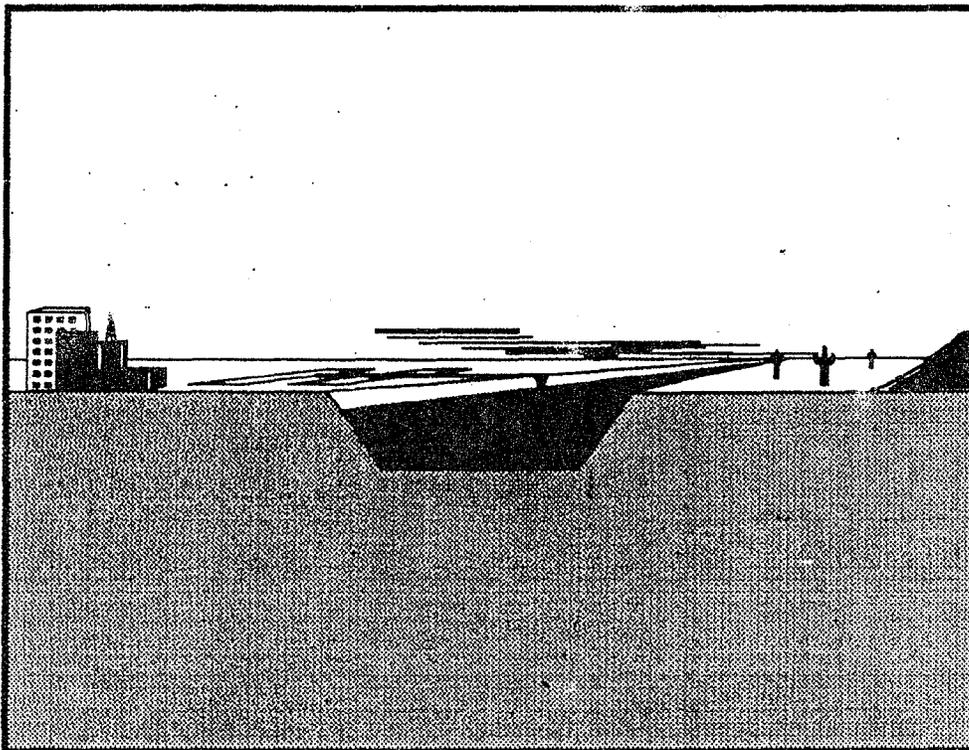


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# **GOVERNOR'S CENTRAL ARIZONA PROJECT ADVISORY COMMITTEE**

## **CAP IRRIGATION DISTRICT DEFAULT AND BANKRUPTCY ISSUES**



**Prepared by Arizona Department of Water Resources**

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**I. INTRODUCTION AND SUMMARY OF THE OBLIGATIONS OF THE IRRIGATION DISTRICTS RELATING TO CAP**

This memorandum is prepared for the Governor's Central Arizona Project Advisory Committee (Committee) as a supplement to the "No Action" analysis. It is intended to provide an analysis of the legal issues related to a possible future default of the CAP irrigation districts on contract and bond obligations and a possible future petition by the irrigation districts under Chapter 9 of the federal bankruptcy code. The question of greatest concern to the Committee is the impact of default or bankruptcy of an irrigation district on the obligation to continue water delivery to the irrigation district and on the obligations of the other CAP water users.

There are four contract and bond obligations that must be analyzed:

1. the Master Repayment Contract, in which the United States agreed to construct the CAP works and to deliver water to the Central Arizona Water Conservation District (CAWCD) in return for the CAWCD's repayment of reimbursable costs of the project;
2. the water delivery contracts and subcontracts among the United States, the CAWCD and each CAP water user for water service and for the contribution of the water users to the operation, maintenance and replacement ("OM&R") costs of the Project and the repayment obligation under the Master Repayment Contract;
3. the Federal 9(d) Contracts between the United States and the irrigation districts for the construction of distribution systems to transport the CAP water within the boundaries of the irrigation districts; and
4. the private bonds which allowed the irrigation districts to meet the 20 percent cost sharing requirement of the Federal 9(d) Contracts.

The impact of default and bankruptcy on each of the contract and bond obligations will be further explored.

## II. STATE STATUTES RELEVANT TO IRRIGATION DISTRICT DEFAULT AND BANKRUPTCY

The inquiry into the impact of default and bankruptcy must begin with the statutes authorizing and constraining the administration of the CAP irrigation districts.

### A. Taxation and Assessment Authority and Liens

To fulfill their contract and bond obligations, the irrigation districts may collect funds through their taxing and assessment authorities under A.R.S. §§ 48-3111 through -3169. The majority of the districts have fund collection authority through the counties' tax collection process described in A.R.S. §§ 48-3111 through -3133. However, the irrigation districts also have the power to levy assessments on the real property of the district and to collect funds for the payment of contract and bond obligations. A.R.S. §§ 48-3151 through -3169 address the required notice and collection, the creation of liens, and the sale of property to enforce the levy.

A.R.S. § 48-2990 provides that the irrigation district board of directors may provide that charges for water service shall become a lien upon the land served until paid in full and the board may withhold water service from any parcel of land pending payment of the water tax assessed against such a parcel. The district taxes and assessments levied and assessed are the first liens against the district lands except for lands owned by the United States or the state. A.R.S. § 48-3159.

*Under these state taxation and assessment provisions, the irrigation districts have a mechanism to fulfill their contract and bond obligations. Water service may be withheld from delinquent land and the irrigation district may enforce a first lien on such land.<sup>1</sup>*

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<sup>1</sup>Under the county tax collection system, an individual can pick up the tax certificate on the subject property and pay taxes for three years. After that time, the individual can obtain a Treasurer's deed and initiate legal action to acquire clear title. A.R.S. § 42-451. During this three year period the landowner is given the opportunity to redeem the lien. See A.R.S. § 42-381 to 454.

