The Myth and Reality of State and Local Governments Debt Financing in the U.S.A. in Times of Financial Emergency

In Good Times and Bad Times
Financial Challenges Past, Present and Future

July 25, 2011

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 This is a preliminary work paper for a chapter on Sovereign Debt Defaults and Debt Resolution Mechanisms for an upcoming book entitled The Oxford Handbook of State and Local Government Debt to be published by Oxford University Press, John Petersen and Robert Ebel, editors. Selected material is taken from Chapters 9 and 44 written by James E. Spiotto in The Handbook of Municipal Bonds published by John Wiley & Son. Sylvan G. Feldstein, Frank J. Fabozzi, editors and from an upcoming 50 state survey of rights and remedies provided by states to investors in financially distressed local governments debt and state authorization of municipalities to file Chapter 9 bankruptcy.

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I. The Myth that State and Local Government Debt Is Prone to Default

Myth: State and local governments debt is just as volatile and prone to default as U.S. corporate debt or the debt of other sovereigns.

Reality: State and local governments in the U.S.A. have a long, proud history of doing whatever it takes to pay their debt obligations and have a significantly lower default rate and higher recovery rate than U.S. corporate debt or the debt of other countries.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

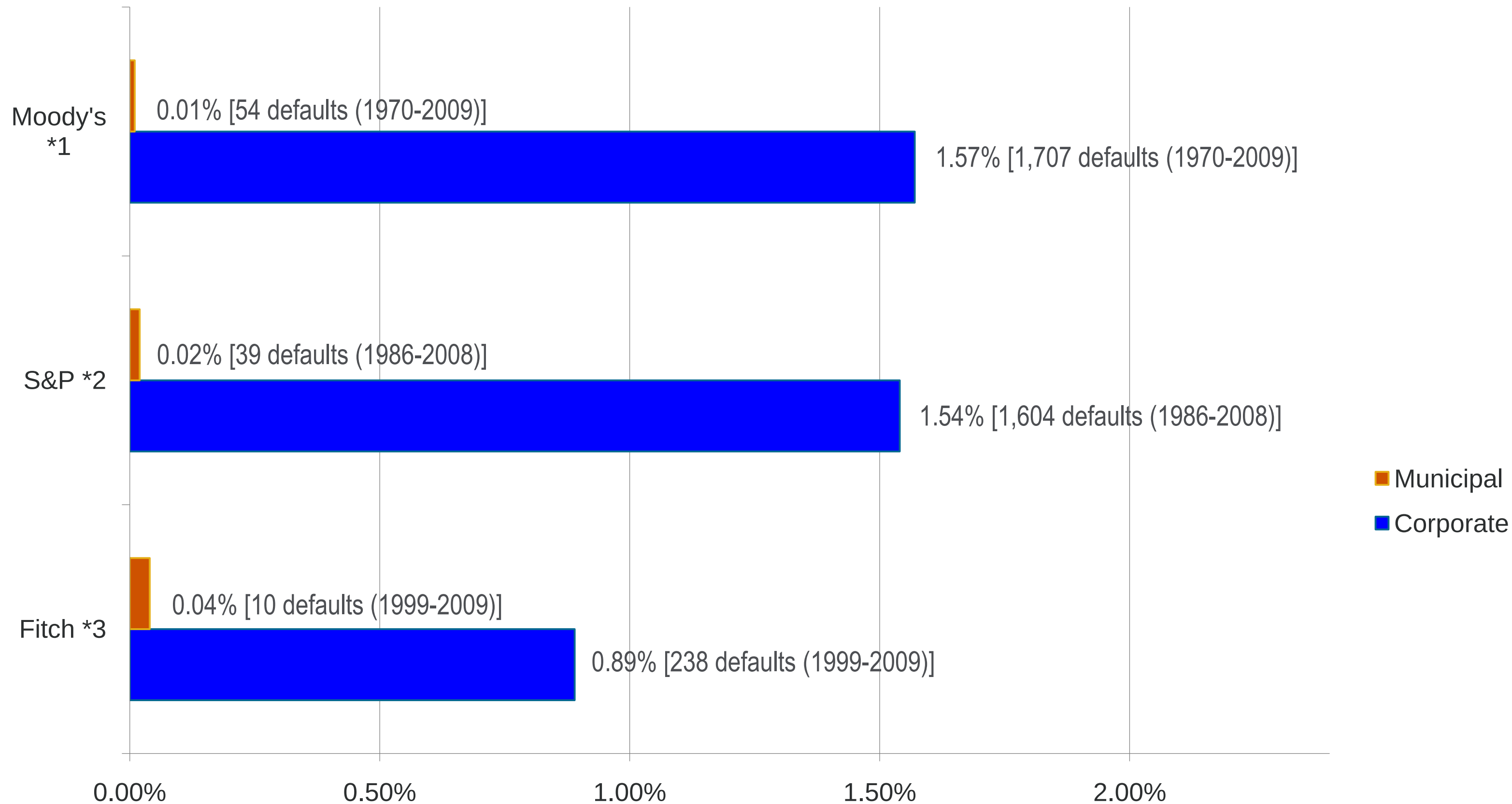
- INTRODUCTION
  - Present global economic conditions have increased the possibility that many Sovereigns will experience significant cash flow problems and ensuing financial crisis (*e.g.*, Greece, Portugal, Spain, Italy, Ireland, Latvia, Ukraine, Romania, etc.).
  - The Sovereign crisis must be addressed to avoid damaging the Financial Market and to ensure that the perception of sovereign debt (including state and local governments in the U.S.A.) not face unfriendly credit markets going forward.
  - The problems facing Sovereigns are not new. The ability of states and municipalities in the U.S.A. to be able to meet financial challenges and successfully resolve them provides a guide as to workable solutions for other Sovereigns to follow.
  - This presentation studies past problems faced by troubled sub-sovereigns in the United States. It presents the myths and realities of the strength of state and local governments debt in the U.S.A. The lessons learned by these sub-sovereigns will help us develop financing structures to avoid and lessen the negative effects of financial distress to the States and the sub-sovereigns.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

Default Rate for Rated Municipal Bonds is Significantly Lower than Rated Corporate Bonds.

- According to Moody's, between 1970-2009, there were 54 Rated Municipal Bond Defaults compared to 1,707 Rated Corporate Defaults.
- 78% of the Rated Municipal Defaults were in the healthcare and housing project finance sectors.
- The median recovery rate for Rated Municipal Issuers was .85¢ on a $1.00.
- In 2009, Corporate Defaulted Rated Bonds and Loan Recoveries ranged from 54% first lien Bank loans, 37.5% Senior Secured Bonds, 37.78% Senior Unsecured Bonds, 22.4% Senior Subordinated Bonds and 34.3% for all Bonds.
- According to S&P, between 1986-2008, there were 39 Rated Municipal Defaults compared to 1,604 Rated Corporate Defaults.
- Recent Statistics on Municipal Defaults show a downward trend in the second half of 2010 and first quarter of 2011.

Rated Municipal vs. Corporate Default Rates by Ratings Service



1. Moody's Investors Services, U.S. Municipal Bond Defaults and Recoveries, 1970-2009 (February 2010); Moody's Investors ServCorporate Default and Recovery Rates, 1920-2009 (February 2010). Percentages based upon average one-year default rate.
2. Standard & Poor's, 2009 Global Corporate Default Study and Ratings Transitions (March 17, 2010); Standard & Poor's; U.S. Municipal Ratings Transitions and Defaults, 1986-2009 (March 11, 2009). Percentages based on average default rate.
3. Fitch Ratings Inc. U.S. Public Finance Transition and Default Study (1999-2009), March 25, 2010; Fitch Ratings Global Corporate Finance 2009 Transition and Default Study.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

Prior to 2000 and the Dawn of this Century, State and Local Governments Financing funded the most sophisticated Public Works System in the World, including:

- 3,866,000 Miles of Roadways,
- 565,000 Bridges,
- 1,000 Public mass transit systems,
- 16,000 Airports,
- 25,000 Miles of in coast and intercostals waterways,
- 70,000 Dams,
- 900,000 Miles of pipe in water systems,
- 15,000 Waste water treatment plants,

while at the same time assuring the funding of operation and infrastructure of the States, Cities, Towns and Villages of the largest economy in the World.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

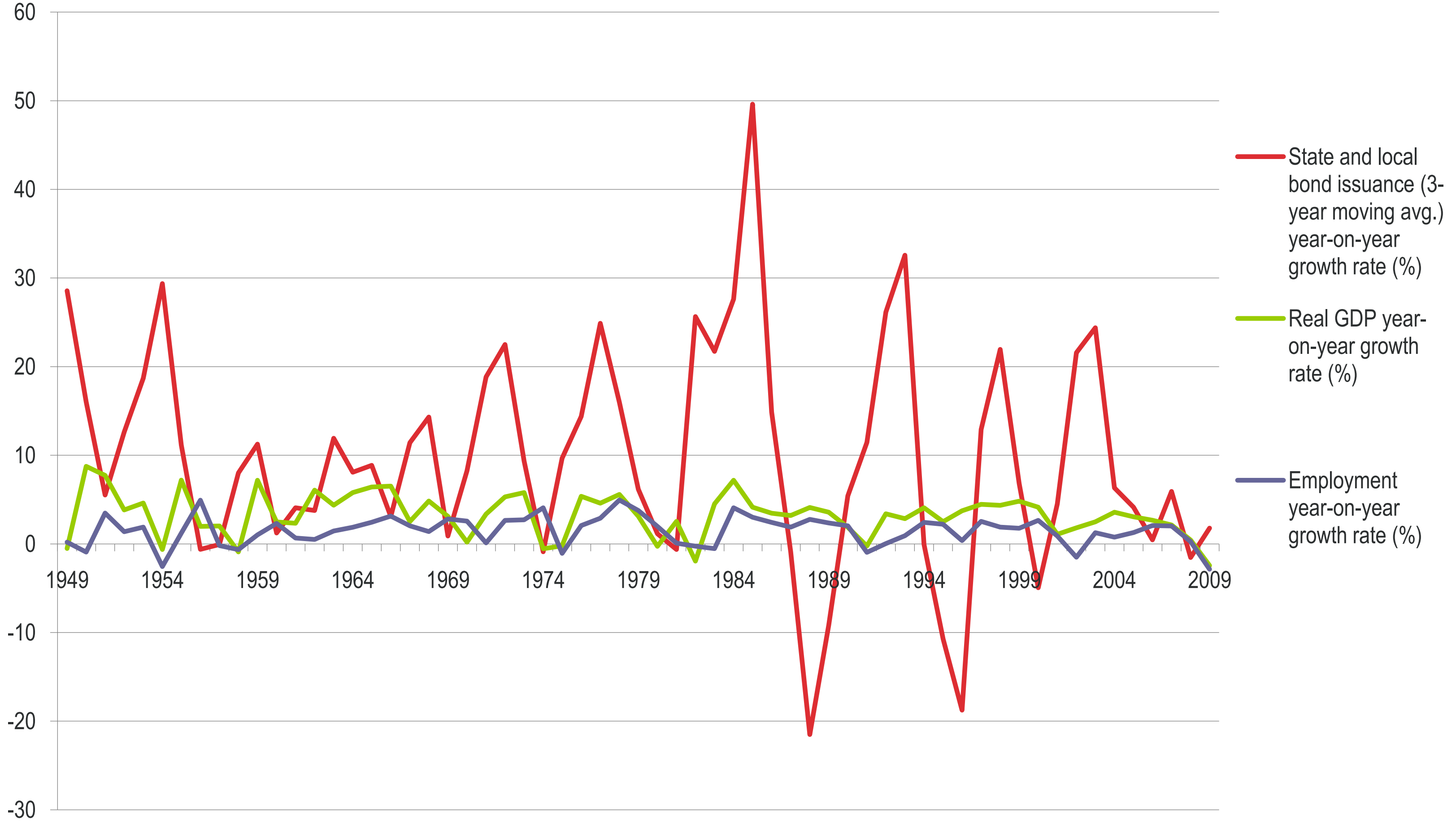
In fact, it has been the increased issuance of state and local debt that has helped stimulate the local, state and national economy during economic recessions. This increased issuance of debt by state and local governments has funded increased governmental financing and infrastructure improvements that create jobs for the unemployed, business opportunities for local businesses, demand for goods, and increased GDP growth and employment, which lead to increased tax revenues.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

