

Pa. City Ch. 9 Ruling Raises Municipal Financing Concerns

By **Lary Stromfeld, Casey Servais and Ivan Loncar** (December 1, 2023)

On Nov. 3, the U.S. District Court for the Eastern District of Pennsylvania in the Chapter 9 bankruptcy case of the city of Chester, Pennsylvania, issued its ruling in an adversary proceeding challenging the perfection of the liens securing certain revenue bonds issued by the city.[1]

The court confirmed the municipal bond market's long-standing understanding that the liens on revenues were properly perfected by the filing of Uniform Commercial Code financing statements, which allow creditors to notify other creditors about a debtor's assets used as collateral for a secured transaction.

However, the court also held that the bondholders did not have a lien on revenues generated after the city filed its bankruptcy petition, by virtue of Section 552(a) of the U.S. Bankruptcy Code, which generally provides that prepetition liens cease to attach to property acquired after the commencement of a bankruptcy case.

Unlike its perfection ruling, the district court's rulings with respect to Section 552(a) appear to run counter to market expectations on a number of issues.

Specifically, the court concluded that a statutory lien and a consensual security interest could not coexist; that post-petition revenues did not constitute the proceeds of a prepetition right to receive such revenues; and that fees, as opposed to taxes, did not qualify as special revenues.

Background

In 2017, the city of Chester, Pennsylvania, issued two series of revenue bonds pursuant to an ordinance and a trust indenture.

The bonds were secured primarily by liens on three major revenue streams:

- An annual slot machine license operation fee that the state of Pennsylvania collects pursuant to the Pennsylvania Race Horse and Development Gaming Act from a Harrah's casino located in Chester, and a portion of which the state then pays to the city;
- A local share assessment that the Harrah's casino is required to pay to the state on account of its table games, and a portion of which the state distributes to the city; and
- Fees paid to the city by a waste incinerator operator pursuant to an agreement that authorized the operation of a waste incinerator in the city.



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In November 2022, the city filed for Chapter 9 bankruptcy protection. The city then commenced an adversary proceeding against the bondholders and their trustee, alleging that the bondholders' liens on the revenues were unperfected and could therefore be avoided, and that the bondholders' liens did not extend to post-petition revenues because of Section 552(a) of the Bankruptcy Code.

The court ultimately ruled for the bondholders on the perfection and avoidance issues, but ruled for the city on the Section 552(a) issue.

Analysis

UCC Financing Statements Can Perfect Liens on Municipal Revenues

Under the UCC, the method of perfecting a lien depends on the nature of the collateral and how it is characterized under the UCC.

In Chester's case, the city argued that the pledged revenues constituted money, a security interest in which can be perfected only by possession. Because the city alleged that the bondholders did not have possession of post-petition revenues as of the petition date, the city argued that their liens could be avoided.

The bondholders countered by arguing that the pledged revenues were properly characterized as either an account or a payment intangible for UCC perfection purposes. The UCC defines an account as a right to payment of a monetary obligation, and defines a payment intangible as a "general intangible under which the account debtor's principal obligation is a monetary obligation."

Unlike a security interest in money, a security interest in an account or a general intangible — including a payment intangible — can be perfected through the filing of a UCC financing statement, and the trustee for the bonds had in fact filed such UCC financing statements.

The court agreed with the bondholders that the pledged revenues were "more akin to an 'account' or 'payment intangible' than 'money' for purposes of perfection."

The district court's ruling appears to be one of the first to expressly hold revenues to constitute accounts or payment intangibles in the case of a municipal revenue bond.

Financing statements are routinely filed to perfect liens on revenues in the municipal finance context, so the district court's perfection holding was consistent with the practices and expectations of the municipal bond market.

Section 552(a) of the Bankruptcy Code

Section 552(a) of the Bankruptcy Code generally cuts off most security interests in property acquired by a debtor after the date of the bankruptcy petition.

There are three main exceptions to Section 552(a), which permit a prepetition lien to continue to attach to property acquired after the commencement of the bankruptcy case if:

- The prepetition lien is a statutory lien;
- The post-petition collateral constitutes proceeds of prepetition collateral; or

- The post-petition collateral qualifies as special revenues as defined in the Bankruptcy Code.

The Chester bondholders argued that each of these exceptions to Section 552(a) applied, but the court rejected the bondholders' arguments, ultimately holding that no relevant exception to Section 552(a) applied.

Certain of the court's rulings with respect to Section 552(a) undermine fundamental principles of revenue bond financing of municipal projects.

Statutory Lien Analysis

Because Section 552(a) by its terms applies only to a "lien resulting from a security agreement," Section 552(a) does not apply to a statutory lien that results from a statute rather than an agreement.

The Bankruptcy Code defines a statutory lien as one "arising solely by force of a statute on specified circumstances or conditions." [2]

The Chester bondholders argued that they had such a statutory lien arising from a provision of the applicable ordinance providing that the "City hereby irrevocably pledges the Pledged Revenues for the payment of the principal of, premium, if any, and interest on the Bonds and grants a security interest in and to all such Pledged Revenues."