**B. Dissolution and Boundary Changes**

The irrigation districts may dissolve pursuant to a petition and election process only when "all indebtedness of every nature whatever has been fully satisfied and paid." A.R.S. § 48-2954. In addition, the provisions governing contracts with the United States limit the authority of the district to dissolve, change its boundaries or release or discharge the obligation of any parcel of land. A.R.S. § 48-3098 provides:

When a contract has been entered into between the United States and an irrigation district, the district shall not be dissolved nor shall the boundaries be changed, nor shall any specified parcel of land be released or discharged from the outstanding bonded indebtedness of the district . . . by payment of a proportion of such indebtedness . . . except upon the written consent of the secretary of interior . . . . If consent is given . . . the excluded lands shall be free from all liens and charges for payments to become due to the United States.

*These statutory provisions ensure that the irrigation districts will remain in existence until their contractual and bond obligations are satisfied.*

**C. Statutory Process for District Insolvency**

The Arizona Legislature also provided a mechanism for the irrigation district or its bondholders to address a default or impending default of the irrigation district in the discharge of its financial obligation with respect to any issued and outstanding bonds. A.R.S. § 48-3241 et seq. describes a detailed process in which the irrigation district or a single bondholder may petition the State Certification Board. The petition of the irrigation district, by resolution of its board of directors, must set forth the financial difficulties and the relief sought. The bondholder's petition must state that a default has occurred. If the petitions are in order, the State Certification Board calls a meeting of all bondholders. A.R.S. § 48-3241.

At the meeting, a committee is formed consisting of three members elected from among the bondholders, three members of the district's board of directors, and the three members of the State Certification Board. At these meetings the bondholder is entitled to one vote for each dollar or major fraction thereof of the principal amount of the bonds held which are surrendered to and certified to be held by the State Treasurer. A.R.S. § 48-3242.

The committee is to formulate a plan to be known as the "Bondholders' Agreement" to restore the district to solvency at the earliest practicable date. The Bondholders Agreement must be adopted or rejected, separately, by the majority vote of the full board of directors and the majority-in-value vote of the bonds represented. If no agreement can be reached within one year from the first meeting, the State Treasurer will return the bonds deposited. A.R.S. § 48-3243. If, on the other hand, an agreement is reached, and bonds aggregating at least 51 percent of all outstanding bonds are deposited with the State Treasurer within two years from the date of adoption of the agreement, the board of directors will petition the superior court to approve the Bondholders' Agreement for retiring or refunding the bonds. A.R.S. § 48-3244 and § 48-3249.

After notice and opportunity for the filing of dissents to the agreement, the superior court shall hear the matter and if all procedures are found to have been followed, the court shall declare the Bondholders' Agreement effective. A.R.S. §§ 48-3245 through 48-3248. The committee may perform, enforce and carry out the terms and conditions of the Bondholders' Agreement. A.R.S. § 48-3253. The committee's actual and necessary expenses are to be paid as other operating expenses of the irrigation district.

*As discussed in the remaining sections of this memorandum, other remedies are available for default in addition to this committee process. A question may arise as to whether the bondholders must exhaust this statutory remedy before taking other action. The answer appears to be "no." There is nothing in these statutory provisions that indicates that this is an exclusive*

*or primary remedy and, in fact, specific statutory authorization of other remedies indicates otherwise. The issue of whether a petition for bankruptcy stays the State Certification Board process will be discussed in Section V.C. of the memorandum.*

**D. Bankruptcy of Taxing District**

A.R.S. § 35-601 et seq. authorizes any taxing district in Arizona to file a petition under the federal bankruptcy statutes and to consummate a plan of debt readjustment. Bankruptcy issues will be more fully discussed in Section V. of this memorandum.

**III. CONTRACT AND BOND RESOLUTION LANGUAGE RELEVANT TO IRRIGATION DEFAULT AND BANKRUPTCY**

The inquiry into the impact of default and bankruptcy must also include as analysis of the contracts and bond resolutions which evidence the intent of the parties.

**A. Master Repayment Contract**

The United States, through the Bureau of Reclamation, and the CAWCD entered into a contract for delivery of water and repayment of the CAP in 1972. This Master Repayment Contract, authorized in section 304(b)(1) of the Colorado River Basin Project Act, 82 Stat. 885 (1968), was amended in 1988. In the contract, the United States agreed to construct the CAP project works and to deliver Colorado River water to the CAWCD. In return, the CAWCD agreed to repay the reimbursable cost of the CAP including the total amount of construction allocated to the non-Indian water supply and power functions, certain operation, maintenance and repair costs during and after construction, and interest allocated to M&I water and power functions.

Several provisions of this contract are relevant to our inquiry. First, paragraph 8 addresses the requirements of subcontracts that the CAWCD and

the Bureau of Reclamation enter into with the water users. Subparagraph 8.8

(b)(ix) provides that:

the subcontractor shall levy all necessary assessments, tolls, and other charges and shall use all of the authority and resources available to the subcontractor to collect the same in order that the subcontractor may meet its obligation thereunder to make in full all payments required under said subcontract on or before the date such payments become due and to meet other obligations under the subcontracts.

Timely payments on the subcontracts are integral to the Master Repayment Contract. However, the CAWCD (the Contractor) is ultimately responsible for meeting the repayment obligation to the United States. Subparagraph 9.4(e) provides, in pertinent part:

It is understood and agreed that the Contractor shall be obligated for the payments . . . regardless of the delinquency or default in payment of any charges due to the Contractor from any subcontractor . . . or regardless of any other reason, the Contractor shall complete repayment of each construction stage within a 50-year period beginning in the year following the announcement by the Secretary of substantial completion of such construction stage.

In the event of a default by the CAWCD, it shall pay a penalty on payments, installments or charges which become delinquent, computed at the rate of 1 percent per month. More important to our inquiry, "[n]o water shall be furnished to the Contractor during any period in which the Contractor may be in arrears more than 12 months in the payments to the United States . . . ."

Paragraph 9.10. All legal remedies are reserved for breach of the contract in any appropriate federal or state court. Paragraphs 9.10(c) and 10.12.<sup>2</sup>

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<sup>2</sup>The non-delivery of CAP water to CAWCD results in a decrease in Arizona's use of its Colorado River entitlement. The availability of this unused entitlement to other users may be discussed in the development of options in future CAP Advisory Committee meetings.