YES – There is a correlation between the Increased Issuance of State and Local Debt during Economic Downturns and the following increased employment and GDP Growth.

In Economic Downturns, Increased Issuance of State and Local Bonds Is Followed by Increases in Employment and GDP Growth

U.S. Economic Trends, 1949-2009:
State/Local Bond Issuance, Real GDP, Employment
(year-on-year % change)



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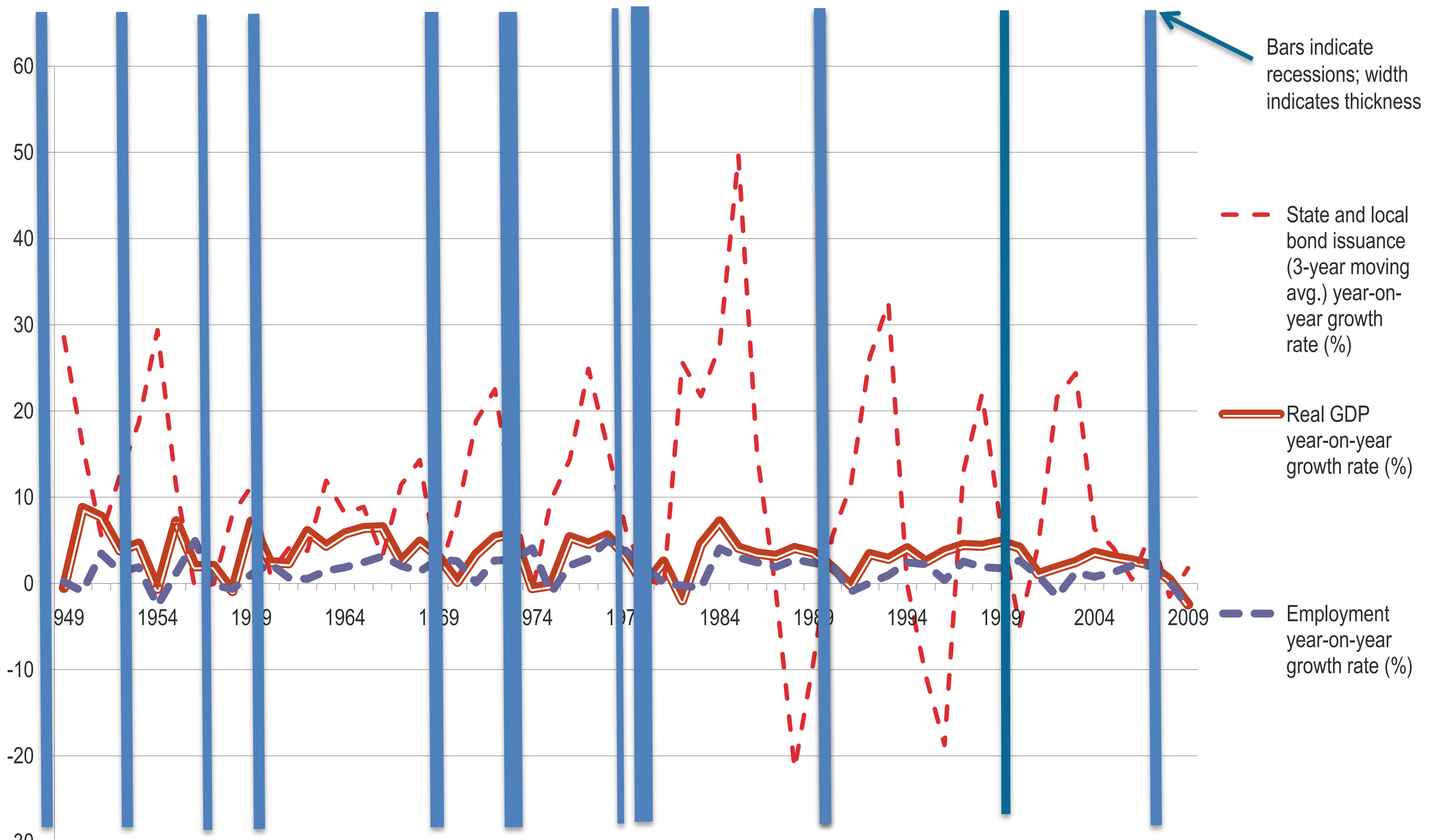
In Economic Downturns, Increased Issuance of State and Local Bonds Is Followed by Increases in Employment and GDP Growth

U.S. Economic Trends, 1949-2009 (year-on-year % change):



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I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

We are presently recovering from a significant economic downturn:

- With unemployment hovering 9% for many months, state and local governments will feel the effects of the following:
  - Lower Sales Tax Collection
  - Lower Real Estate Tax Collection
  - Lower Personal Income Tax Collection
- We have all seen this before and, in the past, issuances of state and local governments debt financing have helped stimulate the way to increased employment and economic growth.

Remember the Industrial Revenue Bonds, Recovery Zone Economic Development Bonds and other forms of financing and all of their efforts to increase business opportunities on the state and local level that have successfully led to past recoveries. Other similarly related state and local governments financing may this time be just what is necessary to encourage economic growth and job creation.

Changes in the Source of State and Local Governments Revenues (1922-2008)

General State and Local Governments Revenues 1922-2008: Totals and Percentage Distribution

	1922	1927	1932	1936	1940	1968	2008
Amount of Gen. Rev. (billions of dollars)	4.8	7.3	7.3	8.4	9.6	101.3	2425.8
Percent Distribution							
Property Tax	69.5	65.1	61.7	48.8	46.1	27.4	16.7
Sales Tax	3.2	6.5	10.3	17.7	20.6	22.6	18.5
Income Tax	2.1	2.2	2.1	3.2	4.0	9.7	14.8
Other Tax	9.2	10.0	10.6	10.2	10.6	7.0	4.5
Misc. Rev.	13.7	14.7	12.0	8.9	8.9	16.3	25.7
Federal Aid	2.3	1.6	3.2	11.3	9.8	17.0	19.8
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Bureau of the Census – John Petersen "Municipal Defaults Eighty Years Makes a Big Difference 5/21/11" p. 9 George Mason University

- Property, income and sales taxes made up over 70% of state and local governments revenues in 1922-1940 but only 50% of state and local governments revenue by 2008. More diverse and varied tax base in 2008 with more federal assistance.
- Property taxes which made up over 60% of the revenues of state and local governments between 1922-1932 was only 16.7% of revenue by 2008 with increases in sale, income other, miscellaneous and federal aid making up the difference.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

But we will never forget that there are economic cycles, and good times will be followed by bad times.

State and local governments have not only survived but have improved and grown through all these past downturns while continuing to provide ever increasing governmental services.

I. The Myth that State and Local Government Debt Is Prone to Default (cont'd)

- State and local government debt has also grown in the USA:
  - USA: State and Local Governments:
    - The debt of state and local governments has more than doubled in the last 10 years, from $1.197 trillion in 2000 to $2.8 trillion at the end of 2010. (Some (Citicorp) contend that the market is actually $3.7 trillion with individual holders being $1.8 trillion (rather than $1 trillion) or 50% of the market but hard to verify.)
    - This does not include over $1 trillion of unfunded pension liabilities and in addition OPEB liabilities over $200-300 or more billion plus the needed debt financing over the next five years to bring infrastructure up to acceptable standards of $2.5 trillion.

