textsuperscript{57} This easing of the notice requirements aids the petitioner with lengthy lists of creditors to whom notice need be given.

In addition to notice to all creditors, notice must also be given to the Securities and Exchange Commission and to the state in which the petitioner is located.\textsuperscript{58} The SEC is to be notified so they can protect investors in the interstate municipal bond market.\textsuperscript{59}

\begin{footnotes}
\item[54] 339 U.S. 306 (1950).
\item[56] H.R. REP. No. 686, supra note 42, at 22.
\item[57] Section 85(d) Act, 11 U.S.C.A. § 405(d) (Supp. 1976).
\item[58] Id. Bankruptcy Rule 9-3 requires notice to be given to the Secretary of State of the state in which the petitioner is located.
\item[59] H.R. REP. No. 686, supra note 42, at 8.
\end{footnotes}
state is to be notified because Section 84 of the Act requires the petitioner to be generally authorized by the state to file under chapter IX. Additionally, notification may stimulate the state to aid the petitioner financially and, perhaps, aid in formulating and implementing the plan.

State authorization for filing under chapter IX was viewed differently by the House and Senate. The House bill stated that the petitioner must not be prohibited from filing by state law. The Senate wanted the petitioner to be specifically authorized by the state to file the petition. The Senate adopted the language in the Administration proposal for chapter XVI, which required specific authorization for filing. Thus, the court was to dismiss the petition if state authorization was denied.

Congress retained the provision prohibiting interference with state powers as mandated by the tenth amendment to the Constitution and specifically noted that

[n]othing contained in this Chapter [IX] shall be construed to limit or impair the power of any State to control, by legislation or otherwise, any municipality or any political subdivision of or in such State in the exercise of its political or governmental powers, including expenditures therefore . . . .

This limitation on the power of the court, initially designed by Congress in 1937 for the amended municipal bankruptcy statute, was relied upon by the Supreme Court in United States v. Bekins, which held that statute constitutional. This provision was intended to permit the debtor or the state to be free to manage its own fiscal affairs. Thus the court is prevented from interfering with property or revenue of the petitioner or any income producing property owned by the petitioner.

Although the petitioner controls its own functions, the court now approaches the boundaries of its power to control the petitioner's affairs when called upon to exercise certain of its new discretionary powers. The court can authorize the issuance of certificates of indebtedness to maintain city services. It can also authorize

64. 304 U.S. 27 (1938).
rejection of executory contracts. 68

Although courts have long had the power to issue certificates of indebtedness and to authorize rejection of executory contracts under business rehabilitation chapters of the Act, the power to do so in chapter IX is new. The certificates are intended to permit the debtor to raise needed money to meet expenses. However, before any certificates can be authorized, the court must conduct a hearing and be shown cause for their issuance. This new power fills a gap in the old law, which had no mechanism for a municipality to raise money to pay for essential city services. Certainly, public services necessary to maintain health and safety must be paid for during the pendency of a case. However, the Act does not specify the types of city services to be maintained. The needs of particular cities will undoubtedly vary. For example, garbage collection is an obvious necessity in a large city but may be relatively unimportant in a small town. A methadone clinic may be required for the health and safety of a particular community and yet not be essential elsewhere. Clearly, the court could find "cause" whenever the petitioner shows that the proposed expense is for a function necessary for the health or safety of its inhabitants.

The authorized certificates are to be privately placed. To enhance the marketability of the certificates, the court can authorize their issuance with security and priority in payment over existing obligations. 69 Priority in payment may even be ordered over existing secured debt. This grant of priority over secured debt was challenged as a violation of due process when such certificates were issued in railroad reorganization cases. Congress apparently felt that the rationale for satisfaction of due process as expressed by the Supreme Court in the regional rail reorganization cases applies in chapter IX should the court override the rights of bondholders. 70 In the railroad cases, the Court explained that by borrowing to meet current expenses, the petitioner was preserving the collateral of prior secured creditors by preserving the business of the debtor as an ongoing entity; and thereby there was no real taking of property when new security was given ahead of preexisting liens.

The power to authorize rejection of executory contracts, as in the instance of certificates of indebtedness, has been vested in the

courts by other chapters of the Bankruptcy Act. However, this power was not available to public debtors until the enactment of the new chapter IX. Although an executory contract can be rejected, the creditor whose contract is rejected has a claim for damages resulting from the breach.