*In summary, if CAWCD defaults on its repayment obligation under the Master Repayment Contract, regardless of the cause, it is a breach of contract. Remedies may be pursued by the Bureau of Reclamation in federal or state court. If the default is for more than 12 months, then the Bureau of Reclamation shall not supply water to CAWCD.*

**B. Non-Indian Agricultural Subcontracts**

Section 304(b) of the Colorado River Basin Project Act authorized the Master Repayment Contract and "contracts subsidiary to the master contracts" between the United States and any users. A number of these subsidiary contracts have been entered into with central Arizona irrigation districts. These contracts envision these irrigation districts using a substantial amount of CAP water in the early years of the project.

**1. CAP Agricultural Subcontracts**

The CAP agricultural subcontracts (subcontracts), in essence, provide for an exchange of money for water delivery service among the irrigation district/subcontractor, CAWCD and the Secretary of the Interior. Those subcontracts are causing economic distress in the districts which state that they cannot afford the water service at the cost imposed by the subcontracts. Thus, there has been discussion regarding how the irrigation districts might be able to relieve themselves of the burdens imposed by the contracts.

The most frequently mentioned methods by which the districts might seek relief are: 1) bringing a court action to alter how the subcontracts are administered or to alter the terms of the subcontracts; 2) defaulting on the subcontracts; or 3) filing for protection under Chapter 9 of the federal Bankruptcy Code. It is also possible that the irrigation districts might pursue none, all or a combination of these actions.

Before discussing each of these alternatives, it is necessary to briefly review the financial provisions of the agriculture subcontracts that are causing the irrigation districts difficulty.

The CAP agriculture subcontracts require two types of payment from the subcontractors once the CAP is declared complete. The first type of payment is for Operation, Maintenance and Replacement ("OM&R"). Subcontract § 5.1. The subcontractor is required to pay "its share" of the total annual OM&R cost for the project. Subcontract § 5.1. The contract is silent as to how the subcontractor's "share" is to be determined. The subcontract does not specifically tie the "share" to the size of the subcontractor's contractual entitlement to water.

The second type of payment is for the Agricultural Water Service Charge. Subcontract § 5.2. The subcontractor is required to pay \$2.00 per acre-foot of water for "each acre-foot of Agricultural Water scheduled for delivery pursuant to [the Subcontract]." (Emphasis added.) Subcontract § 5.2.

Under the terms of the subcontract, the subcontractor "shall have no right to delivery of water" during any period in which the subcontractor is in "arrears in the payment of any charges due." (Emphasis added.) Subcontract § 5.3. Thus, if the subcontractor fails to pay either the OM&R charge or the Service Charge, the right to receive water ends. However, that right may be regained by paying all delinquent charges.

The subcontract also states that if the subcontractor fails or refuses to accept delivery "of the quantity of water available to and required to be accepted" under the subcontract, this failure does not relieve the subcontractor of its obligation to make payments under the subcontract. (Emphasis added.) Subcontract § 5.4. Because, however, there is no requirement that the subcontractor accept a

minimum amount of water, this provision would not seem to have any impact unless an ordered and scheduled amount of water is refused.

Finally, the subcontract states:

The subcontractor agrees to make payment for available water which is refused in the same manner as if said water were scheduled for delivery to and accepted by it in accordance with this subcontract . . . .

(Emphasis added.) Subcontract § 5.4. This is the provision usually referred to as the "take-or-pay provision."

If these contract terms or the way in which these terms are administered make the districts financially incapable of participating in CAP, the project is impacted financially in two ways. First, any OM&R costs not paid by the districts obviously must be paid from some other source of revenue, possibly from increased OM&R costs to the other non-Indian agriculture participants. Second, because that part of the project dedicated to irrigation use is non-interest bearing, CAWCD's repayment obligation increases if less of the project is being used for that purpose.

## 2. Alternative Actions of the Irrigation Districts

Several possible actions have been suggested by which the irrigation districts might seek to relieve the financial burden imposed by the contracts.

### a. Alteration of Terms or Administration of the Subcontracts

One possibility that has been suggested to relieve the financial burden imposed by the contracts on the irrigation districts is a court action by the irrigation districts against CAWCD to alter the terms or administration of the subcontracts.

One theory is the irrigation districts' claim that they were misled when they entered into the subcontracts to believe that the M&I subcontracts would have a take-or-pay provision identical to that in the agriculture subcontracts. If the M&I subcontract had included a take-or-pay provision, it is argued that more of the OM&R burden would fall upon the M&I sector and the agriculture subcontractors would be relieved from the burden of paying OM&R on all water in the system not scheduled for delivery by the M&I subcontractors and the Indians.

Another theory the irrigation districts might use in a court action is that the subcontracts should be administered in a way so as to diminish their "share" of the OM&R costs. As has already been examined, the OM&R cost provisions of the agriculture subcontracts do not directly tie the OM&R cost to the amount of water available to the irrigation districts, but the subcontracts are administered in that way.

It is believed that CAWCD will administer the subcontracts in a way that splits the OM&R charge in to two parts. Part of the OM&R charge will be dedicated to paying the cost of the energy necessary to deliver the water. The other OM&R charge will be based upon the operating cost of the system divided by the amount of water available for delivery. This charge is then applied to each acre foot of water available. The OM&R charge is not applied to the maximum entitlement of the M&I users, but only to the amount the M&I users schedule for use. This is true even though the M&I subcontracts contain language nearly identical to the agriculture subcontracts which require them to pay for their "share" of OM&R costs. The OM&R charge is, however, applied to every acre foot of water available to the agriculture subcontractors

regardless of whether they schedule the water for delivery. Apparently, the take-or-pay provision, which is not included in the M&I subcontracts, has been used to determine that the agriculture subcontractors' "share" of OM&R includes a cost for all water available to them.

