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FINANCIAL RESTRUCTURE FOR BUSINESSES AND GOVERNMENTS

Restructure of State Government Debt Through a Federal Equity Receivership

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1. What an Insolvent Government Can Do to Restructure its Debt

This paper discusses how an insolvent State of the United States of America can restructure its debt through a federal equity receivership using an approach described generally in the following three documents.

Government Debt Restructure Principles[1] describes how to deal with government insolvency by proposing a restructure plan based on reasonable austerity and reasonable use of taxation so that creditors are paid all they can reasonably expect under the circumstances, but more than they would receive by exercising their legal remedies against the government. To use terms of art, this would be a debt restructuring plan that is "fair and equitable" and "in the best interests of creditors."

Leading a Government to Solvency[2] describes how to employ financial experts to do a study of reasonable austerity and reasonable use of taxation to determine how much of its debt a government entity can reasonably afford to pay, and how much creditors would likely obtain using their non-bankruptcy remedies.

Government Debt Restructure Principles outlines how it might be necessary to use a payment moratorium to encourage agreement to a fair and equitable restructure plan. Additionally, a government that does not have a pre-authorized right to a trial about whether such a plan can be approved over the objection of holdouts, such as in chapter 9 of the U.S. Bankruptcy Code, can improvise a way to have such a trial and obtain an order enforcing the debt reduction proposed by a fair and equitable plan.

How City Finances Can Be Restructured: Learning From Both Bankruptcy and Contract Impairment Cases[3] gives a short overview of how federal equity receiverships were used from 1880's to the 1930's to restructure the debt of railroads, which, like governments, serve the public interest and should not be liquidated. These federal equity receivership proceedings were used during a period when Congress had not enacted any bankruptcy laws applicable to railroads, just as it has not enacted any such laws to apply to Illinois, California or other States. Moreover, the "fair and equitable" and "best interests of creditors" principles that were developed in these equity receiverships were later incorporated into federal bankruptcy statutes, including the current U.S. Bankruptcy Code, and could be applied in a federal equity receivership for a State.

This paper discusses the substantial authority supporting use of a federal equity receivership to restructure the debt of a State using such an approach.[4] It concludes that:

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[1] Zack A. Clement, *Government Debt Restructure Principles* was presented at the California League of Cities Annual Convention on September 28, 2014, at the Campbell University Law School Chapter 9 Symposium on October 15, 2014 and at the Duke University Law School Symposium, Modern Municipal Restructurings: Puerto Rico and Beyond, November 10, 2015.

[2] Zack A. Clement, *Leading a Government to Solvency* was presented at the California League of Cities Annual Convention on September 28, 2014, at the Campbell University Law School Chapter 9 Symposium on October 15, 2014 and at the Duke University Law School Symposium, Modern Municipal Restructurings: Puerto Rico and Beyond, November 10, 2015.

[3] 88 AM. BANKR. L. J. 41, (2014), co-authored with R. Andrew Black.

[4] Such an approach might also be used by a foreign sovereign which, like Argentina, which is sued in New York to collect on one series of bonds in default. If all parties necessary for a complete adjudication, including creditors with claims on other bonds, were joined in this suit under FRCP 19, the sovereign would have a

1. There is substantial U.S. Supreme Court and circuit court authority describing how a federal equity receivership can be used to reorganize debt of an entity for which no bankruptcy law has been enacted.

2. Federal *bankruptcy* power permits passage of statutes dealing with the broad subject of restructuring debts between insolvents and their creditors, but that does not preclude (i) federal courts from employing principles of *equity* to restructure debt, or (ii) state legislatures from enacting debt relief statutes in cases when Congress has not enacted an applicable federal bankruptcy statute.

3. The debt of insolvent railroads was restructured in federal equity receiverships for fifty years before the Congress codified the substantive equitable principles developed in those cases into a federal bankruptcy statute applicable to railroads.

4. Also, after the federal municipal bankruptcy statute was ruled unconstitutional in the late 1930's, the U.S. Supreme Court approved a New Jersey state law enacted to restructure unsustainable municipal debt.

5. Power to use a federal equity receivership to deal with insolvency is still present in the U.S. Constitution, the U.S. Code and the Federal Rules of Civil Procedure.

6. Railroad equity receiverships typically had federal jurisdiction based on diversity of citizenship between a western railroad and a New York bond indenture trustee. An equity receivership for a State would have federal jurisdiction because it would involve a dispute between a State and a citizen of another State. In *Zacarias v. Stanford International Bank, Limited, 931 F. 3d 382* (5th Cir 2019), the Fifth Circuit recently upheld powers of a federal court in an equity receivership, describing in great detail why a receivership is useful to deal with an insolvency, and the broad powers it still possesses to bar claims.

7. Initially debt restructure plans for railroads were forced on holdout creditors (who wished to keep their original debt claim and refused to participate in the restructured debt) by selling the railroad's assets to purchasers who agreed to accept restructured debt claims against the sold assets. Holdout creditors were left with their original claims against an empty shell. Those cases protected the purchasers at the sale from original creditor claims if the holdout creditors had been offered participation in the restructured debt and had turned it down. Eventually, however, courts issued injunctions against collections on original

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forum to prove that it could not pay all such claims in full. In such a case, the sovereign could seek an injunction to stop the original collection action while it joined all necessary parties, formulated and proposed a plan to pay all it could reasonably afford to pay; then ask the court to approve that plan as fair and equitable and in the best interests of creditors, and to enjoin collection except in keeping with debt as restructured pursuant to this plan. A subsequent paper will discuss this.

debt after a trial about whether the original obligor's proposed restructure plan was fair without the need for a *pro forma* sale structure.

8. Initially federal railroad equity receiverships were initiated as a response to creditor collection actions. Eventually, however, it was common for a railroad debtor facing imminent default to petition for establishment of a receivership to stay foreclosure and preserve its going concern operations pending the restructure of its debt pursuant to a restructure plan that it would propose and submit for confirmation by the court.

9. In *U. S. v. Bekins*, 304 U.S. 27 (1938) the Supreme Court held that a state entity can be authorized to submit itself to federal jurisdiction in a case where the federal court will decide whether its proposed debt restructure plan is fair and should be enforced as long as the state entity retains control over basic public safety and health functions, and retains control over its finances as provided by state law. Bankruptcy Code sections 903 and 904 describe generally what would be an acceptable reservation of state power for a state entity to pursue a case in federal court to restructure its debt.

10. State laws authorizing the appointment of temporary emergency receivers/managers provide a model for a federal equity receivership to restructure the debt of an insolvent state entity. Ideally, these statutes authorize the appointment of a receiver/manager vested with the power to speak for the government, to propose, negotiate and, if necessary, litigate over the approval of a debt restructuring plan that is fair and equitable and in the best interests of creditors. In the interests of preserving a level of local sovereignty, ideally, that statute would provide for consultation with elected officials, giving them some power to approve or veto the restructure leader's proposals. These principles could be applied to the restructure of the debt of Illinois, California and other States.

11. Federal equity receiverships issued injunctions prohibiting collection against a reorganized debtor's assets, a precursor to the discharge injunction provided in Bankruptcy Code section 1141. By contrast, the section 944 discharge injunction in chapter 9 focuses on creditors rather than municipal assets over which the state has retained control pursuant to section 904. A federal court approving the debt restructuring plan in an equity receivership proceeding could issue a section 944 style injunction prohibiting creditors from attempting to collect on their original, un-restructured claims. There is recent U.S. Circuit court authority for issuance of a strong bar order in a federal equity receivership.

12. FRCP 23 (class action) might be used to join all bond creditor parties in an equity receivership. FRCP 19 (joinder of parties necessary to complete adjudication) provides a better vehicle to join substantial creditor parties in an

equity receivership since it does not provide for opt outs. These two federal procedural rules could be used to make a plan confirmation order in a federal equity receivership as effective as a section 944 discharge injunction in a chapter 9 case.

13. The Supreme Court has recognized that governments, like railroads, involve the public interest and ought not to be liquidated. It has explained that plan confirmation standards in municipal government bankruptcy cases should focus on whether the plan is in the best interests of creditors because it pays at least as much as creditors could expect to collect in light of sovereign immunity that does not permit liquidating the government's assets. Circuit courts have explained that such a plan is also fair and equitable if it pays all the government debtor can reasonably afford.

14. Whether a State's debt restructure plan is fair and equitable and in the best interests of creditors can be adjudicated in a federal equity receivership which has the power to enforce its order.

