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US P3 Bankruptcy Cases Raise Structuring Considerations

By George K. Miller

Three cases filed under US bankruptcy law are testing the structures of P3 projects. The cases are proving that risks are effectively transferred under the P3 procurement model, but they also show that project counterparties should ascertain at the outset of a transaction what a concessionaire's eligibility for relief is under the bankruptcy law. George K. Miller, a partner in Mayer Brown's New York office, takes a look at the three cases. Miller is a member of the law firm's global projects, infrastructure and asset finance groups. He concentrates on international and domestic finance and leasing, in particular in the infrastructure, transportation and energy sectors.

The bankruptcy filings earlier this year by the Las Vegas Monorail Company, South Bay Expressway, L.P. and Connector 2000 Association have tested the structures used in public-private partnerships in the US in several respects. It's still too early to draw definitive conclusions about the impact on P3 structures in the future, but initial rulings in two of them are already focusing the minds of project participants on better structures for their transactions.

In the Las Vegas Monorail case, the bankruptcy court for the District of Nevada handed down two important decisions last spring. In the first, it said the debtor, a not-for-profit corporation, is eligible for relief under Chapter 11 of the Bankruptcy Code. Ambac, the insurer of the company's secured tax-exempt bonds, had challenged that filing on the grounds that the debtor is a government instrumentality that could only file under Chapter 9 of the Code. Nevada state law does not authorize municipalities to file under Chapter 9. Had Ambac prevailed, the monorail would not have been entitled to relief from its creditors. Eligibility for Chapter 9 seemed plausible, since issuers of private activity bonds must be government entities. The bankruptcy judge said Ambac's argument does have "some merit," but that the "low level of state control" of the company means that the monorail is not a municipality.

The South Carolina Case

Connector 2000 Association, a similar entity holding a toll road concession in South Carolina, filed under Chapter 9. The South Carolina Department of Transportation (SCDOT), the grantor of the concession, objects to the Chapter 9 filing. SCDOT is an unsecured creditor of the Connector for license fees and unreimbursed maintenance expenses due under their license agreement. While the Connector could re-file under Chapter 11 (as the Las Vegas monorail did originally) if SCDOT prevails on its objection, SCDOT appears to assume its interest as a creditor would be better protected under that chapter.

The distinction between Chapter 9 and Chapter 11 is also important for reasons other than the availability of relief.

Chapter 9 generally places, in part for federalism reasons, much less incentive on the parties to agree a reorganization plan than Chapter 11. This is because (1) there is no involuntary Chapter 9 proceeding, (2) there is no equivalent to Chapter 7 providing for liquidation of municipalities, (3) the debtor is the only

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party that is entitled to file a reorganization plan and (4) unlike in Chapter 11, the court may not prevent the debtor from, or direct it in, conducting its affairs as it sees fit. On the other hand, Chapter 9 says post-petition revenues securing revenue bonds remain subject to the lien of secured creditors notwithstanding the Bankruptcy Code's prohibition of liens on after-acquired property (but the lien is limited to revenues after paying the project's necessary operating expenses).

Pay Attention to Relief Eligibility

Project counterparties should ascertain a concessionaire's eligibility for relief under either Chapter 9 or Chapter 11 at the outset of a transaction, even though there have been few cases interpreting the Chapter 9 eligibility criteria.

The second Las Vegas ruling highlights another pitfall under either chapter.

The judge held that the trustee for the company's bondholders is not entitled to adequate protection in respect of its asserted lien on the company's revenues. The bond documents attach the trustee's lien to such revenues only after payment of operating expenses. Nor are such revenues considered to be proceeds of the Company's right to operate the monorail under its franchise agreement. The court implied that any payments required from Clark County, the franchisor, under the agreement would have constituted such proceeds. It follows that "availability payments" required by concession grantors under a different structure would seem to qualify as proceeds of the concession agreement. Even a lien on the track or rolling stock, which the bond trustee did not have, might have supported such a characterization of the company's revenues.

As noted, in Chapter 11, a secured creditor's lien on post-petition revenues is cut off, unless these are proceeds of other collateral. In the Las Vegas case, the monorail's revenues were not proceeds. Even if they were, however, the bond trustee's lien covered only the surplus left after operating expenses.

Accordingly, a secured creditor would be well advised to require a lien on all project revenue and assets to avoid any question about whether revenue is covered, even though the continuing lien on revenues subject to operating expenses under Chapter 9 (which appears similar to the lien in the Las Vegas case) obviates the need for adequate protection as to that collateral.

The Las Vegas case also throws into relief the structural differences between traffic risk projects and availability payment projects: in a Chapter 11 case, even if a creditor's lien on revenues is limited, availability payments might qualify as proceeds of its lien over the concession agreement and thus be entitled to adequate protection, even if the latter lien otherwise affords the creditor limited rights over the project.

Of course, availability payments remove traffic risk, but they also engage the credit of the concession grantor and related issues of appropriation risk and taxpayers' bills of rights, not to mention whether it is eligible to file under Chapter 9 and might seek to reject the concession upon such a filing.

The SBX Case

In the South Bay Expressway case, the bankruptcy court for the Southern District of California validated mechanic's liens securing claims including the substantial cost overruns asserted against State Route 125 by the project's construction contractor (despite public ownership of the project subject to the debtor's concession) that precipitated the bankruptcy filing and in the first instance would prime the liens of the project's secured lenders. But the court ruled that the contractor had waived its priority by certifying as to the absence of claims in ongoing payment requisitions.

Both the bankruptcy filing and the subordination of the mechanic's lien could have been avoided by careful drafting of change order, lien waiver and dispute resolution provisions, resulting in earlier identification and resolution of any disputes. This case is also the first test of the U.S. Department of Transportation's (USDOT) "springing parity" with senior secured creditors under its TIFIA subordinated loan program. This parity hasn't been challenged, but it remains to be seen how much control it gives USDOT under its intercreditor agreement.

These early bankruptcy rulings are subject to appeal and are sure to be succeeded by others. They do, however, already underline the need for prompt and close attention to structuring considerations in P3 financings, including understanding the bankruptcy status of the debtor, the implications of gaps in the collateral package, differing ramifications of traffic risk versus availability payment structures and the possible impact of mechanics' liens securing cost overruns.

Risk Transfer

The cases also reveal constraints limiting P3 projects' flexibility in negotiating any restructuring. For example, the term of a concession is limited and cannot be extended without the consent of the grantor. Such an extension may provide an additional period of earnings over which to extend repayment of some of the project's debts. Finally, the public actors involved are not driven solely or even primarily by purely commercial considerations.

These things being said, from a policy perspective, P3 bankruptcy filings can be argued to have shown the P3 model works as intended: concessions have effectively shifted financial risk to the private parties, while the Bankruptcy Code permits projects to be completed and serve the public while the concessionaire reorganizes. ◆