Because the language of the subcontracts does not specify how the OM&R "shares" are to be calculated, the irrigation districts might bring a lawsuit seeking to force CAWCD to administer the subcontracts in a way that lessens the irrigations districts' "share" of the OM&R burden. The irrigation districts might or might not prevail in such an action. It is clear, however, that if the districts did prevail in an action to alter the terms or administration of the subcontracts to lessen their share of OM&R costs, the M&I subcontractors would be forced to pay a greater share of the OM&R cost.

**b. Default on Subcontracts**

Another course of action available to irrigation districts might be simply to default on the subcontracts and fail to make the required payments. As has been described, under the terms of the subcontract, the irrigation district has no right to water at any time at which it is in arrears in its payments to CAWCD. The subcontract, however, does not give CAWCD the express authority to terminate the subcontract if an irrigation district defaults. Instead, the subcontract gives the irrigation district the right to cure the default by making all payments due, including any penalties. Upon payment of such charges, the district regains the right to receive water.

Although the subcontract gives CAWCD no right to terminate the subcontract upon default by the subcontractor, under normal principles of contract law, CAWCD could bring a

breach of contract action against the defaulting district and seek to terminate the subcontract. If an irrigation district failed to pay the OM&R costs required by the subcontract for a substantial period of time, CAWCD would likely have a good action to terminate the contract. CAWCD might also seek any money owed by the district for the OM&R costs that had accrued before the subcontract is terminated. See Section IV. of this memorandum for a discussion of actions for money judgments and writs of mandamus.

**c. District Bankruptcy and Executory Contracts**

Perhaps the option of last resort for the districts is to file for Chapter 9 reorganization under the United States Bankruptcy Code. Because the irrigation districts are political subdivisions of the state, Chapter 9 is the only option available to them under the Bankruptcy Code. As discussed in Section V. of this memorandum, if the districts opt to file under Chapter 9, they will maintain control over all of their day-to-day activities.

Although Chapter 9 does differ in a number of ways from other bankruptcy chapters, it also includes a number of similarities. One of these similarities is the right to either assume or reject executory contracts.

The term "executory contract" is not defined by the bankruptcy statutes, but is generally regarded as a contract under which both parties continue to have obligations which are unperformed. Chapter 9 debtors have the right during their reorganization to either assume the executory contract or reject it.

Arguments would be made regarding whether the subcontracts are executory contracts. Thus far, neither party

has performed any substantial obligation required by the agreement because the major terms do not become effective until the CAP is declared complete. In addition, the subcontracts closely tie the payments required of the irrigation districts to the right to continued water service, quite similar to a licensing agreement. Therefore, the subcontracts could be found to be executory. The other side of the argument is that the subcontracts are debt repayment agreements and are, therefore, nonexecutory. A court would look to the substance over the form of the agreements to make this determination.

If they are found to be executory, the irrigation district may assume or reject the subcontracts *in toto* any time during the reorganization process. Given the financial burden imposed by the subcontracts under their current terms and projected administration, it would seem unlikely that the subcontracts would be assumed unless the districts were successful, either through negotiation or litigation with CAWCD, in altering how OM&R costs will be distributed. If the subcontracts are rejected, the water would revert back to control by the Secretary. This result would also, of course, lead to greater OM&R costs for the remaining subcontractors.

If the districts were to attempt to assume the subcontracts, they might be required to give CAWCD adequate assurance that they would and could perform their obligations in the future. If the districts were to be in default of the subcontracts before filing for Chapter 9 reorganization or were unable to make the payments due while in reorganization, CAWCD would have the right to demand the district to demonstrate in the bankruptcy court that CAWCD would be paid the monies owed it and that the district could make the payment that would be due in the future. If the district fails to

make such a demonstration, the district could not assume the subcontract.

Under the ordinary bankruptcy law of executory contracts, the irrigation district, if the subcontract is assumed, could assign the subcontract to another party. It is unclear how this provision would work in relation to the control of Colorado River water deliveries given to the Secretary of the Interior by the Boulder Canyon Project Act. It is likely that in spite of the bankruptcy law, the subcontract could not be assigned without the Secretary's consent.

*The agriculture subcontracts as they are currently envisioned will likely not survive the legal actions available to the irrigation districts. The subcontracts will either be completely rejected in bankruptcy reorganization or they will be assumed in a form that relieves the districts of a significant amount of the O&M&R costs. If the subcontracts are rejected, the water would revert to the control of the Secretary. It is also significant to the future of the districts that because they will either assume the contracts in an altered form or reject them, they will not be in default of the agreements so as to lose the ability to receive water from the CAP facilities.*

#### C. Federal 9(d) Agreements

In addition to the construction of the CAP works which transport the Colorado River water to the users, the CAP irrigation districts also needed the construction of distribution systems to transport the water within their boundaries. Section 304 (b) of the Colorado River Basin Project Act (CRBPA) authorized the irrigation districts to enter into agreements with the Secretary of the Interior pursuant to § 9(d) of the Reclamation Project Act of 1939 under which the federal government constructed those distribution systems and the irrigation district agreed to reimburse the government for the

costs of that construction. A 1982 amendment to the CRBPA specified that at least 20 percent of the costs of such distribution systems had to be paid by the non-federal party to the agreement. 43 U.S.C.A. § 1528(b). To cover that 20 percent of the costs, some of the irrigation districts issued general obligation bonds. Those bonds are discussed in Section III.D. of this memorandum.

The 9(d) agreements provide that the federal government would build the distribution systems within the irrigation districts and would advance the costs for up to 80 percent of that construction. In exchange, the districts agreed to repay the government in semi-annual installments beginning either in the year following the issuance of a notice of completion of the works or on a date certain, which ever occurs first.

The agreements themselves provide some guidance for what remedies are available to the federal government in case of default by the irrigation districts. The federal government may cease deliveries of water to the district if the district is in arrears of any advance payment of operation and maintenance costs required under the contract or if the district is more than 12 months in arrears of any repayment obligation under the contract. The irrigation district is prohibited from delivering water to any persons or lands which are in arrears of payments necessary for the irrigation district to comply with these same obligations to the federal government.