2. <u>Historically Courts Have Restructured Debt through Federal Equity Receiverships when No Bankruptcy Law was Applicable.</u>

For over 50 years, federal courts developed and applied equitable principles to reorganize bankrupt railroads. After the Civil War, railroad companies began building a nationwide transportation network, which was important to the United States' national interest. Many of these railroad companies became insolvent during construction of their railroad systems and would have been worth very little if bondholders had simply liquidated the assets in a series of foreclosure sales. The only way to preserve going-concern value and ultimately get the rail network built was to stay foreclosure actions, restructure the debt, and enforce the terms of that debt restructure.

Beginning in the late 1890's and continuing into the 1930's, the restructuring of the debt of railroads was done through federal equity receiverships, until in 1934 Congress finally passed a bankruptcy law applicable to railroads codifying the equitable debt restructure principles developed in those receiverships.[5] Many current statutory bankruptcy statute principles thus began as equitable principles in federal equity receiverships.

For example, in *Howard,* the Supreme Court held that "equity regards the property of a corporation held in trust for the payment of debts of the corporation and the rule is well settled that stockholders are not entitled to any share…until the debts of the

[5] *See, e.g.*, *R.R. Co. v. Howard*, 74 U.S. 392 (1869); *Louisville Trust Co. v. Louisville, New Albany and Chicago Ry. Co.*, 174 U.S. 674 (1899); *Northern Pacific Ry. Co. v. Body*, 228 U.S. 482 (1912); *Kansas City Terminal Ry. V. Central Union Trust Co. of N.Y.*, 46 S.Ct. 549 (1926); *Case v. Los Angeles Lumber Products*, 308 U.S. 106 (1939); *Wright v. Union Central Life Ins. Co.*, 311 U.S. 272 (1940); *Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510 (1941).

corporation are paid."[6] This early statement of an absolute priority rule as a test for what is an equitable reorganization was applied for over 50 years in equity receiverships of railroads conducted by federal courts.[7]

More than 50 years after *Howard*, Congress finally exercised bankruptcy power to enact a uniform federal bankruptcy statute concerning railroads and other corporations and required that their plans of reorganization be fair and equitable.[8]

When it applied the fair and equitable concept incorporated into later-enacted bankruptcy statutes, the Supreme Court was guided by the meaning that had been developed for this concept in the earlier equity receiverships. *See e.g.*, *Case v. Los Angeles Lumber Products*, 308 U.S. 307 (1939), (the Bankruptcy Act's language requiring that a plan be "fair and equitable" were "words of art" which "had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations").

The history of federal equity receiverships for railroads thus makes clear that federal courts can apply reasonable, equitable principles to deal with insolvencies that Congress has not yet chosen to enact a statute to deal with.

The Supreme Court has also upheld an individual state's law providing a mechanism for the adjustment of the debts of an insolvent government entity in the absence of an applicable federal bankruptcy statute. In the mid 1930's, the original federal municipal bankruptcy act was struck down as unconstitutional and Congress had not enacted a replacement law. In the absence of Congressional action on the subject, the state of New Jersey passed its own municipal bankruptcy law which permitted insolvent municipalities to propose a plan of debt adjustment which, when approved by a court, would be binding on all creditors. The U.S. Supreme Court upheld New Jersey's creation of this court-based debt restructuring procedure in *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 507-08 (1942).

The Supreme Court in *Asbury Park* and in the railroad reorganization cases upheld the use of the "fair and equitable" and "best interests of creditors" concepts that were originally developed through courts' exercise of the equitable powers. These equitable principles have been codified in every federal bankruptcy statute since the Great Depression.

3. **<u>There is Strong Current Authority for Use of Receiverships to Deal With Insolvency</u>**

Federal courts continue to be vested with the power to apply equitable principles to deal with insolvency. As pointed out by a prominent representative of insolvent sovereign nations, federal equity receiverships are still authorized.

[6] *Howard*, 74 U.S. at 409-10 (emphasis added).
[7] *See, e.g.*, *Northern Pacific Railway Co. v. Boyd*, 228 U. S. 482 (1913).
[8] *See*, The Bankruptcy Act sec. 77B, Act of June 7, 1934, ch. 424 sec 77B (f).

> The equity receivership technique of the late nineteenth and early twentieth centuries evolved over time to meet what the debtors and bondholders of the day saw as a pressing need. Debt rearrangements for corporate and railroad borrowers were occasionally necessary. There was no bankruptcy procedure in place at the time that would accommodate such a workout (short of liquidation) and prevent exploitation by dissident creditors. The equity receivership solution engaged the equity powers of a U.S. court to shield the debtor from piecemeal asset foreclosures while the stakeholders negotiated and implemented the terms of a rearrangement.
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> Those equity powers still exist in U.S. courts. Indeed, the Federal Rule of Civil Procedure 66, provides for the appointment of receivers 'in accordance with the practice heretofore followed in the courts of the United States.' This article will describe how such a receivership can be used to restructure the debt of many kinds of governments.[9]

In *Zacarias v. Stanford International Bank, Ltd, 932 F.3d 382* (5th Cir 2019) the Fifth Circuit recently upheld the power of a federal court in an equity receivership, describing in great detail why a receivership is useful to deal with an insolvency, and the broad powers it still possesses in 2019 to bar claims. Because *Stanford* describes the reason and method of an insolvency receivership process so well it is quoted at length.

The SEC had sued Stanford for securities fraud and asked the District Court to appoint an equity receiver pursuant to the federal securities statute to take charge of Stanford's assets and allocate them fairly to claimants. The Fifth Circuit upheld the broad power of a federal equity receivership court to approve a settling party's payment to the receivership in return for a bar order providing it immunity from related claims against it that are owned by third parties who were not party to the settlement.

The Fifth Circuit described that the power to order this receivership to deal with insolvency came from a federal securities statute ***and*** from 28 U.S.C. § 3103 that provides for the appointment of receivers.

> In the aftermath of the 1929 financial crash, Congress passed a number of statutes to promote competition and free exchange in our country's securities exchanges and the market for unlisted securities. The "basic purpose" of these laws was "to insure honest securities markets and thereby promote investor confidence." These laws established the SEC, an agency armed "with an arsenal of flexible enforcement powers" to uphold the integrity of securities markets. These same statutes also

[9] L.C. Buchheit and G. Mitu Galati, Sovereign Bonds and the Collective Will, 51 Emory Law Journal 1137, 1152 (2002).

> authorize federal courts' jurisdiction over actions protecting the markets. Specifically, Section 22 of the 1933 Act and Section 27 of the 1934 Act confer jurisdiction on the district courts over enforcement actions, including "suits in equity." The acts grant the SEC access to the courts' full powers, including use of the traditional equity receivership, to coordinate the interests in a troubled entity and ensure that its assets are fairly distributed to investor creditors. These implicit authorizations of receiverships are consistent with the more general express authorization Congress provided in 28 U.S.C. § 3103. Otherwise stated, "[f]ederal equity receiverships, despite the name, have a federal statutory framework."[10]

While not cited by the Fifth Circuit, these statutes are grounded in Article III Section 2 of the United States Constitution which provides that:

> "The judicial Power shall extend to **all Cases, in Law and Equity**, arising under this Constitution, the Laws of the United States, and Treaties made, or which shall be made, under their Authority;–to all Cases affecting Ambassadors, other public Ministers and Consuls;–to all Cases of admiralty and maritime Jurisdiction;–to Controversies to which the United States shall be a Party;–to Controversies between two or more States;– **between a State and Citizens of another State,– between Citizens of different States,**–between Citizens of the same State claiming Lands under Grants of different States, and **between a State, or the Citizens thereof, and foreign States**, Citizens or Subjects." [emphasis added]

The *Stanford* Court praised as good public policy the "substitution of orderly, equitable creditor recovery for the chaos and inefficiency of individualized creditor litigation with its irrational allocation of recoveries—one born of necessity."

> Exercising their jurisdiction under the securities laws, federal district courts can utilize the receivership mechanism where a troubled entity will not be able to satisfy all of its liabilities to similarly situated creditors. Where the troubled entity is unable to meet its obligations, creditor-investors encounter a collective-action problem: each has the incentive to bring its own claims against the entity, hoping for full recovery; but if all investors take this course of action, latecomers will be left empty-handed. A disorderly race to the courthouse ensues, resulting in inefficiency as assets are dissipated in piecemeal and duplicative litigation. The results are also potentially iniquitous, with vastly divergent results for similarly situated creditors. So, it is that at the behest of the SEC the district court may take possession of the entity and its assets, and vest control in its officer, the receiver. The court

[10] 931 F.3d at 393 (citations omitted).