II. The Myth That 2011 Would Be Characterized by Widespread Municipal Bond Defaults

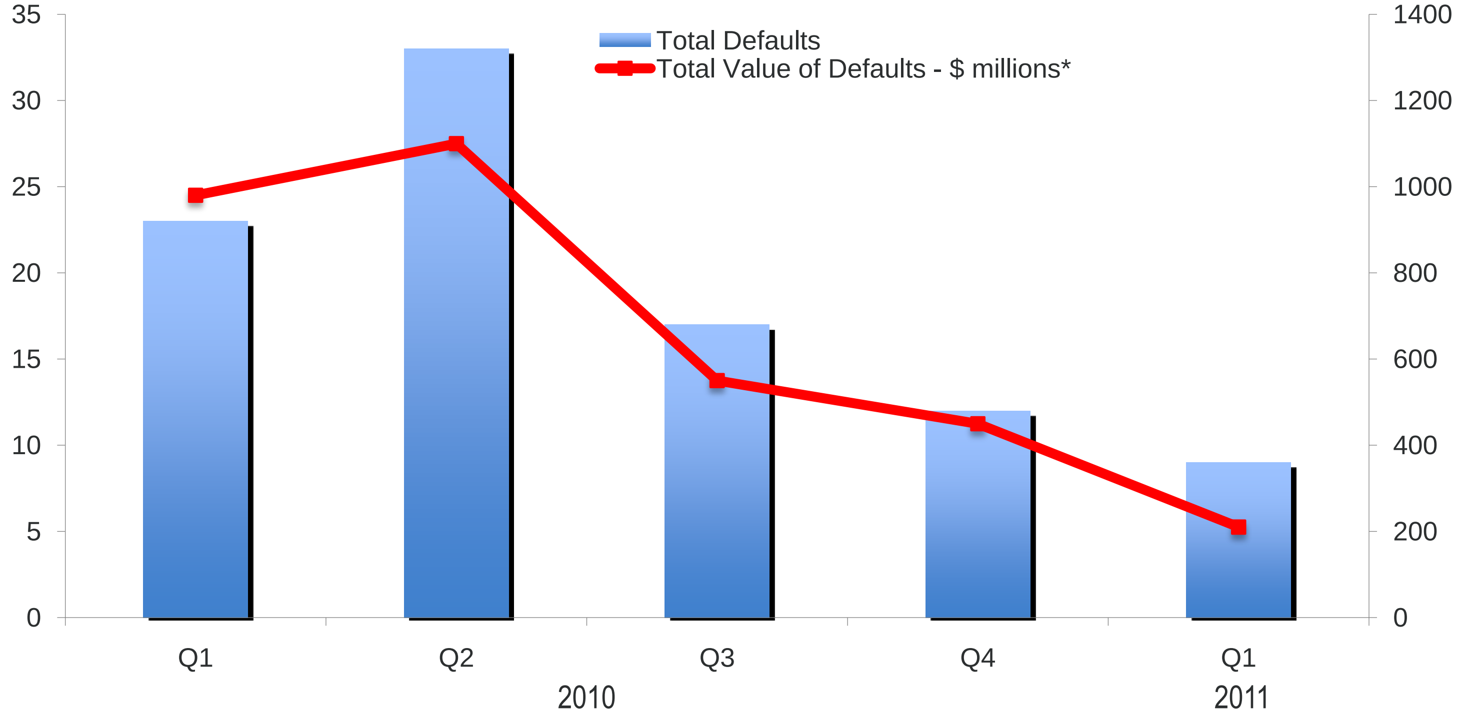
Myth: At the end of 2010, there were predictions of dire consequences to the municipal bond market and over $100 billion of defaulted debt in 2011.

Reality: In keeping with historical precedent, state and local government defaults went down in the last half of 2010 and first half of 2011.

In January to June 2011, there were only 24 municipal defaults totaling $746 million compared to 60 defaults totaling $2.29 billion for the first half of 2010 and 144 defaults totaling $4.89 billion for the first half of 2009.

U.S. Municipal Bond Defaults – 2010 and 2011 (Q1)

Rated and non-rated municipal bond defaults by quarter since January 1, 2010



*Rounded.
Source: Income Securities Advisors, Inc. and Reuters.

III. The Myth That the Strength of the State Economies Resembles That of the PIIGS

Myth: The financial strength of states in the U.S.A. is similar to that of other countries such as the PIIGS (Portugal, Italy, Ireland, Greece and Spain in Europe).

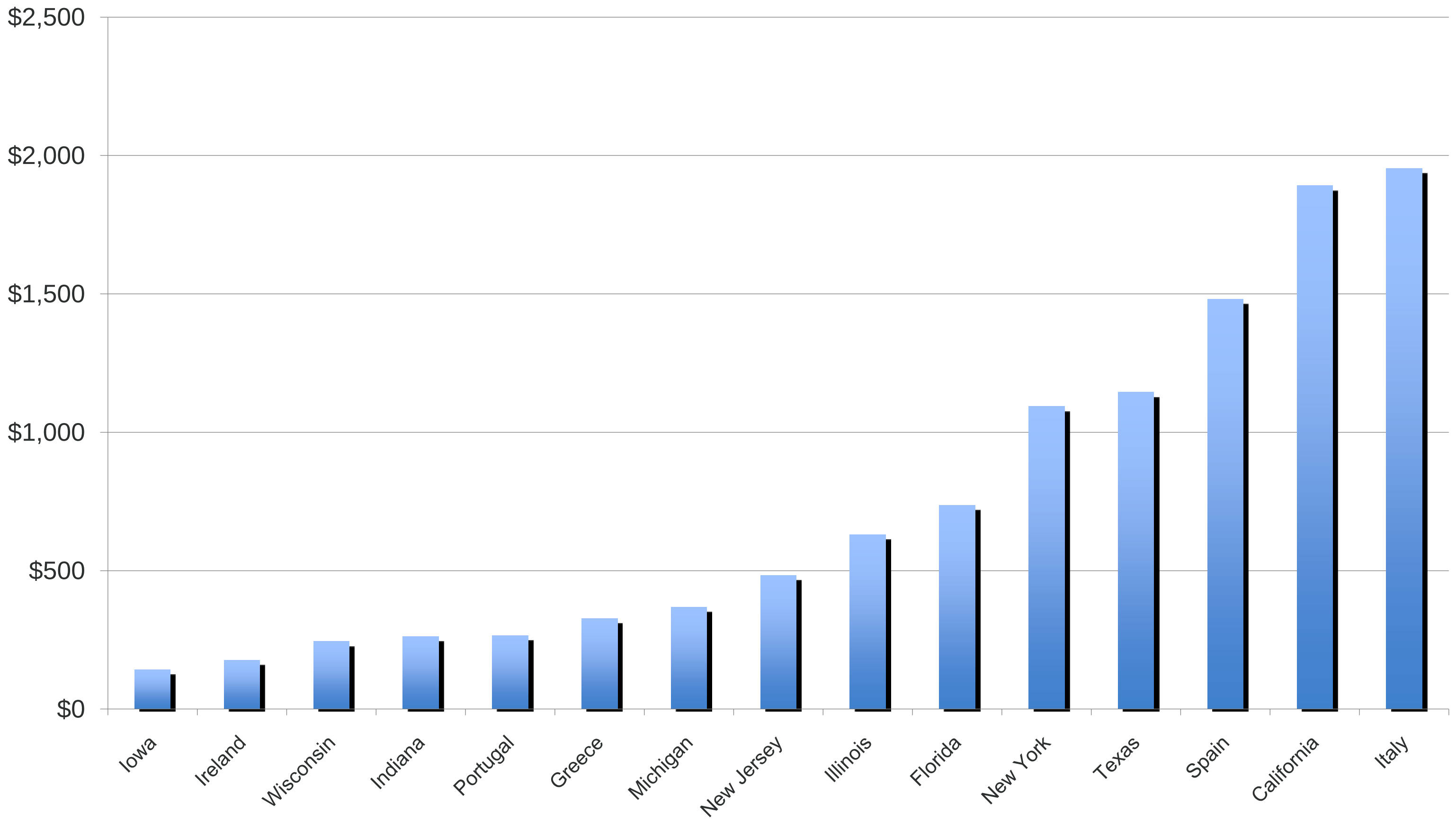
Reality: Even the perceived weakest U.S. state credits have higher GDP per capita, lower debt to revenue ratios than the PIIGS. Further, the percentage of debt of state and local governments to GDF is on average for the last 3 years half of that of what it was in 1931 to 1934.

III. The Myth That the Strength of the State Economies Resembles That of the PIIGS (cont'd)

Will any U.S. state become the next Greece or one of the PIIGS (Portugal, Italy, Ireland, Greece and Spain)?

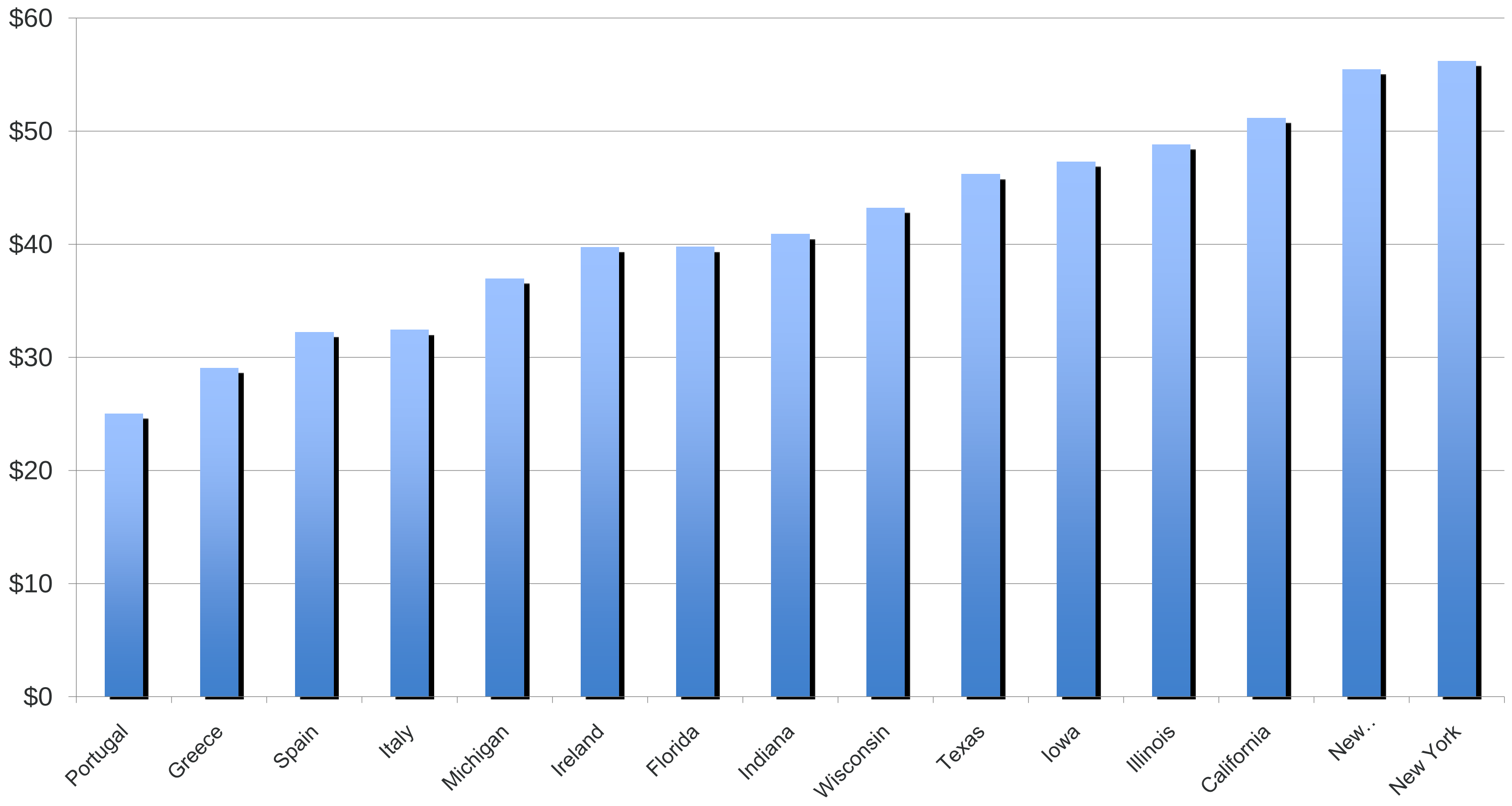
- The per capita GDP of each of California, Texas, Florida, New York, Illinois and New Jersey (certain "Major U.S. States") is higher than Portugal, Greece, Italy and Spain.
- The percentage of debt to revenue ratio is lower for Major U.S. States than Portugal, Italy and Greece.
- The percentage of debt to GDP is lower for certain Major U.S. States than Spain, Ireland, Portugal, Greece and Italy.
- Market perception can be different than reality. Look at Credit Default SWAPs ("CDS") for certain Major U.S. States and the PIIGS, where Italy, Spain, Ireland, Portugal have lower CDS spreads than New Jersey, New York, California and Illinois.