The agreements also require the irrigation districts to assess, levy and collect all taxes necessary to meet the obligations imposed by the 9(d) agreements. The same provisions specifically authorize the federal government to take any court action, including a mandamus action, to compel the district to undertake these actions. If a district were to default, the federal government could avail itself of this provision and bring an action to compel the district to increase taxes sufficiently to meet its obligations under the agreements. This approach has limited utility, however, because at some point the higher taxes will cause more defaults by the customers of the district, requiring yet higher taxes for the remaining customers, causing more defaults and resulting in a "death spiral" for the districts.

Under the authority of the Reclamation Project Act of 1939, 43 U.S.C. § 485b-1, the 9(d) agreements provide an avenue to avoid defaults. The irrigation districts may request a deferment of installments under the repayment contracts based on the probable ability of the water users to pay. Granting deferments is discretionary on the part of the Secretary of Interior and requires congressional approval unless it is not in other respects less advantageous to the government than the existing contract arrangements. Several irrigation districts currently have deferment requests pending before the Secretary.

If a district is faced with the prospect of default and the "death spiral" consequences, it might choose to seek protection in bankruptcy court. Unlike the CAP agriculture subcontracts, the 9(d) agreements are most likely not executory. The federal government has already fully performed its obligations under the contract by constructing the distribution systems, and all that remains is for the district to meet its repayment obligation. It is unlikely that the provision which allows the federal government to refuse water service to the district if it is in arrears would alter this analysis. The agreement is for an exchange of construction for money; the construction has been performed, and the water service is governed by a separate agreement.

Because the 9(d) agreements create no lien on the property of the districts or their landholders, the federal government would be an unsecured creditor of the districts in bankruptcy court. Its debt would be subject to the ordinary provisions allowing for a restructuring of the debtor's obligations.

*Federal bankruptcy court could provide considerable relief to the irrigation districts. The debt owed by them to the federal government under the 9(d) agreements could be restructured in a way that allows them to make payments that make it economically feasible for the districts to continue their operations. By restructuring the debt and avoiding default, the districts would avoid the provisions of the 9(d) agreements which might deny them use of the distribution systems through a denial of water.*

**D. General Obligation Bonds**

As described in Section III.C., under 43 U.S.C.A. § 1528(b), the construction of the water distribution system to transport water within the boundaries of the irrigation districts may be financed by the United States up to 80 percent of the construction costs. The remaining 20 percent or more is funded by the irrigation district. Many of the irrigation districts issued general obligation bonds to fund all or a portion of their 20 percent contribution.

The general obligation unlimited tax bonds are a type of municipal indebtedness payable from the general funds. The official bond statement of the Central Arizona Irrigation and Drainage District (CAIDD) states that the "Series 1984 Bonds will not be general obligations of the State of Arizona or of any political subdivision of the State of Arizona other than the District."

By resolution, the Directors of CAIDD promised the holders of the bonds three things important to our inquiry. First, for each and every year the bonds are outstanding, the CAIDD shall levy and pursue the collection of taxes. The water service agreement between CAIDD and the property owners of the district, Appendix C to the bond statement, is intended to facilitate the collection of the taxes. It provides that the landowner creates a first and prior lien on the lands in favor of CAIDD to secure the obligation of the landowner and to secure the payment of all lawful charges of the CAIDD. This lien remains on the land despite any transfer.

Second, CAIDD pledged its full faith and credit to pay the bonds:

For the punctual payment of the principal or, premium, if any, and interest on the Bonds and for the levy and collection of taxes in accordance with the statutes authorizing the issuance of the Bonds, which taxes have no constitutional or statutory limit as to amount or rate, the full faith and credit of the District is irrevocably pledged; provided however, that the amount to be raised by such taxes in any year shall be reduced to the extent that monies from any source (other than District indebtedness) are on deposit . . . .

By this pledge, CAIDD agrees to meet its bond obligations through its power to levy and collect taxes. Third, consistent with state law, CAIDD promised to maintain its legal existence as a political subdivision and municipal corporation of the State of Arizona until all indebtedness is satisfied.

There are two remedies for default recognized in the bond statement. The statutory process involving the State Certification Board is described in the statement in the same fashion as described in Section II.D. of this memorandum. In addition, the statement recognizes that the bondholders may seek a writ of mandamus to compel any official action including tax levy and collection. The mandamus action will be fully discussed in Section IV.B. of this memorandum.

*In summary, by issuing the bonds for construction of the water distribution system, the irrigation districts have incurred a general obligation which must be met through the levy and collection of taxes to the extent it cannot be met through district monies on deposit. Liens on land within the district assist in the collection of that tax. If an irrigation district is in default, a bondholder may petition the State Certification Board to begin the statutory remedy or the bondholder may seek court action.*

#### **IV. ISSUES POSED BY NON-BANKRUPTCY REMEDIES**

The forms of non-bankruptcy judicial relief available to unpaid bondholders are money judgments and writs of mandamus.

##### **A. Money Judgments**

Bondholders would be entitled to a money judgment against an irrigation district based on a showing that the principal has matured or that interest is due. Once the money judgment is obtained, the bondholders may seek to collect on the judgment. *Because the bonds do not contain a*

*provision accelerating the debt, a separate action would need to be brought as the principal and interest become due.*

*As a general rule, a money judgment may not be enforced on the property of a municipal body and the property of an irrigation district is not subject to enforcement of such a judgment. Meriweather v. Garrett, 102 U.S. 472 (1880); May v. Board of Directors of El Camino Irrigation District, 208 P.2d 661 (1949). However, the benefit of having a legal judgment is obvious from the discussion below on actions for writs of mandamus.*

**B. Writ of Mandamus**

Mandamus is an extraordinary remedy recognized in Arizona to compel the discharge of a duty which already exists. As a general rule, mandamus is granted upon the premise that: 1) the petitioner has a clear right to the relief sought; 2) the respondent had a legal duty to do the thing which is sought to be compelled; and 3) there is an absence of another adequate remedy. Sines v. Holden, 89 Ariz. 207, 360 P.2d 218 (1961). A money judgment will assist in this required proof.