> empowers the receiver to "stand in the shoes" of the troubled entity, allowing him to override holdout creditors and reach decisions for the aggregate benefit of creditors under the court's supervision. If so directed by the court, the receiver will systematically use ancillary litigation against third-party defendants to gather the entity's assets. Once gathered, these assets are used to satisfy liabilities to the entity's creditors, not in a disorderly creditor feeding frenzy, but through a court-supervised administrative distribution process. Receivership is thus a substitution of orderly, equitable creditor recovery for the chaos and inefficiency of individualized creditor litigation with its irrational allocation of recoveries—one born of necessity.[11]

The Fifth Circuit explained why bar orders are important to the receivership process, and have been approved by many circuit courts.

> For this exercise, the federal district courts draw upon "the power ... [to] impose a receivership free of interference in other court proceedings." The receivership's role is undermined if creditor-claimants jump the queue, circumventing the receivership in an attempt to recover beyond their pro rata share. Under the securities laws, the district court's power to determine appropriate relief for a receivership is broad. The court's powers include "orders preventing interference with its administration of the receivership property." As we have stated:
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>> Courts of Appeals have upheld orders enjoining broad classes of individuals from taking any action regarding receivership property. Such orders can serve as an important tool permitting a district court to prevent dissipation of property or assets subject to multiple claims in various locales, as well as preventing piecemeal resolution of issues that call for a uniform result.
>
> These can include stays of claims in other courts against the receivership, and bar orders foreclosing suit against third- party defendants with whom the receiver is also engaged in litigation. Accordingly, at an earlier stage in the litigation we affirmed the district court's order enjoining the Texas Plaintiffs-Objectors' from prosecuting claims against Willis during the pendency of the receiver's action. While that stay was temporary and the bar orders here are permanent, it is of no moment here in the calculus of the court's powers. **Indeed, in both cases the district court, through its control of the receivership, enjoins non-party claims in another court–without exercising jurisdiction over them–to protect the receivership**.

[11] 931 F.3d at 394. (citations omitted).

> **…The district court will exercise its "broad equitable power in this area" in accord with the needs of receivership on the particular facts of each case.** *Rishmague*, *Kaleta*, and *DeYoung* clarify the breadth and reach of the district court's power to protect the operation of the receivership and its custody of the receivership res. We find them persuasive.[12]

Based on this, the Fifth Circuit approved a bar order in *Stanford* prohibiting creditors from pursuing lawsuits in other courts against defendants who had settled and paid money to the receiver and demanded such a bar order in return for that settlement payment. It held that the receivership court had the power to make that bar order because of its power over the settlement payment to the receivership estate, and that it was good reorganization policy to require claimants to recover through the receivership instead of through their separate claims against settling third parties in other courts.

> By entering the bar orders, the district court recognizes the reality that, given the finite resources at issue in this litigation, Stanford's investors must recover Ponzi-scheme losses through the receivership distribution process. The Willis Defendants and BMB contend that the bar orders are preconditions of their respective settlements. The brokers' incentives to settle are reduced—likely eliminated—if each SIB CD investor retains an option to pursue full recovery in individual satellite litigation. Such resolution is no resolution. And the costs of undermining this settlement are potentially large. The receivership—and thus qualifying investor claimants—will be deprived of $132 million in settlement proceeds. Continued prosecution of the receiver and Investors' Committee's suit against Willis and BMB could result in the same if not greater recovery, but this is sheer speculation. Further, any potential value of the receiver's ultimate recovery must be reduced by the costs of prolonged litigation over the same assets, not only in the receiver's own action but also in the Plaintiffs-Objectors' myriad satellite suits, into which the receivership is likely to be drawn. Supposing that Willis, an allegedly deep-pocketed defendant, remains able to satisfy any judgment against it, the same cannot be said of BMB: continued litigation would eat away at the limited funds available under its "wasting" insurance policy.
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> …
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> **The bar orders—enjoining these investors' third-party claims—fall well within the broad jurisdiction of the district court to protect the receivership res.** The exercise of jurisdiction over a receivership is not an exercise of jurisdiction over other judicial proceedings. It rather permits the barring of such proceedings where they would undermine the receivership's operation.

[12] 931 F.3d at 394-95 (citations omitted)(emphasis added).

> "'[T]he district court has ... wide discretion to determine the appropriate relief in an equity receivership.'" Again, **the receivership solves a collective-action** problem among the Stanford entities' defrauded creditors, all suffering losses in the same Ponzi scheme. **It maximizes assets available to them and facilitates an orderly and equitable distribution of those assets. Allowing creditors to circumvent the receivership would dissolve this orderly process—circumvention must be foreclosed for the receivership to work.** It was no abuse of discretion for the district court to enter the bar orders to effectuate and preserve the coordinating function of the receivership.[13]

Stanford thus stands as strong, current precedent for (1) the use of federal equity receivership to deal with insolvency, (2) the powers of a receivership court to control claims relating to that insolvency, and (3) the power of the receivership court to issue an order enforcing a debt restructure. The strong bar order entered in *Stanford* performs a function similar to a discharge order entered in a bankruptcy that bars assertion of a claim based on its original, pre-restructured terms; allowing only the restructured claim to be asserted.

4. <u>Basis Used to Discharge Debt of Holdout Creditors in a Federal Equity Receivership</u>

In a debt restructuring plan under the Bankruptcy Code, the proposed plan, once approved by a bankruptcy court, is binding on all creditors.[14] Creditors, including those who voted against the plan, are enjoined from attempting to collect discharged debts from the debtor or its assets.[15]

Equity receiverships initially dealt with the problem of holdout creditors by using a foreclosure sale of the debtor's assets to a new entity in which agreeing creditors received an interest. Holdouts who did not agree to take the restructured securities retained their original claims, but those claims were now against a shell company whose assets had all been transferred away in the sale.

The Supreme Court upheld such a *de facto* discharge in the *Boyd* case finding it equitable.

> His [creditor] interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come to a just reorganization, could not be heard in a court if equity to attack it. . . .If, however, no such tender was made and kept good he retains the right to subject the interest of the old

[13] 931 F.3d 397-99 9 (citations omitted)(emphasis added).
[14] 11 U.S.C. §§ 943, 944, 1129, and 1141.
[15] *Id.*

> stockholders in the property to the payment of the [original] debt [claim].[16]

A fair and continuing offer of restructured securities was, thus, crucial to the issuance of an equitable discharge.

Eventually, some courts dropped the requirement of a sale and held that, if a debt restructuring plan was found by the court to be fair and equitable it could provide for the return of the assets of the original insolvent debtor to the now-solvent, reorganized debtor with the court to enjoin creditors from collecting on their original, un-restructured claims.[17]

> The courts in this case had the same power to vest in the reorganized solvent corporation the title to the property of the insolvent corporation free from the claims against and stock in the latter, and to bar actions and suits against the reorganized corporation and against the property they delivered to that corporation, that the courts in the foreclosure cases had and exercised to protect the new corporations and the property which they delivered to them against like claims. And the conclusion of the whole matter is that the decree of the United States District Court of the Northern District of Illinois, whereby that court adjudged that the property of the insolvent railway company should be delivered pre-receivership back to that corporation so reorganized as to be solvent without a sale, and that the unsecured creditors and stockholders of the insolvent company were enjoined and forever barred from interfering with or maintaining claims, actions, or suits against the property so delivered, or against the reorganized company, on account of such claims against or stock in the old insolvent corporation, in any other way than that specified in that decree, *was far within the jurisdiction and power of that court, and was fair, equitable, and just*.[18]

For all practical purposes, the injunction issued in *Phipps* acted as a discharge of pre-receivership debts similar to that provided under today's Bankruptcy Code.[19]

This still-valid concept from the railroad receivership cases is important for a government using an equity receivership to restructure its debt. For obvious reasons, a transfer of all of a government's assets to some "purchasing" entity in a foreclosure sale is impractical and nonsensical.

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[16] *Boyd*, 228 U.S. at 508.

[17] See e.g., *Phipps v. Chicago R. Co*, 284 Fed. 945 (8th Cir 1922), *writ of error dismissed* 262 US 762 (1922).

[18] *Phipps v. Chicago R. Co*, 284 Fed. at 954 (emphasis added).

[19] See, e.g., 11 U.S.C. § 1141 and 944.