GDP of Selected U.S. States and European Countries Billions of 2009 USD



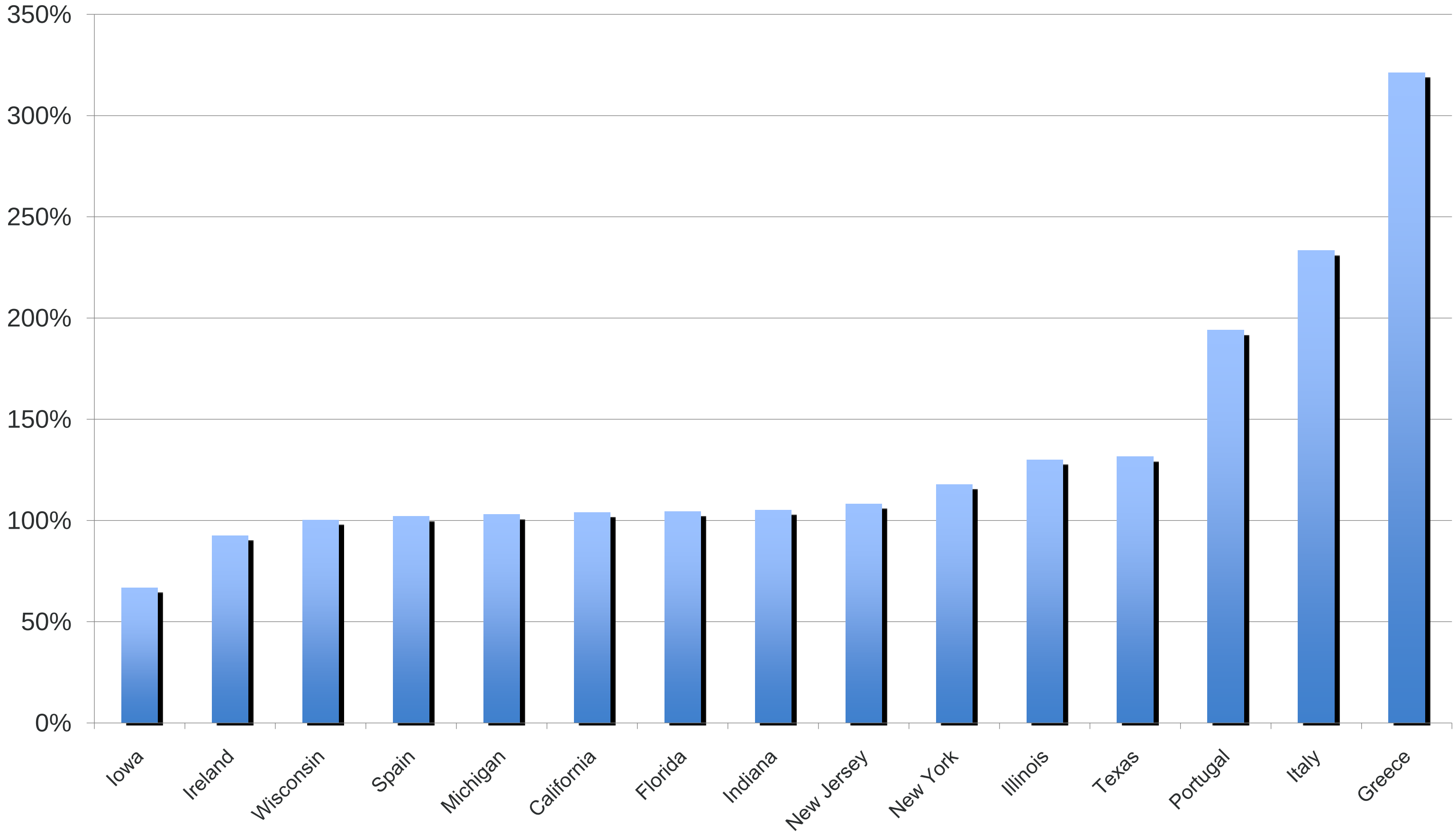
Source: US Bureau of Economic Analysis; OECD.

GDP per capita of Selected U.S. States and European Countries Thousands of 2009 USD



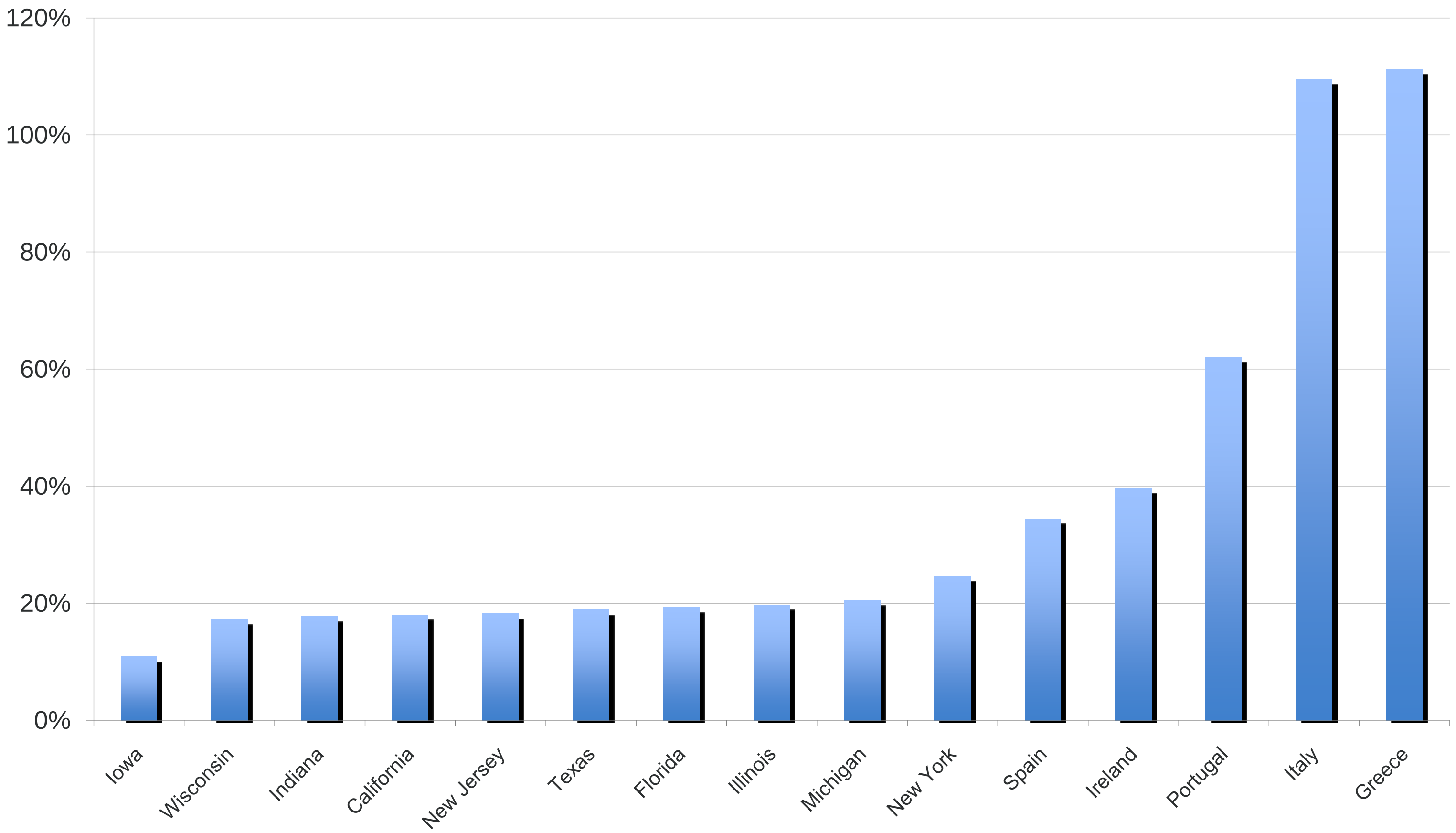
Source: US Bureau of Economic Analysis; US Census Bureau; OECD.