A.R.S. § 48-3131 recognizes mandamus as a remedy for failure of irrigation districts to create liens or collect taxes. It provides in pertinent part:

If the board of directors of the district, a board of supervisors, or officer of a board, or a county assessor or tax officer of a county neglects or refuses to perform any official act necessary to create or impress a lien of taxes or to collect taxes as required by this chapter, any person holding evidence of a matured, unpaid and undisputed indebtedness of the district may compel the performance of such official act by mandamus.

This provision applies to any indebtedness, including those imposed either by contracts or bonds. Although the property of an irrigation district may not be subject to enforcement of a money judgment, an irrigation district or the county assessor could be forced by a bondholder or contract creditor to utilize

the lien enforcement statutes to sell property in arrears on assessments or taxes.

"Mandamus is a proper remedy to enforce a city's duty to pay a judgment debt and to compel an appropriation." Garcia v. City of South Tucson, 135 Ariz. 604, 663 P.2d 596 (1983). "The duty of the board of directors of an irrigation district to levy an assessment to pay its bonds and interest thereon is clear, unequivocal and mandatory." May, 208 P. 2d at 663. Therefore, once a court has entered a judgment regarding the bond or contract debt default, a mandamus action could be sought to compel the collection of taxes even through the enforcement of property liens.

A duty to make a second levy sufficient to pay a debt can be compelled through mandamus only if there is an affirmative allegation of showing of the improbability of collecting the delinquent taxes. Board of Supervisors v. Miners Etc. Bank, 59 Ariz 460, 130 P.2d 43 (1942). The improbability of payment may be linked to the financial distress of the municipal corporation, but the courts have held that:

it is not defense to a proceeding by a bondholder to obtain a writ of mandate to compel the levy of taxes or assessments to pay the bonds, or interest thereon, that such a levy will impoverish or cause serious financial embarrassment to the public corporation.

May, 208 P. 2d at 664. Impossibility of performance is not a recognized defense to mandamus. Maricopa County v. State, 126 Ariz. 362, 616 P.2d 37 (1980). So the county assessor or the irrigation districts may be compelled to collect a tax or levy an assessment to meet the bond and contract obligations even though it may result in financial ruin for the property owners and the irrigation district itself.

However, the financial distress of the municipal corporation may be addressed through the discretion of the court as to the manner in which the judgment should be paid. The payment may be spread over a number of

years. City of South Tucson, supra. In Borough of Fort Lee, N.J. v. United States, 104 F.2d 275 (3rd Cir. 1939), the court held that while the financial distress of the municipality was not a bar to granting of a writ to compel the collection and assessment of taxes to satisfy a judgment on overdue bonds, the period of time over which the borough was entitled to raise funds to pay the judgment on its bonds was within the discretion of the court. The Borough of Fort Lee Court allowed 15 years.

*As described in Section II. of this memorandum, the irrigation districts, in coordination with the county assessors, have adequate legal authority to levy and collect taxes and assessment. The courts recognize a duty to pay judgments and a writ of mandamus may issue to compel the collection of assessments or taxes on overdue contract or bond obligations, even though it may result in financial difficulty and may force the bankruptcy of the property owners or the irrigation districts to avoid a sale of the property. As is discussed in Section V.C. of this memorandum, the filing of the petition for bankruptcy may stay actions seeking a writ of mandamus.*

## V. ISSUES POSED BY BANKRUPTCY

It is possible that at some point, one or more of the irrigation districts may choose to file for protection under Chapter 9 of the Bankruptcy Code. This section will provide an overview of the provisions of Chapter 9 and an analysis of some threshold issues which might arise from a district filing under Chapter 9. The Bankruptcy Court's treatment of the executory contract issue is discussed in Section III.C. of this memorandum.

### A. Overview

There are a number of distinctions between the bankruptcy laws which apply to political subdivisions and those which apply to private entities. These distinctions are necessitated by the federal Constitution. Although the Constitution authorizes Congress to enact laws relating to bankruptcy, U.S.

Const. art. I, § 8(4), the Supreme Court has held that the principles of state sovereignty embodied in the Constitution and explicitly stated in the Tenth Amendment prohibit federal bankruptcy courts from excessive interference in the internal operations of the states and their political subdivisions. The Supreme Court struck down the first bankruptcy code applicable to political subdivisions for this reason. Ashton v. Cameron Water Improvement District No. 1, 298 U.S. 513 (1936).

Thus, Chapter 9 of the Bankruptcy Code is designed to provide relief to financially burdened political subdivisions without allowing federal courts to interfere excessively in the entity's operations. There are numerous distinctions from "ordinary" bankruptcy which flow from this principle. For example, there is no mechanism for involuntary municipal bankruptcy. In addition, liquidation, which would result in the dissolution by federal law of an arm of a sovereign state, is also unavailable. Usually, no trustee is appointed for the debtor, thus allowing the debtor to maintain control over its affairs. State law must authorize the entity to seek protection under federal bankruptcy law. These and other distinctions will be addressed more fully below.

#### **B. Filing for Chapter 9 Protection**

Chapter 9 is the only protection available to a "municipality" under federal bankruptcy law. 11 U.S.C.A. § 109(c). The Code defines a "municipality" as a "political subdivision or public agency or instrumentality of a State." 11 U.S.C.A. § 101(40). Under Arizona law, irrigation districts are political subdivisions. Ariz. const. art 13, § 7. Thus, irrigation districts are limited under federal bankruptcy law to the reorganization protection of Chapter 9. As previously explained, dissolution is available to the irrigation districts under state law, but only if "all indebtedness of every nature whatever has been fully satisfied and paid." A.R.S. § 48-2954(A).

A political subdivision must establish a number of factors before being allowed to seek protection under the Bankruptcy Code. The entity must be authorized under state law to be a debtor under Chapter 9. U.S.C.A. §

109(c)(2). There is specific legislation allowing Arizona taxing districts to seek protection under the bankruptcy act that existed prior to the enactment of the new Code in 1978, and that statute likely provides current authorization for an irrigation district to seek Chapter 9 relief. A.R.S. § 35-603.