Section 7 below discusses the relationship between (i) a *Phipps*-style discharge injunction that focuses primarily on the *assets* of the debtor entity, but inevitably involves creditors (as provided in section 1141 of the Bankruptcy Code), and (ii) another kind of discharge injunction that focuses primarily on the *creditors* of the debtor entity, but inevitably involves the debtor's assets (as provided in section 944 of the Bankruptcy Code governing municipalities). This is the kind of bar order that was entered in *Stanford*.

Section 8 also discusses the possibility of joining creditor parties to an equity receivership under FRCP 23 (governing class actions but permitting opt outs) and FRCP 19 (joining all parties necessary to a complete resolution, and not permitting opt outs) to make the injunction issued at the end of such a receivership case meaningful.

5. <u>Who can Start a Receivership and what is the Basis to Institute it in Federal Court?</u>

In the earliest railroad receivership cases, receivers for insolvent railroads were appointed in connection with lawsuits seeking to foreclose on mortgages. Mortgage foreclosures were classically brought in federal court based on diversity of citizenship between a midwestern railroad and a New York indenture trustee, not based on a federal statute such as the Securities Act that the Fifth Circuit relied on in *Stanford*.

Writing in the 1933 Virginia Law Review, Robert L. Swaine described this use of diversity jurisdiction very bluntly.

> The only escape which a corporation and its creditors have if its financial situation subjects it to such a risk [of insolvency and imminent foreclosure], is to arrange, in advance of such an attack, with one of its creditors, who has an overdue claim and is a resident of a state other than that in which the corporation is domiciled, for the filing of a creditor's bill in a federal court in a district in which the corporation is operating. The action is one designed to subject the assets of the corporation to the payment of, the plaintiff's debt, in the nature of an equitable execution. It seeks such relief on behalf of all creditors similarly situated, in the nature of a bill of peace to avoid multiplicity of actions. The basis for federal jurisdiction is diversity of citizenship. The prayer is for the determination of the rights of the respective creditors, the ultimate sale of the corporation's assets for the benefit of all the creditors and, pending the sale, for the appointment of a receiver. The corporation then answers, admits the allegations of the bill and consents to the appointment of receivers.[20]

By the late 1800's it had become common for debtor railroads to initiate receivership proceedings themselves when they were insolvent but believed they had going concern

[20] Lloyd K. Garrison, <u>Corporate Reorganization-An Amendment to the Bankruptcy Act—A Symposium</u>, Virginia Law Review, Vol XIX, No. 4, pp. 318-19 (Feb 1933).

value worth preserving, often obtaining the appointment of a receiver close to the management of the railroad.[21]

The Harvard Law Review noted that:

> Since the Wabash case, many like cases have arisen; and it may now be said that the practice is well established; indeed, that under like circumstances it is the almost invariable practice. By this is meant precisely, that when a railway company is in financial straits, or about to be in a case where under the former practice its creditors would be entitled to bring suit to subject its property to a sale for the payment of its debts, and, pending such suit, to ask the appointment of a receiver, **the recent practice is for the company itself to anticipate the occurrence of such conditions, and, as the creditors cannot move till they do occur, to seek the court in advance of default, file a petition or bill on its own behalf, and ask the appointment of receivers, usually of its own selection, . . . it is certainly true that the practice is actually followed, so far as we know, in nearly all the courts of the United States, as occasions arise.**[22]

By 1933, in the depths of the Great Depression, "more than fifty railroad companies owning more than twenty thousand miles of railroad in the United States . . . [were] in receivership."[23]

If a state such as Illinois or California were to initiate an equity receivership as Wabash did, the jurisdictional basis would be US Constitution Article III section 2 jurisdiction over "controversies…between a State and citizens of another State." This would be every bit as good a basis for federal equity jurisdiction as diversity jurisdiction was for 50 years-worth of railroad equity receivership cases.

6. Can a State Pursue an Equity Receivership?

a. *Bekins*' Rationale is Broad

In *U.S. v. Bekins*,[24] the Supreme Court held that a "state" can exercise its discretion to authorize one of its municipalities to go to a federal court to access federal bankruptcy power in order to discharge unaffordable debt because this intrusion on state sovereignty is consensual and for the limited purpose of seeking a restructuring of unsustainable debt that would be unavailable under state law.

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[21] *See, e.g., Atkins v. Wabash*, 29 F. 161 (Cir. N.D. Ill. 1886); *Central Trust v. Wabash*, 29 F. 618 (Cir. E.D. Mo. 1886); *Wabash v. Central Wabash, Central Trust Co*., 22 F. 272 (Cir. E.D. Mo. 1884).

[22] D. H. Chamberlain, New Fashioned Receiverships, 10 Harv. L. Rev., 139, 145-46 (1896)(emphasis added).

[23] Corporate Reorganization—An Amendment to the Bankruptcy Act—A Symposium, 19 Va. Law Rev., 317, 317-18 (1933).

[24] 304 U.S. 27 (1938).

> Nowhere in our scheme of government – in the limitations express or implied of our federal constitution – do we find that [a state] is prohibited from assenting to conditions that will assure a fair and just requital for benefits received. …
>
> **In the instant case we have cooperation to provide a remedy for a serious condition in which the states alone were unable to afford relief.** Improvement districts, such as the petitioner, were in distress. Economic disaster had made it impossible for them to meet their obligations. As the owners of property within the boundaries of the district could not pay adequate assessments, the power of taxation was useless. **The creditors of the district were helpless. The natural and reasonable remedy through composition of the debts of the district was not available under state law by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by state legislation. The federal bankruptcy power is competent to give relief to debtors in such a plight** and, if there is any obstacle to its exercise in the case of the districts organized under state law it lies in the right of the State to oppose federal interference. **The State steps in to remove that obstacle.** The State acts in aid, and not in derogation, of its sovereign powers**. It invites the intervention for the bankruptcy power to save its agency which the State itself is powerless to rescue.** Through its cooperation with the national government the needed relief is given. We see no ground for the conclusion that the Federal Constitution, in the interest of state sovereignty, has reduced both sovereigns to helplessness in such a case.[25]

Bekins held that the Bankruptcy Act was constitutional because the newly enacted municipal bankruptcy provisions permitted the state to retain adequate control over the "governmental" and "fiscal" affairs of its municipality while it was subject to federal bankruptcy jurisdiction in a federal court which could apply bankruptcy power to restructure its debt.[26]

It was crucial to *Bekins'* finding of constitutionality that the intrusion of federal power into state sovereignty (a) was consensual, (b) was focused on financial restructure, not the general exercise of police power, (c) permitted the state to continue to control its assets and revenues, and (d) was used for a limited purpose of restructuring debt pursuant to a

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[25] *Bekins,* 304 U.S. at 53-4 (emphasis added).

[26] The bill here recommended for passage expressly avoids any restriction on the powers of the States or their arms of government in the exercise of their sovereign rights and duties. No interference with the **fiscal** or **governmental** affairs of a political subdivision is permitted. The taxing agency itself is the only instrumentality which can seek the benefits of the proposed legislation. No involuntary proceedings are allowable, and no control or jurisdiction over that property and those revenues of the petitioning agency necessary for essential governmental purposes is conferred by the bill. *Bekins* 304 U.S. at 51 (emphasis added).

plan proposed by the municipality. Indeed, the limitations on a federal bankruptcy court's power in a case involving a state municipal debtor described in *Bekins* were incorporated into sections 903, 904 and 941 of the current Bankruptcy Code.[27]

b. A State Could Pursue a Federal Equity Receivership Under *Bekins*' Broad Rationale

Congress has the power to enact statutes that provide for uniform laws concerning bankruptcy throughout the United States.[28] However, the current Bankruptcy Code does not empower a State or Territory to file a federal bankruptcy case to restructure and discharge its own debt; it only makes provision for States to authorize their municipalities to use federal bankruptcy law in a chapter 9 case.[29] Moreover, the Bankruptcy Code specifically excludes Puerto Rico and its municipalities, political subdivisions, public agencies or instrumentalities from the list of entities given access to proceedings under chapter 9 of the Bankruptcy Code.[30] As described above, in the absence of a federal bankruptcy statute permitting the restructure of railroad debt in a bankruptcy case, federal courts restructured that debt for fifty years by using equity powers in receiverships.

Bekins' rationale for the constitutionality of the exercise of federal jurisdiction over matters normally the subject of state sovereignty supports a State authorizing one of its government instrumentalities or agencies to pursue a federal equity receivership to restructure its debts if this does not "materially restrict its control over fiscal affairs." It supports a State legislature authorizing one of its governmental entities to submit to federal court jurisdiction for a limited period of time to litigate about and obtain approval of a reasonable allocation of insufficient State resources pursuant to a restructure plan that pays all the entity can reasonably afford after reasonable austerity and reasonable use of taxation, that is still more than creditors would receive by exercising their limited remedies.