The court rejected the bondholders' statutory lien argument, holding that because the bondholders had a consensual security interest arising from the applicable trust indenture, they did not have a statutory lien. In reaching this conclusion, the court relied on language from the legislative history of the Bankruptcy Code indicating that statutory liens and consensual security interests are mutually exclusive.

The court seemed to take this legislative history to mean that a statutory lien and a consensual security interest can never coexist, but that is by no means a consensus reading of the legislative history. A significant number of courts have instead read the mutually exclusive language in the legislative history simply to mean that a single lien cannot be both a statutory lien and a consensual security interest.

This does not necessarily mean that a statutory lien and a consensual lien cannot exist simultaneously if they arise from two different sources — i.e., one is created by a statute and the other is separately created by a security agreement.

Indeed, the court's approach leads to the illogical conclusion that a cautious creditor trying to create a lien regardless of which of the two sources applies instead runs the risk that no lien will be created.

The Chester bondholders argued that the applicable ordinance does create a statutory lien, because the ordinance itself irrevocably pledges the pledged revenues, and the term "pledged revenues" is defined within the ordinance itself without reference to the trust indenture.

Furthermore, the bondholders argued that an ordinance qualifies as a "statute" under Pennsylvania law, and the city did not meaningfully dispute that argument.

Section 552(b) "Proceeds" Analysis

The bondholders also argued that the Section 552(b) "proceeds" exception to Section 552(a) applies.

Section 552(b) permits prepetition liens to continue to attach to property acquired by the debtor after the commencement of the bankruptcy case if the post-petition collateral constitutes proceeds of prepetition collateral.

The bondholders argued that Section 552(b) applied because their prepetition collateral package included a security interest in the city's right to receive the pledged revenues, such that post-petition revenues were the proceeds of the city's right to receive those revenues.

The court rejected the bondholders' argument based on its reading of the applicable trust indenture, holding that the indenture just defined the applicable collateral as the pledged revenues themselves, without expressly granting a security interest in the city's right to receive the revenues.

Not only is the court's reading of the trust indenture inconsistent with creditors' expectations, it also runs counter to the court's own holding that the relevant collateral qualified as an "account" for UCC purposes, because the UCC defines an "account" as "a right to payment of a monetary obligation." [3]

A more internally consistent analysis therefore might have concluded that the collateral included the city's right to payment both for purposes of the UCC's perfection requirements and for purposes of the Section 552(b) "proceeds" exception.

Special Revenues Analysis

Section 928(a) of the Bankruptcy Code overrides Section 552(a) with respect to security interests in special revenues.

Section 902(2) of the Bankruptcy Code in turn defines "special revenues" to include "special excise taxes imposed on particular activities or transactions," among other categories of special revenues. [4]

The Chester bondholders argued that the fees and assessments that the state of Pennsylvania imposed on Harrah's slot machine and table game operations under the Gaming Act qualified as special excise taxes and therefore special revenues, but the district court rejected this argument by drawing a distinction between taxes and fees.

Specifically, the court concluded that the fees and assessments imposed on the casino under the Gaming Act were more like fees than taxes, because those fees and assessments were imposed only on specific entities operating gaming enterprises, and were imposed as a precondition to the privilege or benefit of operating such gaming enterprises.

To date, there has been limited authority interpreting the phrase "special excise taxes" specifically in the context of the Bankruptcy Code's "special revenues" definition.

Although the Chester decision surely will not be the last word on this issue, participants in the municipal bond market should be aware of the court's distinction between fees and taxes as potentially relevant to their assessment of how likely particular revenue streams are to qualify as special revenues.

Conclusion

The district court's holding that a revenue pledge can be perfected through the filing of a UCC financing statement is consistent with the municipal bond market's long-standing practice and expectations, and therefore serves to strengthen the foundations of the municipal bond market.

However, other aspects of the court's decision demonstrate that bankruptcy courts continue to struggle with some of the unique features of municipal revenue bonds and issue rulings that contradict market expectations.

In part, bankruptcy courts' lack of familiarity with some of the nuances of municipal finance may result from the fact that Chapter 9 municipal bankruptcy cases have been relatively rare historically as compared to other types of bankruptcy cases.

One might hope that, as the Chapter 9 case law continues to develop, bankruptcy courts may gradually become better equipped to interpret municipal revenue bonds in a manner more consistent with the expectations of market participants.

The Chester bondholders filed a notice of appeal on Nov. 14, and the appeal has been assigned to U.S. District Court Judge Mia Roberts Perez. Additional insights on important municipal bankruptcy issues may therefore be forthcoming from the district court.

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[1] See *In re City of Chester*, Adv. Proc. No. 22-00084-AMC, 2023 WL 7274750 (Bankr. E.D. Pa. Nov. 3, 2023).

[2] 11 U.S.C. § 101(53).

[3] See 13 Pa.C.S.A. § 9102.

[4] See 11 U.S.C. § 902(2)(B).