Under Chapter 9, the debtor must also be insolvent, 11 U.S.C.A. § 109 (c)(3), which, for a municipality, means that the debtor is generally not paying undisputed debts as they become due or is unable to pay its debts as they become due. 11 U.S.C.A. § 101(32)(C). The debtor must also desire to effect a plan to adjust its debts. 11 U.S.C.A. § 109 (c)(4). Once the OM&R obligations currently imposed on the districts by the subcontracts becomes effective, the irrigation districts in question would seem likely to meet one of these requirements.

In addition to the requirements discussed above, the debtor must establish one of four tests related to reaching an agreement with creditors. The debtor must establish: 1) that it has obtained agreement to file for bankruptcy protection from creditors representing a majority in amount of each class of claims likely to be impaired by the action; 2) that it has failed to reach such an agreement but has in good faith attempted to do so; 3) that it has not negotiated with creditors because it would be impracticable; or, 4) that it reasonably believes that one creditor may attempt to obtain a preference, that is, a transfer of property from the debtor to the creditor in anticipation of a bankruptcy that puts the creditor in a better situation than it would have been in under the bankruptcy laws. It is likely that if the irrigation districts seek to file bankruptcy, they would be able to meet one of these requirements.

### **C. Reorganization**

Once the political subdivision voluntarily files for Chapter 9 relief and qualifies as a debtor under the Bankruptcy Code, the action proceeds in most ways as an ordinary reorganization under Chapter 11. 11 U.S.C.A. § 901 lists those provisions of the other chapters of the Bankruptcy Code which are applicable to Chapter 9 actions. This list includes many of the provisions of

Chapter 11; those provisions which are excluded are those which might allow the bankruptcy court to interfere with the sovereignty of the political subdivision.

**1. Commencement of the Case**

If and when an irrigation district in Arizona files for Chapter 9 protection, the chief judge of the Ninth Circuit Court of Appeals will appoint the judge who will hear the case. 11 U.S.C.A. § 921(b). Notice of the commencement of the case includes publication in newspapers of general circulation in the district in which the action is filed, and the court may order that the notice be placed in a publication having general circulation among bondholders. 11 U.S.C.A. § 923.

**2. Automatic Stay and Relief**

Upon qualifying as a debtor under Chapter 9, the debtor is entitled to the protection of the automatic stay provided by 11 U.S.C.A. § 362. That section prevents creditors from beginning or continuing actions against the debtor to obtain property of the debtor in satisfaction of monies owed. Thus, any actions by bondholders, the federal government, or CAWCD against the irrigation districts discussed in previous sections of this memorandum would be preempted by a Chapter 9 filing. As a result, actions to compel levy and collection of taxes, actions to terminate the contracts, and petitions to the State Certification Board would be subject to the stay provisions.

The provisions of § 362 allowing creditors to seek relief from the stay are also applicable to municipal bankruptcy. Sufficient cause to vacate the stay and permit the creditors to return or resort to state of federal court may be provided by the need to determine an unsettled question of state law of policy, the desire to permit an action to proceed to completion before another court or, the inability of the

municipality to propose a confirmable reorganization plan.<sup>3</sup> In the South Tucson bankruptcy case, the court ordered that the stay be lifted if the city could not produce an equitable plan by a specified date. See, "Municipal Defaults, Bondholders' Legal Remedies Limited", The Los Angeles Daily Journal, April 10, '84 p 4 col 3.

In addition to the § 362 stay, Chapter 9 creditors are also stayed from actions against officers or inhabitants of the debtor. 11 U.S.C.A. § 922. This protection prevents a creditor from circumventing the stay by bringing an action against an officer of the debtor or by seeking to collect against taxes or fees owed to the debtor by an inhabitant.

### **3. Interference in Governmental Affairs**

The constraints on the bankruptcy court to interfere with the governmental affairs of the municipal corporation is evident in other ways. Section 904 provides that the Bankruptcy Court may not interfere with the political or governmental powers of the debtor, the property or revenues of the debtor or the debtor's use or enjoyment of any income-producing property unless the debtor consents or its plan of debt adjustment so provides. As a result, the Bankruptcy Court would have little or no power to require the irrigation districts to relinquish CAP water service contracts unless it was part of a reorganization plan.

### **4. Reorganization Plan**

The ultimate goal of Chapter 9 is the preparation and confirmation of a plan adjusting the debtor's obligations. The claims of the creditors are classified to group those similarly situated, 11 U.S.C.A. § 1122, and negotiations begin with each group to restructure

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<sup>3</sup>The federal government might argue that a federal action on the districts' obligations falls under the police or regulatory exception to the stay provision. See also, 28 U.S.C. 157(d) regarding permissive and mandatory withdrawal of reference which results in certain issues being determined by federal district court rather than the bankruptcy court.

the debts. Unlike a Chapter 11 reorganization, only the debtor may propose a reorganization plan to the court in a Chapter 9 proceeding. 11 U.S.C.A. § 941. This distinction is again required by the constitutional limitations on federal interference with the sovereignty of the state.

One avenue for creditor input into the reorganization is for the bondholders to petition the court for the appointment of an official bondholders' committee under 11 U.S.C. § 1102. This committee would have various powers to investigate aspects of the district's operation and finances and participate in the formulation of a plan.

All impaired classes of creditors must consent to the reorganization plan. 11 U.S.C.A. § 1129(a)(8). Incorporated into Chapter 9, however, are the provisions relating to "cram down" of the plan with regard to classes of creditors who do not accept the plan. 11 U.S.C.A. § 1129(b). If a minimum of one class of creditors must accept the plan voluntarily, the Court may confirm it if the plan does not discriminate unfairly and is fair and equitable with respect to each impaired class of claims that has not accepted the plan. The plan must be in the interest of the creditors and be feasible. Since liquidation is not possible, the "best interest of the creditors" may be interpreted to mean that the plan must be better than the alternative that creditors have through a mandamus proceeding. 11 U.S.C.A. § 1129(a)(10).