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[27] 11 U.S.C. § 903 ("This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, . . .").
11 U.S.C. § 904 ("Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property.")

[28] U.S. Const. art I, § 8, cl. 4.

[29] A debtor is eligible to file a chapter 9 case if it (i) is a ***municipality***, (ii) is specifically authorized under state law to be a chapter 9 debtor, (iii) is insolvent, (iv) desires to effect a plan to adjust its debts, and (v) either (a) has obtained majority approval of creditors in each class for the proposed plan of reorganization, (b) has negotiated in good faith with creditors and failed to obtain such a majority, (c) is unable to negotiate further because such negotiations are impracticable, or (d) reasonably believes a creditor may attempt to obtain a preferential transfer.11 U.S.C. § 109(c)(1)-(5) (emphasis added). "Municipality" is defined in 11 U.S.C. §101(40) as a "political subdivision or public agency or instrumentality of a State."

[30] "State" as it is currently defined "includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under Chapter 9 of this title." 11 U.S.C. § 101(52).

Bekins also supports a State legislature appointing *de facto* chief restructuring officer to lead the State through a federal equity receivership The state legislature could propose such a person to act as a receiver to lead the debt restructuring effort and give that person power over the State necessary to carry out that role.Ideally, a state statute would authorize the appointment of a receiver/manager vested with the power to speak for the government, to propose, negotiate and, if necessary, litigate over the approval of a debt restructuring plan that is fair and equitable and in the best interests of creditors. Ideally, in the interests of preserving a level of local democracy, that statute would provide for consultation with elected officials, giving them some power to approve the restructure leader's proposals.

The Michigan Emergency Manager statute[31] provides one model of the powers that the state could give to an appointed official to control the finances of a state entity and use federal equitable powers while still respecting state control as required in Bankruptcy Code sections 903 and 904. That statute leaves little control for local elected officials, which worked out well for Detroit but poorly for Flint, Michigan.

Under the Michigan statute, the governor essentially appointed a Chief Restructure Officer for Detroit and gave him two years to finish restructuring Detroit's debt, using federal bankruptcy law if necessary, to accomplish the task. The Emergency Manager was given broad powers over city finances, including the power to formulate a restructure plan, to start a federal bankruptcy case to restructure Detroit's debt pursuant to a plan that he proposed, and to control city revenue and expenditure decisions as they might affect the debt restructure. Although Michigan's statute provides for very little consultation with elected officials, the exercise of emergency manager control resulted in a positive outcome for Detroit.

In contrast, in Flint, Michigan, the emergency managers' short-sighted focus solely on financial austerity rather than the greater public welfare led to a health crisis from a poisoned public water system. Local elected officials were largely powerless to protect public health from his actions. This illustrates the importance of continued consultation with elected officials by a person who might be appointed under a state statute to have sufficient power to lead a government in restructuring through a federal equity receivership.

7. What Kind of Discharge Order could be Entered in an Equity Receivership for a State?

If a federal equity receivership can handle the restructuring of the debt of a State, what power does it have to enforce its ruling restructuring and partially discharging the State's debt against holdouts who do not agree to the proposed restructuring plan and who wish to ignore the restructure? Two ways of dealing with this issue emerged over time, one

[31] Mich. Comp. Laws § 141.1541 et seq.

focusing on the debtor's assets, the other focusing on the creditors' claims against a government, both currently appear in the Bankruptcy Code.

a. Immunize Assets

In *Phipps*, *supra*, the court held that a federal receivership court could use equitable power to immunize the assets of a reorganized debtor from claims made by a holder of an original "unrestructured" claim. See section 4 above.

Similarly, as described in a leading treatise concerning sovereign debt restructure,[32] after Saddam Hussein was deposed from power, the United Nations Security Council supported Iraq's restructure of its sovereign debt by immunizing Iraq's oil assets from collection actions by unrestructured bond claimants.

> The exit consent that re-immunized Uruguayan assets from attachment by holdout creditors in 2003 prefigured a much more sweeping action by the United Stations Security Council (UNSC) following the ousting of Saddam Hussein in that same year. By the time he was asked to leave office, Saddam had accumulated a debt stock, most of it in default, equal of about US$140 billion. Iraq's economic recovery following the removal of the Saddam regime depended critically upon a satisfactory resolution of that gargantuan debt stock. UNSC Resolution 1483 (22 May 2003) was the instrument by which the international community sought to facilitate this debt restructuring.
>
> Among other things, Resolution 1483 strongly encouraged both Iraq and its Saddam-era creditors (official and private) to set about a comprehensive restructuring of those debts. Recognizing that holdouts in such a restructuring could significantly undermine its effectiveness, however, the Security Council immunized all petroleum assets of Iraq against 'any form of attachment, garnishment, or execution', and clothed the proceeds of Iraqi oil sales (as well as the bank account into which the proceeds of all such oil sales were to be directed) with privileges and immunities identical to those enjoyed the United Nations itself. The obvious and intended effect of immunizing Iraqi assets in this way was to deflate any expectation on the part of prospective holdout creditors that a better recovery might follow litigation and enforcement of a judgment. The UNSC- mandated immunities for Iraq remained in place through the middle of 2011--long enough for Iraq to complete a successful restructuring of its Saddam-era debt stock that imposed an 89.75 percent net present value loss on the affected creditors. Resolution 1483 was later described by the US Congressional Research Service as "a stay on the enforcement' of debt claims.[33]

[32] R. Lastra and L. Buchheit, Sovereign Debt Management, (Oxford Univ. Press 2014).

[33] *Id*. p. 20 (internal references omitted). Note also that the US Congressional Research Service observed that:

Indeed, Sovereign Debt Management suggests that other government entities might have the power to issue such injunctions in support of a government debt restructure.

> It has been proposed elsewhere that the 2012 Treaty Establishing the European Stability Mechanism might be amended to immunize, within the Eurozone, the assets of a debtor country receiving financial support from the European Stability Mechanism (ESM--the European bailout fund) against attachment by a creditor who was invited to participate in an ESM-approved debt restructuring, but declined to do so. The objective of such a measure would be similar to UNSC Resolution 1483 for Iraq: to encourage creditor participation in debt restructurings by dimming the outlook for a successful alternative litigation strategy.[34]

Such an injunction, whether issued in an equity receivership, by the United Nations or an E.U. entity, is the functional equivalent of the discharge injunction issued in a federal equity receivership in *Phipps*. It is currently provided in chapter 11 cases by Section 1141 of the Bankruptcy Code which protects the property of the reorganized debtor.[35]

> The Iraq case thus illustrates that the United States and the international community are willing to shield a debtor from its creditors bankruptcy regime. This can be accomplished multilaterally through U.N. Security Council Resolutions or bilaterally, on a case-by-case basis, through executive orders. Since these measures were not taken on other recent financial crises-afflicted countries, such as Argentina or Brazil, it appears that policymakers are only willing to use such measures selectively, and for countries that exhibit a perceived threat to U.S. and international security. This understanding is made more explicit by implementing the stay through the United Nations, a political institution seen principally as focused on international security, rather than the International Monetary Fund, which is primarily a financial institution. Sovereign Debt Management suggests that other government entities might have the power to issue such injunctions in support of a government debt restructure.

[34] Sovereign Debt Management, pp. 20-21. (internal references omitted)

[35] (a) Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.

(b) Except as otherwise provided in the plan or the order confirming the plan, the confirmation or **a plan vests all of the property of the estate in the debtor**.

(c) Except as provided in subsection (d)(2) and (d)(3) of this section and except as otherwise provided in the plan or in the order confirming the plan, after confirmation of a plan, **the property dealt with by the plan is free and clear of all claims and interests** of creditors, equity security holders, and or general partners in the debtor.

(d) (1) Except as otherwise provided in this subsection, in the plan, or in the order confirming the plan, the confirmation of a plan—

(A) discharges the debtor from any debt that arose before the date of such confirmation, and any debt of a kind specified in section 502(g), 502(h), or 502(i) of this title, whether or not—

(i) a proof of the claim based on such debt is filed or deemed filed under section 501 of this title;

(ii) such claim is allowed under section 502 of this title; or

(iii) the holder of such claim has accepted the plan.

...