Debt-to-Revenue Ratio of Selected U.S. States and European Countries (2008 figures)



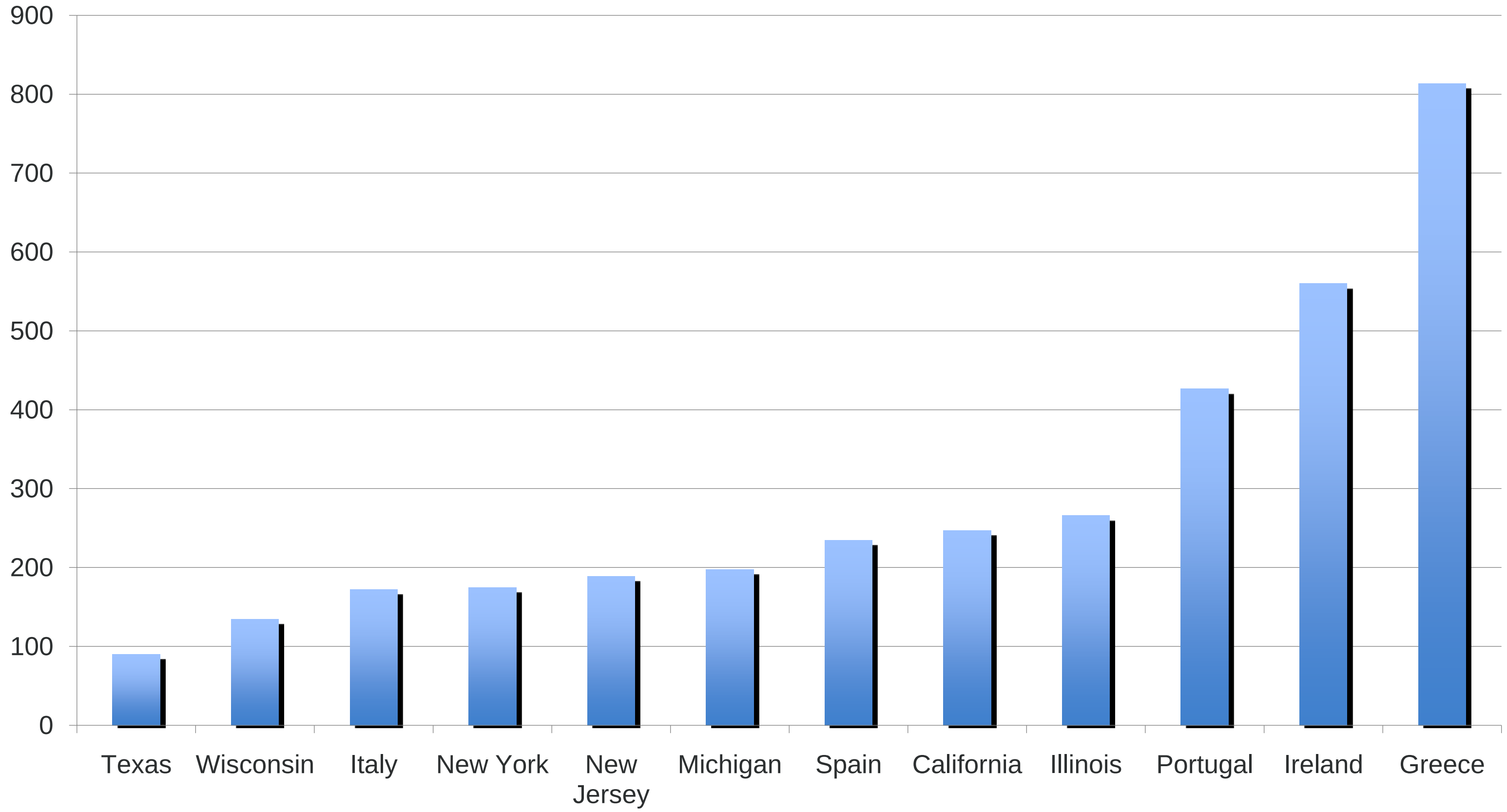
Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

Debt-to-GDP Ratio of Selected U.S. States and European Countries (2008 figures)



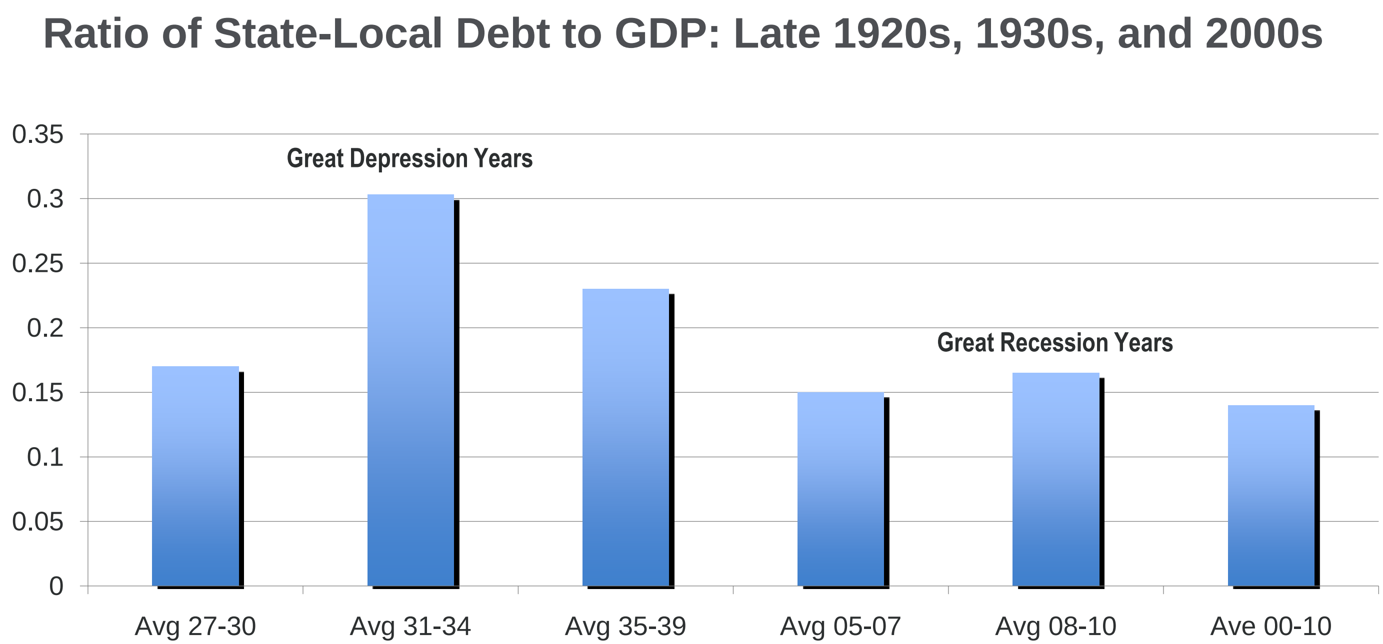
Source: US Bureau of Economic Analysis; US Census Bureau; Eurostat; OECD.

Credit Default Swap Spreads (bps) of Selected U.S. States and European Countries



Source: Bloomberg (February 8, 2011).

State and Local Governments Debt to GDP Percentage Has Improved from that of the Great Depression



Source: John Petersen: “Municipal Defaults Eighty Years Makes a Big Difference 5/21/11” p. 16 George Mason University

- Even much talked about individual states (such as California, Illinois, Michigan, New Jersey, New York and Texas) have GDP to Debt Ratios significantly lower than the 30% average during the Great Depression years.
- The current trend is reduced borrowing and debt issuance by state and local governments.

IV. The Myth That Economic Downturns Result in More Chapter 9 Filings

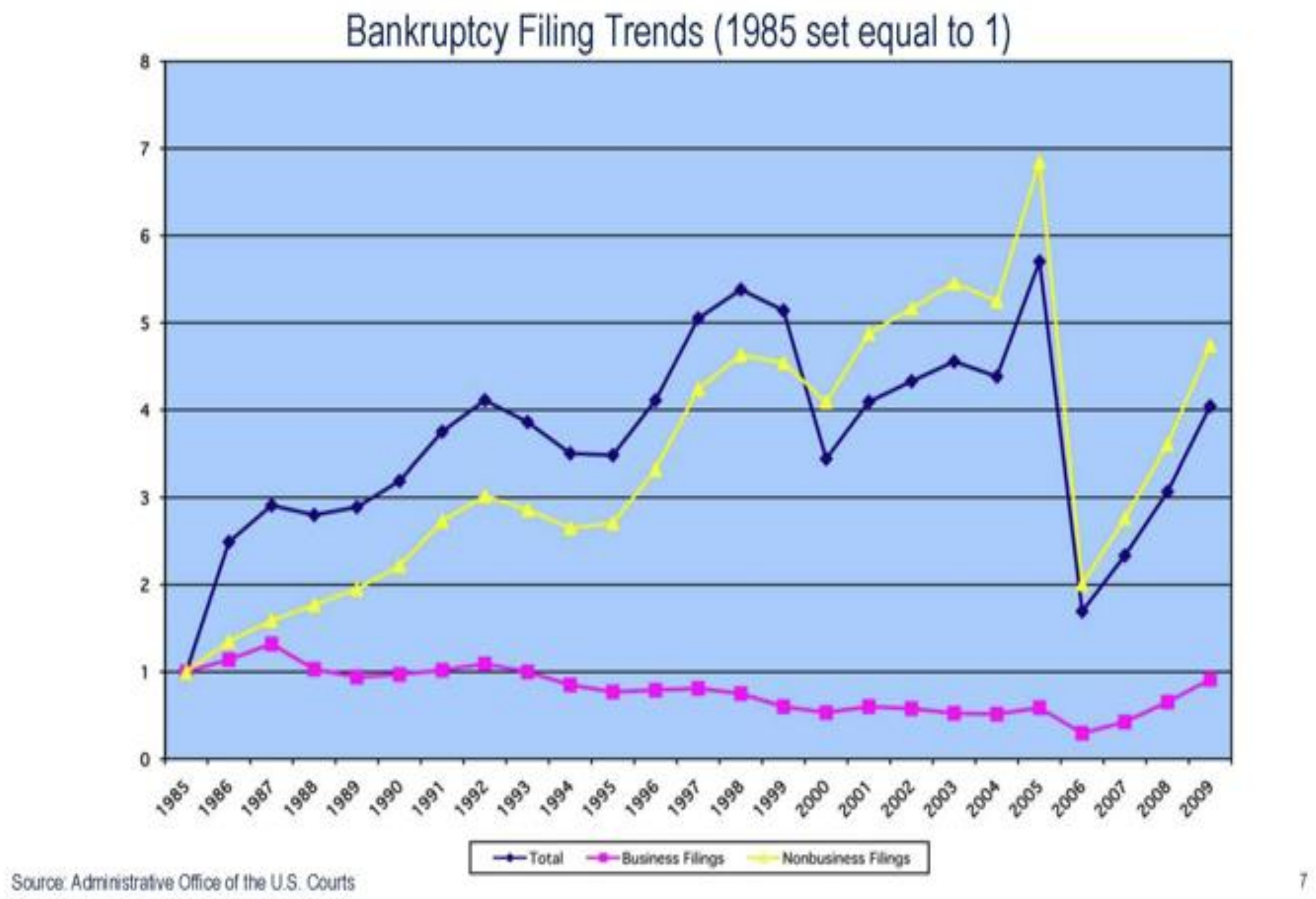
Myth: The use by local governments of Chapter 9 bankruptcy increases in times of economic downturn just like corporations.