In addition to the approval by the various classes of creditors, before the court can confirm the plan the court must also find that: 1) all the sections of the Bankruptcy Code incorporated by 11 U.S.C.A. § 103(e) and § 901 into Chapter 9 have been complied with; 2) all the requirements of Chapter 9 have been complied with; 3) all administrative expenses have been disclosed and are reasonable; 4) all actions required by the plan are legal; 5) any regulatory or electoral approval necessary to comply with the plan has been obtained; and 6) the plan is in the best interest of the creditors. 11 U.S.C.A. § 943.

The debtor's debts are discharged when the plan is confirmed, when any consideration required of the debtor by the plan is deposited with an agent appointed by the court, and when the court determines that any consideration so deposited is a valid legal obligation of the debtor. All debts are discharged but those specifically excepted by the plan and those held by entities that had no notice or knowledge of the bankruptcy. 11 U.S.C.A. § 944.<sup>4</sup>

*Because of the control given to a debtor by municipal bankruptcy, there will likely not be a significant alteration in the day-to-day operations of the districts should they choose to file for bankruptcy. They will also have substantial control over any reorganization plan.*

## VI. CONCLUSIONS

Based on the foregoing analysis, the following would seem to be likely sequences of events regarding the CAP irrigation districts and their financial obligations.

It is reasonable to assume that at some point, some or all of the irrigation districts may choose or feel compelled to seek the protection of federal bankruptcy court. While the sequence of events leading to bankruptcy court at this point is speculative, each of the three obligations of the districts may lead to the districts seeking the protection of the bankruptcy court.

Perhaps the most likely scenario leading to bankruptcy would start with the subcontracts. There are two potential routes to bankruptcy court here. The districts

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<sup>4</sup>"Court have shown a willingness to let state governments bail out struggling municipalities. The case of *Ropico, Inc. v. City of New York* emerged from the celebrated fiscal crisis of New York City in 1975. The state enacted legislation which authorized New York City to suspend the payments of principal on notes for three years and leave bonds untouched . . . . The Federal District Court ruled that the state had merely used its long acknowledged police power to pass such legislation in times of emergency. The court granted no compensation to those affected. As long as a statute is enacted for a rational purpose, it can withstand a due process or equal protection challenge." Municipal Bankruptcy: The Worst-Case Scenario, by Leonard Kopelman, Boston Bar Journal, Sept/Oct 1990, 11. (citations omitted).

might bring suit against CAWCD seeking to diminish their share of OM&R costs due under the subcontracts. If this court action failed, the districts might seek bankruptcy protection. Or the districts might instead simply not make the payments CAWCD required. An action by CAWCD for the OM&R payments might also lead the districts to file for bankruptcy.

Another sequence of events might start with the 9(d) agreements. The irrigation districts may seek deferment of their payments under the terms of the 9(d) agreements, be rebuffed by the federal government and then fail to make payments under those agreements. If this were to happen, the federal government might bring an action against the districts for moneys owed, leading to the filing for bankruptcy protection by the districts.

A final sequence leading to bankruptcy might begin with the bonds. If the districts are unable to meet payments to the bondholders, are unable to work out a plan in the State Certification Board process and are otherwise unable to work out an agreement with the bond holders, then the districts may file for bankruptcy to avoid actions for a money judgment and mandamus.

The sequence of events which might lead to bankruptcy is not particularly significant. What the irrigation districts may expect to achieve in bankruptcy court is the significant issue. As has been stated in regard to the 9(d) agreements in bankruptcy, the contracts are not executory, and the federal government would likely be an unsecured creditor of the districts. This debt would be restructured in such a way as to allow the district to make payments on the obligations but in a way that makes it economically feasible to continue their operations.

With the debt restructured by the bankruptcy court and assuming that the restructured payments are timely made, it is likely that the federal government would not be able to invoke the provision of the 9(d) agreements giving them the right to refuse water service through the distribution system. In addition, common sense would dictate that the federal government allow the districts and its land owners to continue to use the distribution systems in whatever manner necessary to continue their operations. Without the districts continuing their operations, the federal

government would have no hope of ever seeing repayment of the obligations and would simply be the owner of an extensive series of canals within the districts of Pinal County.

The bondholders would also be creditors in the bankruptcy court but with slightly stronger rights than the federal government. They would be entitled to a certain amount of repayment, but again in a manner that would allow the irrigation districts to continue their operations.

As has already been discussed, the non-Indian agricultural subcontracts could either be assumed or rejected as executory. Undoubtedly, the initial question in determining whether the subcontracts would be assumed is whether they will in some way be reformed by negotiation or by action of state superior court or federal district court to diminish the districts' share of OM&R. If they are not reformed, the subcontracts will likely be rejected. If the subcontracts are rejected by the districts, the water subject to those contracts would return to the control of the Secretary.

It is impossible at this time to say whether the subcontracts will be reformed and assumed by the districts or rejected by the districts. But some consequences can be foreseen under either scenario. Regardless of whether the subcontracts are assumed in some form that greatly diminishes the districts' obligations or are simply rejected, CAWCD will be forced to find a new source of revenue to pay the OM&R cost that was expected to come from the districts. Also, under either scenario, the provision in the subcontracts denying the districts water service through project facilities if the districts are in default will not be invoked. The districts will either assume the subcontracts and make their reduced payments or reject the subcontracts and not be subject to default provision at all. Thus, these provisions will not prevent the districts from receiving some subcontract water, spot market water or water from other sources through their distribution systems. It is possible, then, that the irrigation districts might continue to receive some project water and thereby pay some money toward the OM&R obligation. This result would also leave at least a part of the CAWCD repayment obligation as non-interest bearing.

*In summary, if the irrigation districts choose to reorganize under federal bankruptcy laws, it is likely that at the conclusion of the reorganization, the districts will still be in operation and making payments on their debt to the federal government and their bond holders at a rate that makes it economically feasible for the districts to continue operations. They will either not have CAP subcontracts, or they will have subcontracts which allow them to take CAP water while paying a much smaller share of the OM&R cost of the system. They will likely be using their distribution systems to deliver CAP subcontract water, CAP spot market water or other sources of water to their customers. Because of their diminished OM&R obligations, CAWCD will need to find an alternative source of revenue to pay the OM&R costs that were to have been paid by the irrigation districts.*