The foundation for a section 1141 discharge injunction is 28 U.S.C. § 1334(e) which gives a federal district court handling a bankruptcy case "exclusive jurisdiction . . . [over] (1) all of the property, wherever located, of the debtor as of the commencement of the case. . ." Based on this section, 11 U.S.C. § 541 creates a debtor's "estate" as of the commencement of the case. The discharge injunction of section 1141 applies to all "property" of the chapter 11 debtor's "estate" as defined in section 541.

b. Enjoin Creditors

By contrast, Bankruptcy Code sections 904 and 941 permit a municipality, as a state entity, to keep control over its "assets" and "revenues," and to be the only entity that can propose a plan to adjust its debts. Such provisions make chapter 9 constitutional under the Supreme Court's analysis in *Bekins*.

Section 541 regarding "property of the estate" is not incorporated into chapter 9 pursuant to 11 U.S.C. § 901 because, unlike in chapter 11, there is no "estate" consisting of the municipal debtor's assets that is theoretically given over to the bankruptcy court during the reorganization case. Rather, the state entity debtor keeps control of its assets as provided by section 904. Consequently, a discharge injunction such as imposed pursuant to section 1141, based on the federal bankruptcy court's control over the debtor's assets, was not included in chapter 9 of the U.S. Bankruptcy Code. 11 U.S.C. § 901.

Rather, chapter 9 contains section 944 which binds "creditors" who were or could have been active parties in the case, rather than focusing on the property of the government entity.[36] This is in keeping with Bankruptcy Code section 904.[37]

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11 U.S.C. § 1141. (emphasis added).

[36] (a) The provisions of a confirmed plan bind the debtor and any creditors, ether or not—
(1) a proof of such creditor's claim is filed or deemed filed under section 501 of this title;
(2) such claim is allowed under section 502 of this title; or
(3) such creditor has accepted the plan.
(b) Except as provided in subsection (c) of this section, the debtor is discharged from all debts as of the time when—
(1) the plan is confirmed;
(2) the debtor deposits any consideration to be distributed under the plan with a disbursing agent appointed by the court; and
(3) the court has determined--
(c) The debtor is not discharged under subsection (b) of this section from any debt—
(1) excepted from discharge by the plan or order confirming the plan; or
(2) owed to an entity that, before confirmation of the plan, had neither notice nor knowledge of the case. 11 U.S.C. § 944

[37] Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with
(1) any of the political or governmental powers of the debtor;
(2) any of the property or revenues of the debtor; or
(3) the debtor's use or enjoyment of any income-producing property.
11 U.S.C. § 904. (emphasis added)

There should be no conflict between a sovereign state's control over its assets and the power of a restructure court to issue an injunction immunizing a government debtor's assets from claims except claims that have been restructured by a court-approved reorganization plan. Still section 944 suggests that court control over creditor parties is an important part of the analysis in a government insolvency case.

c. A Section 944 Discharge Injunction and Sovereignty

Section 944 provides an alternate theory for a federal equity receivership court to enforce its judgment that the government debtor's plan to restructure its debt is fair and equitable and should be enforced. Section 944 focuses on the essence of sovereignty, the ability of a government to control claims against itself and its assets asserted by creditors claiming some kind of waiver of sovereign immunity.[38] Everyone who deals with a sovereign government knows, or should know, that a sovereign has the power to decide whether and to what extent to waive its sovereign immunity; and, a sovereign has the inherent police power to protect the welfare of its citizens.[39]

As the Supreme Court said in *Asbury Park*,

> The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, cannot be available for distribution.
>
> … A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power. Indeed, so far as the Federal Constitution is concerned, the taxing power of a municipality … is wholly subordinate to the unrestrained power of the State over political subdivisions of its own creation.
>
> …
>
> In effect, therefore, the practical value of an unsecured claim against the City is inseparable from reliance upon the effectiveness of the city's taxing power.
>
> The only remedy for enforcement of such a claim is a mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depressions of '73 and '93, shows that the right to enjoin claims against the city through mandamus is the empty right to litigate.[40]

Section 944 goes to the heart of these issues when it aims a discharge injunction at creditors who assert claims against the debtor government, rather than at the government's assets over which government retains control.

[38] *See, e.g., Asbury Park*, 316 U.S. at 510-12.
[39] *Id.*
[40] *Asbury Park*, 316 U.S. 509-11.

8. Joining all Parties Necessary to Make a Discharge Order Effective

It would help to enforce a bar order approving a plan of reorganization in an equity receivership if all bond creditors were a party to the proceeding as they would be in a chapter 9 case.

A leading sovereign debt restructure lawyer suggested that the mandatory class action mechanism contained in the US Federal Rules of Civil Procedure FRCP 23(b)(1)(B) might provide a procedure to deal with holdouts in a restructure.[41] The FRCP mandatory class action mechanism could provide for a ratable allocation of the sovereign's debt servicing capacity.[42] But it permits opt outs from settlements, precisely the kind of loophole that holdouts could exploit to maximize their returns to the detriment of the debtor and settling creditors.

FRCP 19 concerning joinder of necessary parties could address the holdout problem more comprehensively.[43] While it might be more difficult to implement, requiring service and joinder of all affected bond debt parties, it could be more effective as it does not permit holdouts to opt out.[44]

The plain words of FRCP 19 support the joinder of all a debtor government's major creditors if:

> **(A) in that person's absence, the court cannot accord complete relief among existing parties; or**
>
> **(B) that person claims an interest relating to the subject of the action and is so situated that disposing of the action in the person's absence may:**

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[41] Buchheit and Gulati (n. 23), 1352-7. "The true successor to the old equity receivership technique, however, may lie in the federal class action procedures. FRCP 23 contains the rules for the commencement, certification, and settlement of class actions in U.S. federal courts. The prerequisites to a class action in a federal district court are set out in FRCP 23(a):"

[42] R.M. Lastra and L. Buchheit, *Sovereign Debt Management*, at p. 22 (Oxford Press 2014).

[43] Required Joinder of Parties
(a) Persons Required to Be Joined if Feasible.

[44] F. R. Civ. P. Rule 19. Required Joinder of Parties provides as follows:
(a) Persons Required to Be Joined if Feasible.
(1) ***Required Party.*** A person who is subject to service of process and whose joinder will not deprive the court of subject-matter jurisdiction must be joined as a party if:
(A) in that person's absence, the court cannot accord complete relief among existing parties; or
(B) that person claims an interest relating to the subject of the action and is so situated that disposing of the action in the person's absence may:
(i) as a practical matter impair or impede the person's ability to protect the **(ii)** leave an existing party subject to a substantial risk of incurring double, interest; or multiple, or otherwise inconsistent obligations because of the interest.
(2) ***Joinder by Court Order.*** If a person has not been joined as required, the court must order that the person be made a party. A person who refuses to join as a plaintiff may be made either a defendant or, in a proper case, an involuntary plaintiff.

> **(i) as a practical matter impair or impede the person's ability to protect the interest; or**
>
> **(ii) leave an existing party subject to a substantial risk of incurring double, multiple, or otherwise inconsistent obligations because of the interest.**

The Fifth Circuit's rationale for an equity receivership in *Stanford* describes persuasively why these Rule 19 standards require joinder of all bond creditors to avoid incomplete, inconsistent and unfair results.

> …[F]ederal district courts can utilize the receivership mechanism where a troubled entity will not be able to satisfy all of its liabilities to similarly situated creditors.
>
> Where the troubled entity is unable to meet its obligations, creditor-investors encounter a collective-action problem: each has the incentive to bring its own claims against the entity, hoping for full recovery; but if all investors take this course of action, latecomers will be left empty-handed. A disorderly race to the courthouse ensues, resulting in inefficiency as assets are dissipated in piecemeal and duplicative litigation. The results are also potentially iniquitous, with vastly divergent results for similarly situated creditors.
>
> So it is that at the behest of the SEC the district court may take possession of the entity and its assets, and vest control in its officer, the receiver. The court empowers the receiver to "stand in the shoes" of the troubled entity, allowing him to override holdout creditors and reach decisions for the aggregate benefit of creditors under the court's supervision.
>
> If so directed by the court, the receiver will systematically use ancillary litigation against third-party defendants to gather the entity's assets. Once gathered, these assets are used to satisfy liabilities to the entity's creditors, not in a disorderly creditor feeding frenzy, but through a court-supervised administrative distribution process.
>
> Receivership is thus a substitution of orderly, equitable creditor recovery for the chaos and inefficiency of individualized creditor litigation with its irrational allocation of recoveries—one born of necessity.[45]

A subsequent paper will discuss in greater detail the use of FRCP 19 (joinder of necessary parties) and FRCP 23 (class action) to add to the power of a U.S. federal court to enforce its decision that a government debtor's plan of reorganization is fair and equitable and in the best interests of creditors, and to enforce restructure of claims pursuant to that plan, including reduction of claims.