Reality: Local governments rarely use Chapter 9 – generally only special tax districts and small municipalities files. No large issuers of municipal debt (with the exception of Orange County, California in 1994, Bridgeport, Connecticut in 1991 and Vallejo, California in 2008) have filed. Only 624 Chapter 9 filings since 1937. In 2008, 2009 and 2010 there were 4, 10 and 5, respectively, municipal Chapter 9 filings. There were 58,721 business (14,745 Chapter 11) filings in the year ending September 30, 2009 and 58,322 business bankruptcy (14,191 Chapter 11) filing in the year ending September 30, 2010.

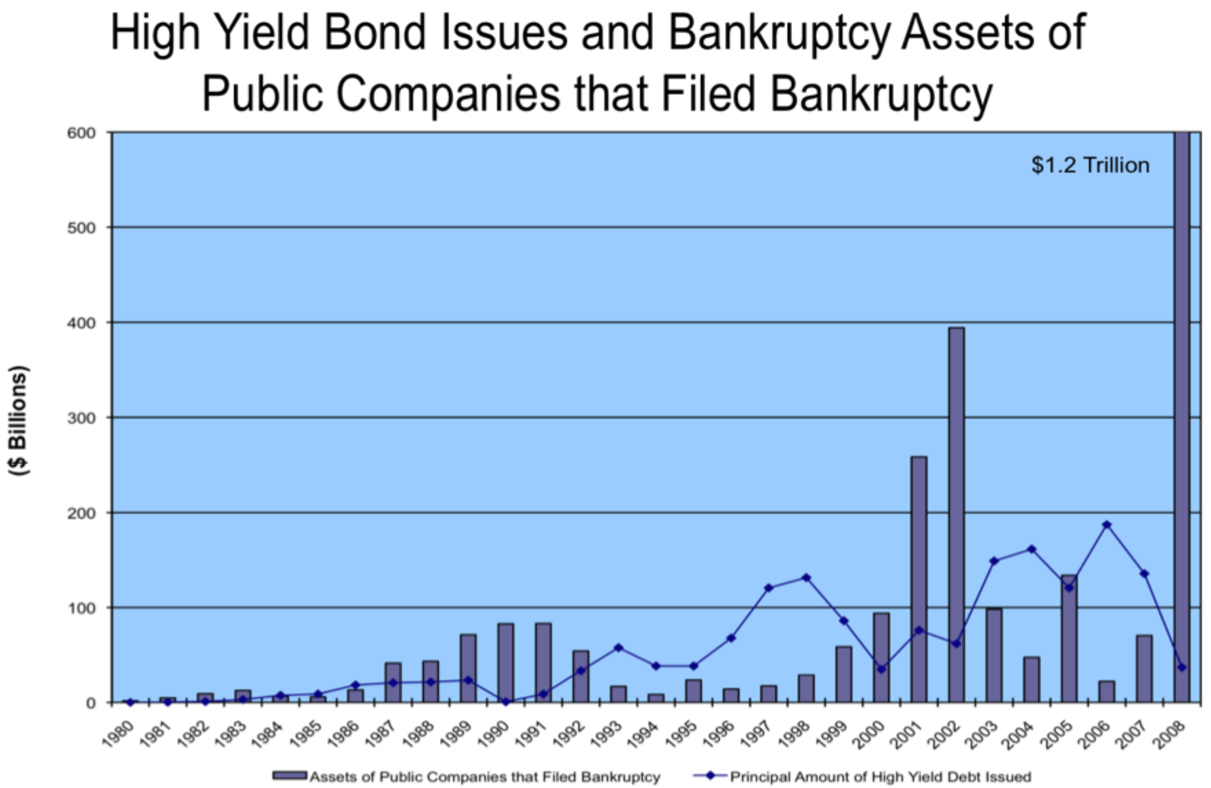
IV. The Myth That Economic Downturns Result in More Chapter 9 Filings (cont'd)

- Comparing Chapter 11 corporate organization filings to Chapter 9 municipal debt adjustment filings reveals the strength and credit quality of municipal bond debt. In 2009 and 2010, there were over 14,000 Chapter 11 corporate reorganizations filed each year. Since 1937, there have only been 620 Chapter 9 cases filed, most of which have been small special tax district and entities that did not issue municipal bonds.

Default Statistics

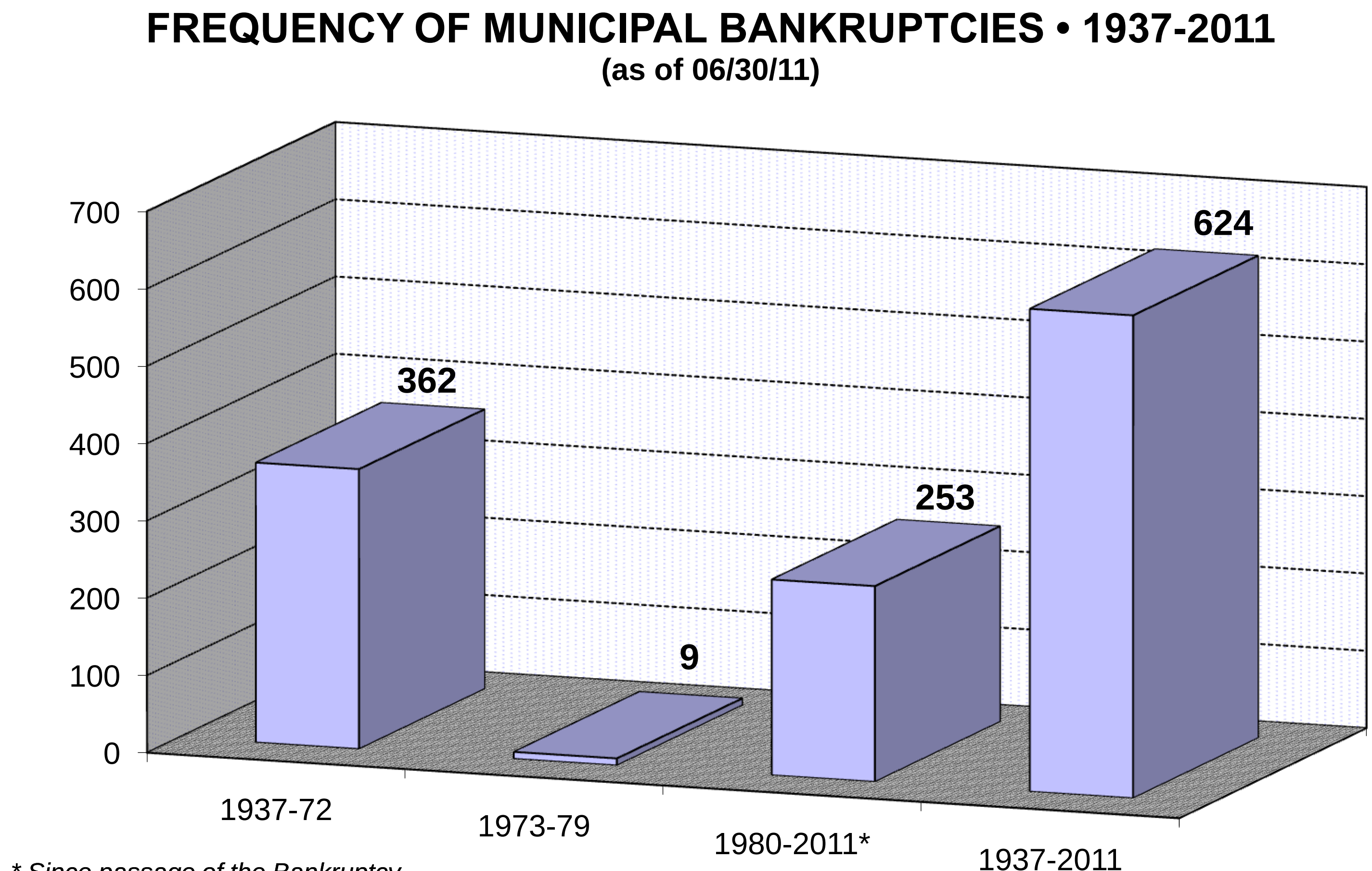


Default Statistics (cont'd)



Source: Thomson Financial

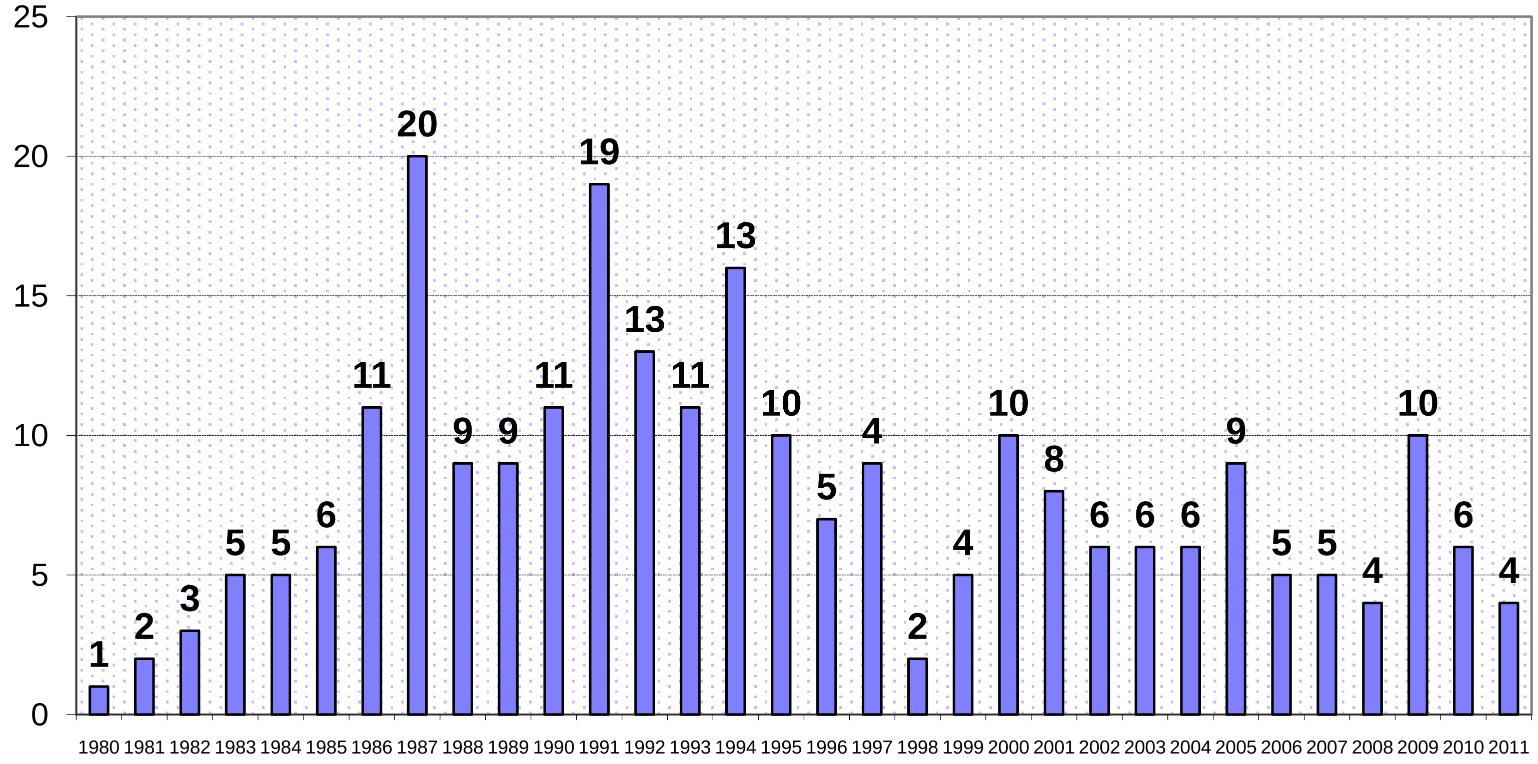
Default Statistics (cont'd)