The legislative history of the new statute indicates that Congress intended that the case law interpreting the executory contract provisions in chapters X and XI apply to chapter IX. Generally, the tests for rejection of contracts in other bankruptcy chapters are that the contract is a detriment to the debtor and that rejection will aid the debtor's reorganization. The primary concern is for the interests of the debtor, not the rejectee.

Among the contracts which can be rejected by a court in chapter IX are labor contracts. With respect to labor contracts, the courts have expressed concern for the interest of the employees as well as the debtor. The court must weigh these interests before permitting rejection. In the event that labor contracts are rejected, new contracts would ordinarily have to be negotiated. If renegotiation is required, the bankruptcy court will have to consider not only federal law but also applicable state laws governing labor contracts. Applicable law may require a process or procedure for the renegotiation and formulation of a new collective bargaining agreement for public employees. A rejection might also be considered sufficiently similar to a termination of the contract that applicable law might require maintenance of terms and conditions of employment existing under the terminated or rejected contract during the interim between rejection and conclusion of the bargaining process. Section 83 of the Act would prohibit a chapter IX proceeding from interfering with or derogating from any state law that regulates the way in which cities execute these governmental functions.

The right to reject a contract may also include the right to reject contractual obligations under pension agreements. The recently enacted Employee Retirement Income Security Act (ERISA) does not protect government workers against such a rejection because the Act only applies to private pension plans. However, a

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72. Sections 82(b) and 88(c) Act, 11 U.S.C.A. §§ 402(b) and 408(c) (Supp. 1976).
74. 6 COLLIER ON BANKRUPTCY (14th ed.) ¶ 3.23(4), at 571; 8 COLLIER ¶ 3.15(8), at 206.
75. Shopmen's Local 445 v. Kevin Steel Prods., Inc., 519 F.2d 698 (2d Cir. 1975).
state may have pension legislation to protect against such rejections, and those provisions must be respected.

Rejection of an executory contract can be requested at any time after the petition is filed. This permits rejection of onerous contracts early in the proceeding. Request for rejection may result in a modification of terms of the contract prior to the hearing on rejection. Whenever possible, courts will undoubtedly allow time for renegotiation before the hearing on rejection. However, the benefits of rejection may prove illusory, because the cost of terminating a contract may exceed the cost of continuing it. In the instance of employment contracts, severance pay requirements may outweigh the practical benefits of rejection.

Another change introduced by the new Act is in the number of creditor acceptances needed to approve the plan. The former chapter IX required an affirmative vote by two-thirds of the aggregate amount of claims of all classes of creditors affected by the plan. The new Act sets the requisite majority for acceptance at two-thirds in amount of claims of each class and "more than 50% in number" of claims of each class. The purpose of the dual voting requirements is to balance the voting powers of a few large creditors against the collective position of a large number of smaller creditors. Neither should dominate the proceeding.

The two-thirds vote is determined on the basis of the total amount of claims for which a written acceptance or rejection has been filed. This is a change from former law which required acceptances by creditors holding two-thirds of the aggregate amount of all claims whether or not acceptances or rejections were filed. The vote is now computed by totaling the acceptances and rejections of those eligible to vote who actually do vote. An acceptance or rejection may only be filed by claimants affected by the plan. The filing of a claim in and of itself does not compromise acceptance or rejection of the plan. In fact, the filing of a claim is not required for allowance of a claim if the claim is properly listed on the petitioner's schedules.

Creditors vote by classes designated by the court. A class is comprised of creditors holding claims of "substantially similar char-
acter," the members of which enjoy "substantially similar rights." The former law prescribed the class to be made up of claimants holding claims payable out of the same source. Although the former classification scheme worked for limited debt structures, it appeared as another unworkable feature considering the needs of large cities. The variety of debt paper and the various strata of suppliers, contractors and employees of the debtor led logically to liberalizing the former classifications.