9. <u>Substantive Standards for Debt Restructure in a Federal Equity Receivership for a State</u>

Were a State to initiate a federal equity receivership, it could rely upon fundamental principles such as *fair and equitable* and *best interests of creditors* that were both

[45] 931 F.3d at 394. (citations omitted).

originally developed in railroad equity receiverships. As one noted bankruptcy scholar observed:

> The Court's 1939 decisions in *Taylor v. Standard Gas and Electric Co.*, 306 U.S. 307 (1939) and *Case v. Los Angeles Co*., 308 U.S. 106 (1939), extended the principles of the fair and equitable test formed in the railroad equity receivership cases to the reorganization of non-railroad businesses.[46]
>
> Bankruptcy Act §77B(f)'s words requiring that the plan be "fair and equitable" were "words of art" which "had acquired a fixed meaning through judicial interpretation in the field of equity receivership reorganizations" …[47]

Fair and equitable and best interests of creditors are both common sense principles of equity. When applied to a government, one focuses on how much a government debtor can reasonably afford to pay. The other focuses on how much the creditor could collect using its limited remedies against a government debtor. Federal courts have the power to apply these principles in a federal equity receivership for a government entity, and they should govern the approval of a debt restructuring plan for a government entity in such a proceeding.

a. <u>Governments, Like Railroads, Should Not Be Liquidated</u>.

The Supreme Court has recognized that governments, like railroads, should not be liquidated to pay creditors. Both are important to the public. Accordingly, reorganizations for both ought to be based on projected cash flows, not the hypothetical liquidation value of assets that ought not be sold. In *Kelley v. Everglades Drainage District*, 319 U.S. 415 (1943), the Supreme Court noted:

> . . .[T]he reorganization of properties which cannot readily be liquidated requires resort to "practical adjustments, rather than a rigid formula," *Consolidated Rock Products Co. v. DuBois, supra*, 529. Hence, we concluded that findings of the future earnings of the reorganized railroad distributable to each class of security holders and creditors were an adequate substitute for findings of asset value in terms of dollars and cents, which we held could be dispensed with as affording no more than a delusive appearance of a certainty which the subject matter did not warrant.
>
> Delusive exactness of findings is likewise not demanded in cases of municipal bankruptcy. But where future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available

[46] K. KLEE, BANKRUPTCY AND THE SUPREME COURT, p. 377 (2005).
[47] *Id.* At 380.

basis for appraising the respective interests of different classes of creditors.[48]

b. Best Interests of Creditors.

"[B]est interests of creditors" has a different meaning in chapter 9 concerning governments than it does in chapter 11 concerning corporations. In chapter 11, this test is set forth in section 1129(a)(7)(A)(ii) and focuses on a hypothetical liquidation of the debtor's assets. It requires that each holder of a claim receive under the plan "not less than the amount such holder would so receive … if the debtor were liquidated under chapter 7."

This plan confirmation requirement is, however, not included in the list of section 1129(a) subsections that are made applicable in chapter 9.[49] The legislative history of chapter 9 shows that Congress intended this explicit exclusion.

> "…The best interests of creditors test does not mean liquidation value as under Chapter XI of the Bankruptcy Act. In making such a determination, it is expected that the court will be guided by standards set forth in *Kelley v. Everglades Drainage District*, 319 U.S. 415 (1943) and *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940)… ."[50]

Both of the cases cited in the legislative history assumed that the municipal debtor's assets would not be sold.

In *Kelley v. Everglades*, the Supreme Court held that the findings supporting confirmation of the plan were so inadequate that it vacated the confirmation order and remanded for additional findings.[51] However, in setting guidelines for the remand, the court noted that since a municipal bankruptcy case, like a railroad equity receivership case, involves "reorganization of properties that cannot readily be liquidated,"[52] when a reorganization plan proposes to pay a secured creditor's claim from future earnings rather than from sale of collateral, the court need not determine the value of the collateral.[53] Rather, it is only

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[48] *Id.* At 419-20.
[49] 11 U.S.C. § 901(a).
[50] Statement of the Hon. Don Edwards, Chairman of the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary, upon Introducing the House Amendment to the Senate Amendment to H.R. 8200, 124 *Cong. Rec.* H 11089 (Sept. 28, 1978) (footnotes omitted); Statement by the Hon. Dennis DeConcini, Chairman of the Subcommittee on Improvements in Judicial Machinery of the Senate Committee on the Judiciary, upon Introducing the Senate Amendment to the House Amendment to H.R. 8200, 124 *Congressional Record* S 17406 (Oct. 6, 1978).
[51] *Kelley v. Everglades*, 319 U.S. at 422.
[52] *Id.* at 419.
[53] *Id*. ("Hence we concluded that findings of the future earnings of the reorganized railroad distributable to each class of security holders and creditors were an adequate substitute for findings of asset value in terms of dollars and cents, which we held could be dispensed with as affording no more than a delusive appearance of a certainty which the subject matter did not warrant.").

necessary to evaluate the future cash flows which were the source of funding for the plan.[54]

In *Fano*,[55] the other case cited in the chapter 9 legislative history concerning the best interests test, an objecting bondholder appealed a plan in which the debtor proposed to reduce by one- third the principal amount of bonds it had issued to build an irrigation system. The Ninth Circuit noted that the debtor had spent twice what was needed to refurbish its equipment and had failed to show why it was unable to use its taxing power to enact the small tax increase that would have permitted it to make its bond payments.[56] The court concluded that, in view of this evidence, the plan was not "'equitable' and 'fair' and for the 'best interests of creditors.'"[57]

In reversing the confirmation of the debtor's plan, the court's "best interests of creditors" analysis focused not on any hypothetical liquidation value of the debtor's assets, but on (i) whether the municipality had spent its money reasonably and (ii) whether it had made adequate use of taxation. As will be shown below, this particular formulation of best interests of creditors is what the courts developed under the fair and equitable standard.

A year before its decision in *Kelley v. Everglades*, the Supreme Court made a "best interests of creditors" analysis the centerpiece of its opinion in *Asbury Park*.[58] In that case, bondholders asserted that a reduction in the bond interest rate implemented in a plan remedying a municipal insolvency had impaired their contract rights. The Supreme Court explained that, when considering how a municipal restructuring plan can best resolve the claims of unsecured creditors, the focus should be on how "the municipality is to be kept going as a political community and, at the same time, [realize] the utmost for the benefit of the creditors."[59] The Supreme Court observed that:

> The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, cannot be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power [60]

The opinion highlighted the distinction between the broader remedies available to creditors with claims against private entities and the much more limited mandamus

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54 *Id.* ("[W]here future tax revenues are the only source to which creditors can look for payment of their claims, considered estimates of those revenues constitute the only available basis for appraising the respective interests of different claims of creditors.").
55 *Fano v. Newport Heights Irrigation Dist.*, 114 F.2d 563 (9th Cir. 1940).
56 *Id*. At 565-66.
57 *Id*. at 566.
58 *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942).
59 *Id.* At 510.
60 *Id.* At 509.

remedy available to unsecured municipal bondholders who cannot seize the city's assets.[61] It found that, in light of the poor remedies available to the unsecured bondholders,[62] the debt composition plan had actually made the bonds worth more than when default was looming, and, thus, there was no actual impairment of the bondholders' rights.[63] It was, in essence, in the best interests of creditors because it paid them more than they would receive by exercising their weak mandamus remedy. *Fano, Kelley v. Everglades* and *Asbury Park* confirm that a municipality should not be liquidated and that a municipality's debt restructuring plan should be premised on what the entity's revenues can support. The "best interest of creditors" analysis in those cases complemented the law that had developed during the Great Depression concerning what is "fair and equitable," directing the focus away from what could be recovered by stripping a governmental entity of its assets, toward how much a governmental entity could reasonably pay as it continues to operate and serve its citizens.