** Since passage of the Bankruptcy*

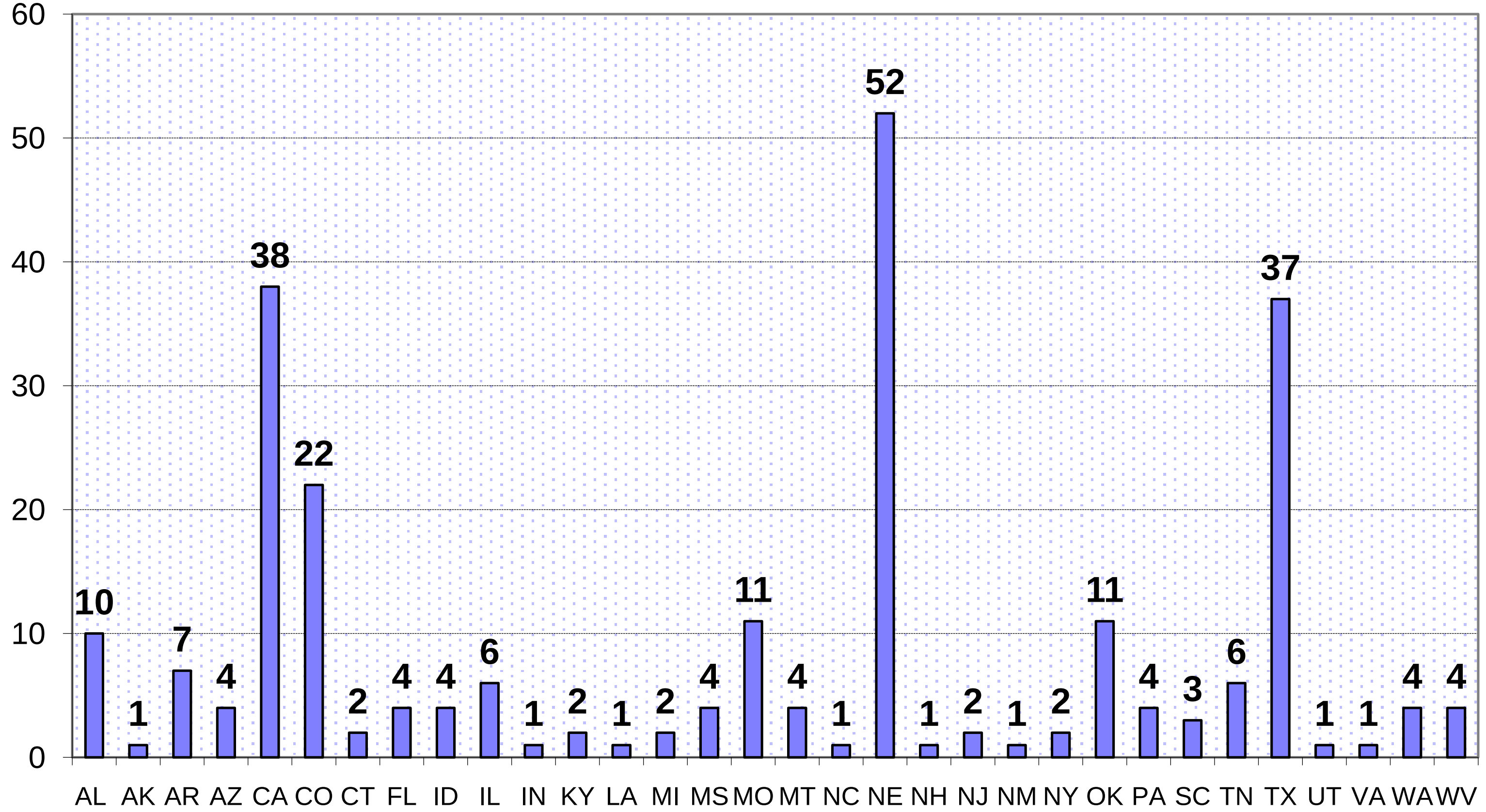
Default Statistics (cont'd)

CHAPTER 9 FILINGS BY YEAR • 1980-2011
(as of 06/30/11)

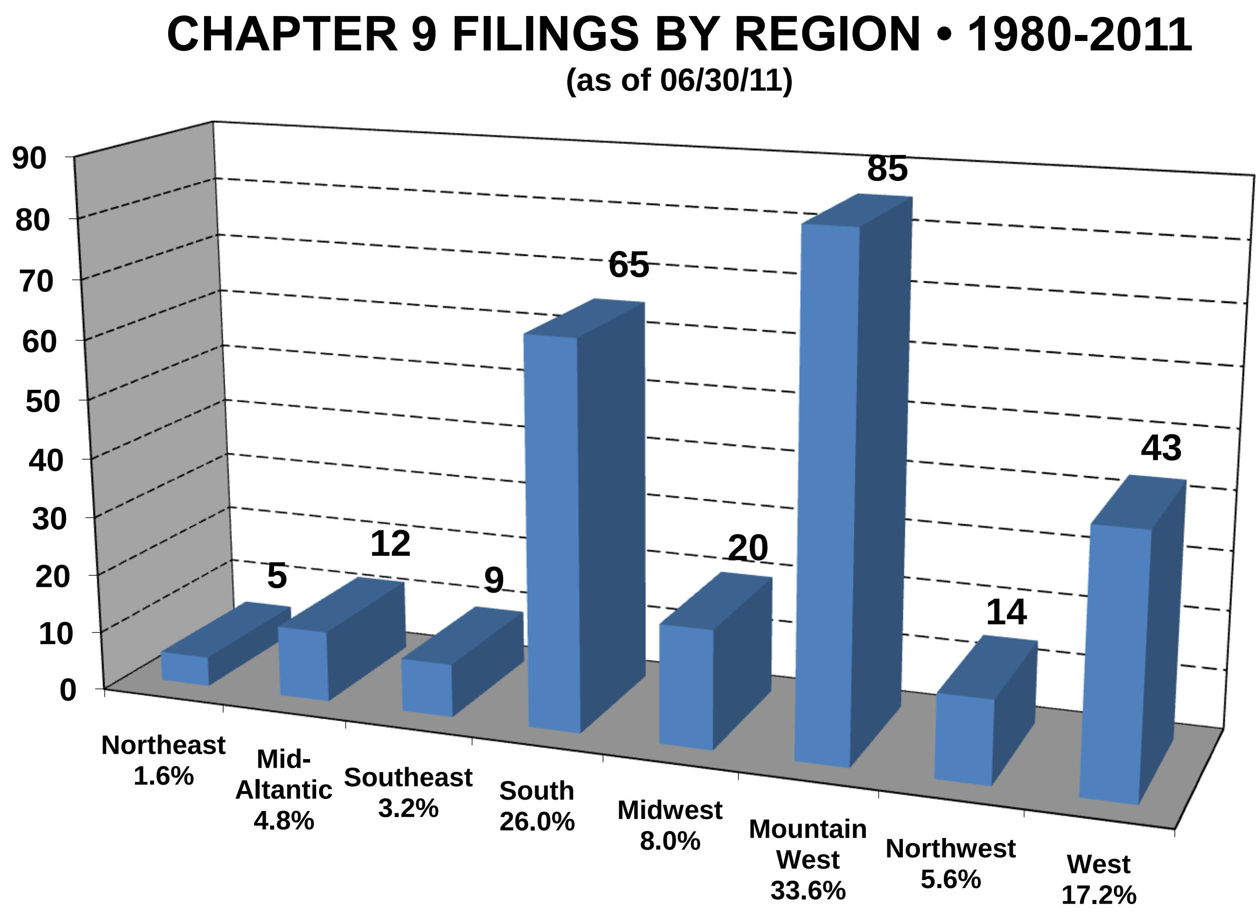


Default Statistics (cont'd)

CHAPTER 9 FILINGS BY STATE • 1980-2011
(as of 06/30/11)



Default Statistics (cont'd)