The creditors vote on the plan by class. The requisite majority, two-thirds of amount and more than 50 percent in number, is to be sought within each class for acceptance of the plan. However, a plan can still be confirmed by the court even where there is a reluctant class of creditors which has voted to reject the plan. If a class is not affected by the plan or if a class is to be paid in cash in full, then the class’ acceptance is not necessary. Also, if the plan provides “for the protection of the interest, claims or lien of such creditor or class of creditors,” again the plan may be considered accepted by that class even though the class votes nay. This section, including the “cram down” provision, was taken from the former act. The constitutionality of this provision was upheld in Louisville Joint Stock Land Bank v. Radford and Regional Rail Reorganization Act Cases. Accordingly, the nonconsenting creditor class is considered “not affected” since the court can substitute fair value for the creditors’ claims. A “fair” valuation of a claim for this purpose is not necessarily the face amount of the claim. Valuation requires among other things a considered estimate of the future revenues of the petitioner.

Under former chapter IX, once the court approved the petition as properly filed, the proceeding could be dismissed when the case had not been prosecuted with “reasonable diligence,” where it was unlikely that the plan will be accepted by the requisite number of creditors, or where confirmation was denied. These provisions have been incorporated and expanded to permit both permissive and mandatory dismissal. The case may be dismissed in the court’s discretion after hearing on notice for want of prosecution, for failure

91. Act of August 16, 1937, ch. 657, § 83(b) and (e), 50 Stat. 653.
to file a plan on time, or for creditor failure to accept a proposed plan. In addition, the court may dismiss where it has retained jurisdiction after confirmation of a plan and the petitioner defaults in performance. The court is obligated to dismiss the case if confirmation is refused. However, the court is not limited to these grounds for a dismissal in view of its inherent powers.

Although a plan may be accepted by the appropriate vote of creditors, it must pass certain statutory tests before it can be confirmed by the court. Notably, the court must be satisfied that the plan is "fair and equitable and feasible and does not discriminate unfairly in favor of any creditor or class of creditors." Other considerations include disclosure of payments for services and expenses, good faith of the petitioner, and compliance with the requirements of the chapter. The court's findings and conclusions on these factors for confirmation are to be made independent of the fact that creditors have voted to accept the plan and were thereby impliedly satisfied with its provisions.

The principal requirement that the plan be fair and equitable incorporates the absolute priority rule. That rule requires that senior creditors are entitled to the benefit of the value of their claims before the claims of junior creditors. The court determines these priorities among creditors on the basis of state law.

The new chapter IX requires that the plan also be "feasible." Although the term "feasible" is newly included in the chapter, feasibility has always been a factor to consider prior to confirmation. Feasibility means simply that there is reasonable prospect that the petitioner will be able to meet obligations imposed by the plan. If the plan is based on receipt of tax revenues, the past and projected revenues and expenses are to be considered. In this regard, the petitioner is to exercise its taxing powers to the fullest extent legally permissible for the benefit of creditors.

A unique feature of this Act is the granting of power to the court to consider the interests of the petitioner's employees during the confirmation process. Labor unions and employees' associations may be heard by the court "on the economic soundness of the plan

96. Id.
affecting the interests of the represented employees" of the petitioner. However, the union or association may not contest the vote on a plan nor appeal matters concerning the plan.

The Senate proposal for a new chapter XVI would have added an additional condition for confirmation to those finally enacted. The Senate would have required that the petitioner's projected budget be balanced within a reasonable time after adoption of the plan. The Senate gave this condition considerable emphasis, because failure to show a balanced budget mandated dismissal of the case. Although a minority of the House Judiciary Subcommittee was also strongly in favor of the balanced budget requirement, the Conference Committee rejected the proposal. Even though the Act does not require a balanced budget, the petitioner's future ability to balance its budget should be considered by the court when weighing factors for confirmation.

After confirmation, the court has been newly empowered to retain jurisdiction over the case. It retains jurisdiction for the period the court determines necessary for the successful execution of the plan. The term of retention may be years—as long as the longest security issued under the plan. The purpose of retention of jurisdiction is to enforce compliance with terms of the plan. This new provision was obviously introduced to insure continuity in complying with terms of the plan although political administrations of the petitioner may change.

Both the former chapter IX and the present chapter provide for severability in the event any portion of the chapter is deemed invalid. Severability is a common rule of statutory construction. However, the application of the rule in the new chapter may have rather curious results, because the statute also provides in section 3:

If the amendment made by this Act is judicially finally determined to be unconstitutional then Chapter IX of the Bankruptcy

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103. S. REP. No. 458, supra note 90, at 18.
104. Section 817(c)(7) of S. 2597, supra note 30.
108. Ranger, Texas (Civil No. 204, N.D. Tex.) is notable for its filing of a number of successive plans. Succeeding administrations failed to meet the requirements of the plans agreed to by their predecessors.
Act, as such Chapter existed on the day before the date of enactment of this Act, is revived and shall have full force and effect with respect to cases filed after such determination.