More recent cases have reached the same conclusion, noting that "Courts generally agree that the best interests of creditors test in §943(b)(7) requires 'that a proposed plan provide a better alternative for creditors than what they already have.'"[64] In the chapter 9 bankruptcy of Stockton, California, the appellate panel recognized that "[a] municipality cannot be liquidated, its assets sold, and the proceeds used to pay its creditors, ... Creditors cannot expect that all excess cash go to the payment of their claims. The debtor must retain sufficient funds with which to operate and to make necessary improvements in and to maintain its facilities. [Courts] must apply the test to require reasonable effort by the municipal debtor that is a better alternative to its creditors than dismissal of the case."[65]

c. Fair and Equitable

[61] [25] In effect, therefore, the practical value of an unsecured claim against the city is inseparable from reliance upon the effectiveness of the city's taxing power. The only remedy for the enforcement of such a claim is a mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depression of '73 and '93, shows that *the right to enforce claims against the city through mandamus is the empty right to litigate. Id*. at 509-10 (emphasis added).

[62] *Id.* at 514 ("The question whether the remedy on this contract was impaired materially is affected not only by the precarious character of the plaintiff's right, but by considerations of fact – of what the remedy amounted to in practice. To say that the right of the Asbury Park bondholders in 1935 was of precarious character is pure understatement. And we have already seen how empty was the remedy with which to enforce that right.").

[63] *Id.* at 515-16. ("Here we have just the opposite – no security whatever except the effective taxing power of the municipality; the effective taxing power of the municipality prostrate without state intervention to revive the famished finances of the city; state intervention, carefully devised, worked out with scrupulous detail and with due regard to the interests of all the creditors, and scrutinized to that end by the state judiciary with the result that that which was a most depreciated claim of little value has, by the very scheme complained of, been saved and transmuted into substantial value.").

[64] *In re City of Detroit*, 524 B.R. 147, 213 (Bankr.E.D.Mich.2014), quoting *In re Pierce County Housing Auth*., 414 B.R. 702, 718 (Bankr.W.D.Wa.2009)

[65] *City of Stockton (In re City of Stockton)*, 542 B.R. 261, 284-5 (B.A.P. 9th Cir. 2015)

The Bankruptcy Code provides that unsecured creditors who are not paid in full are treated fairly and equitably under a plan as long as "any claim or interest that is junior . . . will not receive or retain under the plan or on account of such junior claim or [equity] interest any property."[66] This is generally referred to as the "absolute priority rule" and, in corporate chapter 11 cases, it means that shareholders, the most junior class of claims or interests, cannot retain any equity ownership interests unless all holders of allowed unsecured claims are paid in full.[67] Often, when there is not enough value in a corporate chapter 11 case to pay creditors in full, existing corporate stock is cancelled and newly issued shares in the reorganized company are distributed to unsecured creditors under the chapter 11 plan.

Since there are no "equity owners" of a municipality, the literal terms of the absolute priority rule contained in section 1129(b)(2)(B)(ii) can easily be met in a municipal case even if unsecured creditors are not paid in full. One case decided under current chapter 9, *Corcoran Hospital*,[68] applied the absolute priority rule by its literal terms. It relied on bankruptcy cases of not-for-profit organizations in reaching its conclusion that it was permissible for a municipal debtor to "continue in existence and in possession of its property even though . . . unsecured creditors will not be paid in full."[69] It held that "control [of the debtor's assets] alone, divorced from any right to share in corporate profits or assets, does not amount to an equity interest."[70]

However, the *Corcoran Hospital* analysis did not end there. The court went on to apply what it called a "good faith" standard under section 1129(a)(3)[71] citing to two Great Depression era cases that had analyzed whether a plan was fair and equitable by considering whether spending had been reasonably limited or taxes reasonably increased.[72]

Cases analyzing whether a plan is "fair and equitable" have focused on a wide range of facts and theories.[73] A salient consideration has been whether a chapter 9 plan proposes

[66] 11 U.S.C. § 1129(b)(2)(B)(ii).
[67] *See*, *e.g.*, *Case v. L. A. Lumber Prods.*, 308 U.S. 106 (1939).
[68] *In re Corcoran Hosp. Dist*., 233 B.R. 449-58 (Bankr. E.D. Cal. 1999).
[69] *Id.* at 458.
[70] *Id.* ("The mere fact that . . . [citizens] are benefited by … [the municipality's] operations and might be disadvantaged by its demise also does not give them an 'interest cognizable in bankruptcy.'" "[T]he present group retaining control over the debtor entity does not give them anything. . . Certainly not a favored position over the dissenting creditors. It gives them problems and great anguish ahead.").
[71] *Id*., at 459.
[72] *Id.*, at 460-61, citing *Fano,* 114 F.2d at 565-66 and *Newhouse v. Corcoran Irrigation Dist.*, 114 F.2d 690, 691 (9th
Cir. 1940).
[73] 35 For example, under chapter IX of the old Bankruptcy Act, the fair and equitable standard was held also to include a feasibility requirement. *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415 (1943). Fair and equitable has been held to mean that the plan must embody a "fair and equitable bargain openly arrived at and devoid of overreaching." *Town of Belleair, Fla. v. Groves*, 132 F.2d 542, 542 (5th Cir. 1942), *cert. denied*, 318 U.S. 769 (1943). Fair and equitable has also been interpreted as requiring that there is no unfair discrimination in favor of any creditor or class of creditors. *Am. United Mut. Life Ins. Co. v. City of Avon Park*, 311 U.S. 138, 147 (1940).

to pay unsecured creditors "all that they 'can reasonably expect in the circumstances.'"[74] Applying this standard, some courts have denied confirmation when the debtor governmental entity did not sufficiently cut expenditures or did not make adequate use of taxation.[75] Other courts have determined that a plan is fair and equitable if it provides creditors with "the maximum … [the municipality] could reasonably pay."[76]

The analysis of whether "[creditors] are receiving all that they can reasonably expect" and whether the governmental entity is paying "the most … it could reasonably pay" has included the following inquiries: (i) has the municipality acted reasonably in reducing the scope and cost of the services it provides, (ii) has the municipality taxed its residents in a reasonable and adequate fashion,[77] and (iii) does the municipality have adequate funds to carry out its chapter 9 plan. The statute suggests, and courts have held, that a governmental debtor's business judgment on these issues is entitled to deference.[78]

Conclusion

There is thus substantial authority for a State to use a federal equity receivership to restructure its debt following the approach described in *Leading a Government to Solvency*.

A subsequent paper will describe how that approach might be used by a foreign sovereign, such as Argentina, whose debt is governed, in large part, by New York law with Southern District of New York as an agreed venue.

[74] *Lorber v. Vista Irrigation Dist*., 127 F.2d 628, 639 (9th Cir. 1942); COLLIER ON BANKRUPTCY §943.03 [1][f][i][B] (Alan N. Resnick et al. eds., 16th ed. rev. 2010).

[75] *See, e.g., Fano v. Newport Heights Irrigation Dist*., 114 F.2d at 565-66 (Confirmation denied where the debtor had spent twice what was needed on capital expenditures to improve facilities that had been in bad repair and, even with that, would only have had to raise taxes a small amount to meet existing bond obligations). However, taxes need not be increased where there is evidence that this would not be feasible. *In re Corcoran Hosp. Dist.*, 233 B.R. at 461 (Bankr. E.D. Cal. 1999) ("[I]n these cases under Chapter IX, the Ninth Circuit Court of Appeals looked at the insolvency of the debtor and whether the debtor could, in fact, raise taxes sufficient to pay the bondholders in full. Here the court has found that the debtor Hospital District could not raise taxes sufficient to pay more to Class 5.").

[76] *See, e.g.*, *Lorber v. Vista Irrigation Dist*. 143 F.2d 282, 284 (9th Cir. 1942), *cert. denied*, 323 U.S. 784 (1944). ("[H]eavy delinquencies in meeting assessments . . . an increase of taxes and assessments would make this matter worse . . . the need for large expenditures in the restoration to good working conditions of the District irrigation pipelines . . . the District bonds were listed on exchange at 18 cents; while RFC offered to refinance at 55¢ . . . substantial evidence that the District had been unsuccessful in obtaining a loan from sources other than RFC. We hold that the findings are a sufficient basis for the concluding paragraph IX to the effect that 55¢ on the dollar was the maximum that the District could reasonably pay on outstanding bonds.").

[77] The use of the power of taxation is within the discretion of the municipality. The U.S. Supreme Court has stated: The principal asset of a municipality is its taxing power and that, unlike an asset of a private corporation, cannot be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power. *Asbury Park*, 316 U.S. at 509.

[78] *See* 11 U.S.C. § 904; *see also In re Corcoran Hosp. Dist., supra; In re Sanitary & Improvement Dist. No. 7*, 98 B.R. 966 (Bankr. D. Neb. 1989).

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