Clearly, section 3 is a form of statutory hedging.

The new substantive matters within the chapter, such as authorization of certificates of indebtedness and rejection of executory contracts, apparently rested uneasily with some members of Congress. These innovations are untested as they apply to municipalities. Undoubtedly, they will draw constitutional challenges. The underlying reason for section 3 apparently is the fear that the new chapter IX may be found wholly unconstitutional, and municipalities will be left without any remedy in bankruptcy court.

How section 2, the severability section, will interact with the reversion section, section 3, is unclear. It is difficult to anticipate how the invalidation of "the amendment made by this Act," which is applicable to one or more sections of the new chapter, will affect the validity of the entire chapter, thereby causing reversion to prior law. Should the provision for certificates of indebtedness be found to be invalid, will the court merely resort to severability? If both the executory contracts and certificate sections are found unconstitutional, will the weight of these provisions result in reversion to the former chapter? Clearly, the chapter can stand without these sections even though they incorporate major changes. What is unknown is the combination of substantive and procedural changes that might cause reversion. The interaction of these two sections may itself result in litigation because the scope of section 3 is not clearly defined.

V. CONCLUSION

The new chapter IX has met many of the problems perceived in the former Act. Public debtors now have better access to the court. Means exist to raise funds for the maintenance of the debtor during chapter IX proceedings. Procedures for filing have been substantially eased. The power to reject executory contracts and the various discretionary powers of the court should aid the formulation of viable plans and their progress to confirmation.

Although cities may now issue priority certificates of indebtedness to raise operating cash for essential services, there is no assurance that there will be a market for these certificates. There may be need for some form of guarantee of certificate repayment to en-

courage marketability at reasonable interest rates. Such a guarantee provision seems an inappropriate subject for a bankruptcy law; however, it may be accomplished by separate statute. There is precedent for similar guarantee legislation in the Penn Central and Lockheed situations.

The Act also lacks a method for involving state or regional authorities in the formulation of a city's plan. In some instances, it may be necessary for these authorities to assume responsibility for some of the city's functions. For example, the city may have reached the point where it can no longer carry a transit system or municipal hospitals, or maintain airport facilities. These functions cannot be unilaterally discontinued or terminated; however, they can be maintained by larger taxing units, such as the state, county, or regional authorities. Where it appears that the petitioner cannot alone design a workable plan, the court should have the power to bring necessary parties together to produce such a plan.

The court's power to dismiss a case before successful completion of a plan seems wholly misconceived and entirely inappropriate in the case of a public debtor. While dismissal in private litigation may be an effective punitive power of the court, dismissal of an insolvent city without a confirmed plan leaves the citizenry without relief. It would seem that the dismissal of a case before its successful conclusion should be affirmatively precluded in view of the nature of such a proceeding. The court has sufficient traditional powers to enforce movement of a case, and any failure of plan acceptance or confirmation should only lead to further efforts to find an acceptable solution. Mandatory dismissal, if confirmation is refused, certainly does not meet the needs of the parties. The dismissal provisions, both permissive and mandatory, give undue power to creditors and the court.

In spite of these imperfections, chapter IX should serve well for cities overburdened with debt they can no longer carry. The chapter provides the only statutory process for a city to divest itself of obligations it has incurred which its tax base can no longer support.

The traditional tensions between federal powers and states' rights will inevitably bring constitutional challenges to the various new aspects of the chapter. Challenges to expansion of bankruptcy legislation are not new. Justice Cardozo's dissenting opinion in Ashton v. Cameron County Water Improvement Dist. No. 1, 113 chapter IX, the federal Reconstruction Finance Corporation often granted loans to finance chapter IX plans. See Kelley v. Everglades Drainage Dist., 319 U.S. 415 (1943).

112. In the early years of chapter IX, the federal Reconstruction Finance Corporation often granted loans to finance chapter IX plans. See Kelley v. Everglades Drainage Dist., 319 U.S. 415 (1943).

acterized the history of bankruptcy law as an "expanding concept that has had to fight its way." Undoubtedly, this new legislation will also take its historic turn in fighting its way to meet the challenge of the cities in these times.