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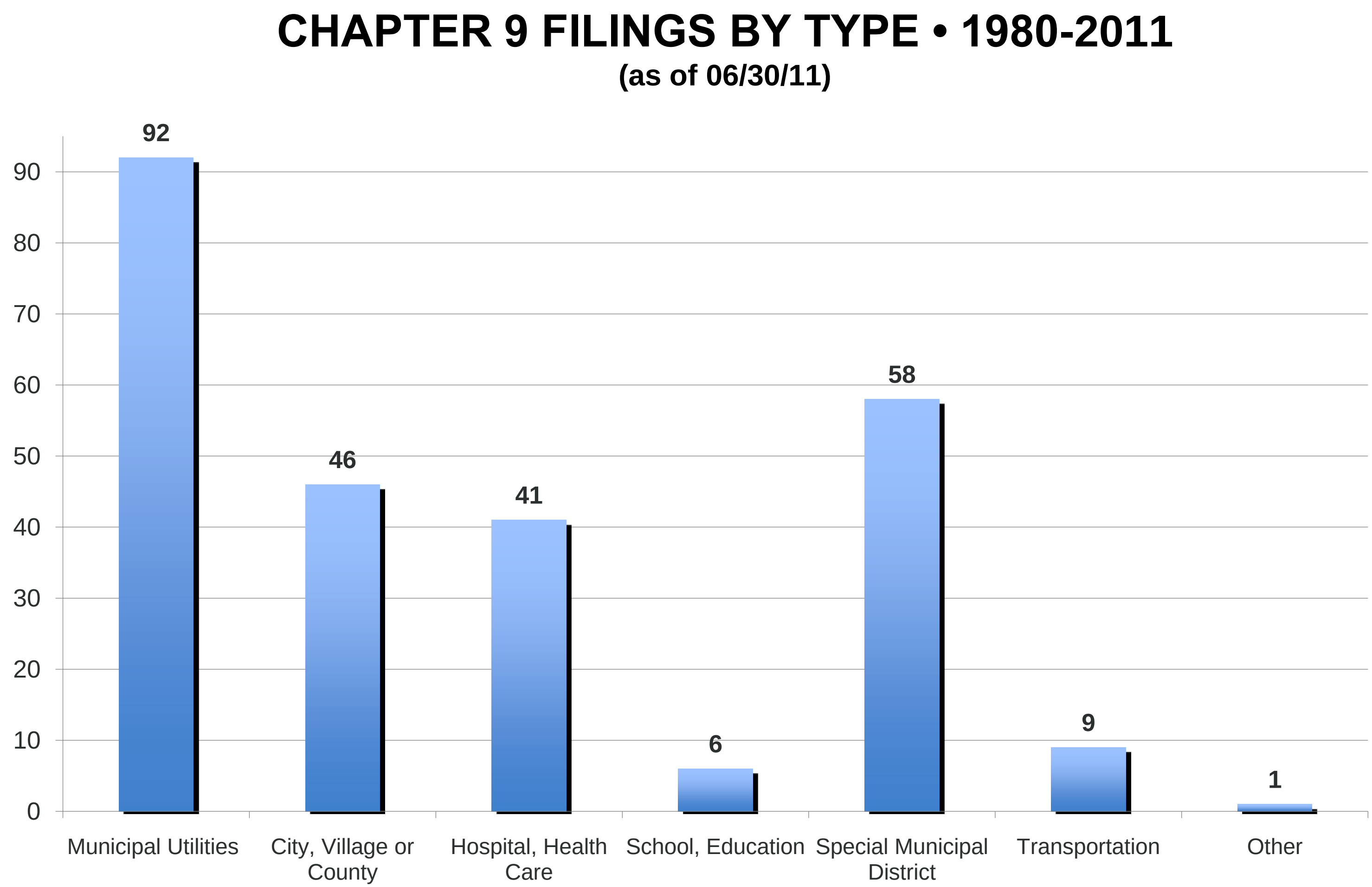
Default Statistics (cont'd)



IV. The Myth That Economic Downturns Result in More Chapter 9 Filings (cont'd)

Corporate Bankruptcies – Trend Towards Acceptance of Default and Bankruptcy (Reorganization)

- Increase with less acceptance. Increased more than 5 times between 1950-1989.
- Since 1983 average of over 15,000 per year Chapter 11 (Corporate Restructurings).
- Now viable means of Corporate Restructuring. For the 12 Month Period ending September 30, 2004, 34,817 "business filings (36,183 in 2003 and 39,091 in 2002) (Sources: Annual Reports of the Director of the Administrative Office of the United States Courts). While higher number of overall business filings in 1980's and early 1990's there now appears to be more acceptance with Mega Company filings.
- 2008-2009 Lehman, Washington Mutual, GM, Chrysler, CIT Group – just those five recent cases add up to $1.151 trillion of Assets in Bankruptcy.

Municipal Defaults

Frequency of Municipal Defaults

Less than 11,000 defaults since 1839 for over 50,000 municipal and state entities.

There were 6,195 defaults between 1839-1969 consisting of:

- 727 counties and parishes.
- 1,911 incorporated municipalities.
- 313 unincorporated municipalities.
- 1,372 school districts.
- 1,872 special purposes districts.
- (4,770 default between 1929-1937).

Defaults by Governmental Bodies During the Period of 1929-1937

Type of Government Unit	Number in Default	Percentage of Total Number in Default	Indebtedness of Defaulting Unit (in $ millions $)	Percentage of Debt in Default
Counties	417	13.7	$ 360	15.1
Incorporated Municipalities	1,434	8.3	1,760	19.9
Towns Organized townships	88	.4	10	2.9
School Districts	1,241	.9	160	7.8
Reclamation, levee irrigation, and drainage districts	944	28.2		
Other special districts	644	12.4	400	25.0
Total	4,770	2.7	$2,690	17.7

Source: A Commission Report "City Financial Emergencies: The Intergovernmental Dimension," Advisory Commission on Intergovernmental Relations, Washington, D.C. July 1973.

Municipal Defaults

Frequency of Municipal Defaults (cont'd)

1944–1970 — only $450 million Bonds Defaults (most Toll Roads and Bridges).

Between 1937 and Present 624 Municipal Debt Adjustment – Bankruptcy – Chapter 9 Filings.

Between 1937–1972 — 362 involving $217 million in Debt (Small Special Tax Districts).

Traditional Causes of Default by State and Local Government

<u>Traditional Causes of Municipal Bond Defaults in U.S.A.</u>

1. Economic Depression:
   - 1837 - Mobile.
   - 1843 - Bridgeport.
   - 1857 - Chicago-Philadelphia.
   - 1860s - Civil War Debts — 13 States Repudiate Reconstruction and War Debt.
   - 1873 - Mobile.
   - 1877 - Pittsburgh.

Traditional Causes of Default by State and Local Government (cont'd)

<u>Traditional Causes of Municipal Bond Defaults in U.S.A. (cont'd)</u>

2. Non Essential Services:
   - Railroad Station (with no railroad).
   - Real Estate speculation.
   - Refuse burning facilities.
   - Large housing developments on Guam.
3. Feasibility of Projects and Industries:
   - Ranger Texas.
   - WPPSS.

Traditional Causes of Default by State and Local Government (cont'd)

<u>Traditional Causes of Municipal Bond Defaults in U.S.A. (cont'd)</u>

4. Fraud:
   - Irrational Investment Strategies – Orange County.
5. Mismanagement.
6. Unwillingness to pay:
   - 13 States in 1860s.
   - WPPSS.
   - Orange County.
7. Natural and Man Made Disasters:
   - South Tucson, Arizona – Tort Liability.
   - 1900 Galveston, Texas – Hurricane.
   - 9/11/01 attack on NYC.

Corporate Default Frequency

Frequency of Corporate Defaults

1900-1943	-	average default rate of 1.7%.
1944-1965	-	1/10 of 1%.
1970	-	over $1 billion dollars of Default.
1987	-	$21.4 billion of Corporate Debt Default.
1991	-	$26.5 billion of Corporate Debt Default.
1993	-	$7 billion of Corporate Debt Default.
1979-1990	-	High yield Corporate Debt $21.4 billion $26.9 billion defaulted by 1990 (12.564%).
1998-2002	-	Increasing Corporate Defaults $7.3 billion for 1998, $20.7 billion for 1999, $32.2 billion for 2000 and $63 billion or 9.3% of High Yield Bond Market for 2001.
2002-2004	-	A drop off from the high in 2002 of $108 billion to $24.7 billion in 2003 and $10.3 billion in 2004. Speculation that defaults will increase in late 2005 and 2006.
2008	-	Assets in Bankruptcy increased to $1.2 trillion with Lehman's $639 billion of assets in Bankruptcy and Washington Mutual's $325 billion (almost triple any other year in recent history).

V. The Myth That Every Municipality Can File for Chapter 9

<u>Myth</u>: Every municipalities in each of the 50 states can file for Chapter 9 whenever the municipality desires.

<u>Reality</u>: Municipalities have to be specifically authorized by their state to file Chapter 9 municipal bankruptcy. Only the municipalities in 11 states are specifically authorized to file (and in 13 additional states the authorization is conditional on the approval of some state official or commission to file). In addition, a municipality must meet the requirements of the Bankruptcy Code that it is a municipality, authorized by its state, that is insolvent, willing to effectuate a plan of debt adjustment and has obtained the consent of a majority of amount of claims that would be impaired or was unable to obtain consent after attempting in good faith to do so, or given the number it was impractical to seek consent.

General Analysis of Chapter 9
Who Can File?

- To be a Debtor in a Chapter 9, an entity must be:
  - An entity that is a municipality;
  - Specifically authorized under State law to be a Debtor. Thirteen States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, CA, ID, MN, MO, MT, NE, OK, SC, TX, WA), another eleven States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI) Three states (CO, OR and IL) grant limited authorization, two states prohibit filing (GA) but one of them (IA) has an exception to the prohibition. The remaining 21 are either unclear or do not have specific authorization;
  - Insolvent;
  - Willing to effectuate a plan; and
  - Either have obtained the agreement of creditors holding majority amount of the claim of each class that the municipality intends to impair or have attempted to negotiate in good faith, but was unable to do so or it was impractical to negotiate with creditors or a creditor is attempting to obtain a preference.

General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case

The following are statutory provisions in which states have authorized Chapter 9 filings for certain governmental entities

<u>13 States that specifically authorize municipal bankruptcies</u>:

Ala. Code 1975 § 11-81-3
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
Cal. Gov't Code § 53760
Idaho Code Ann. § 67-3903
Minn. Stat. Ann. § 471.831
Mo. Ann. Stat. § 427.100
Mont. Code Ann. § 7-7-132
Neb. Rev. St. § 13-402
Okla. Stat. Ann. tit. 62 §§ 281, 283
S.C. Code Ann. § 6-1-10
Tex. Loc. Gov't Code § 140.001
Wash. Rev. Code § 39.64.040

The 21 Remaining States are either unclear or do not have specific authorization. AK, DE, HI, IN, KS, ME, MD, MA, MS, NE, NH, NM, ND, SD, TN, UT, VA, VT, WV, WI, WY.

<u>11 States that *conditionally* authorize municipal bankruptcies</u>:

Conn. Gen. Stat. Ann. § 7-566
Fla. Stat. Ann. § 218.01 and §218.503
Ky. Rev. Stat Ann. § 66.400
La. Rev. Stat. Ann. § 39-619
Mich. Comp. Laws § 141.1222
N.J. Stat. Ann. § 52:27-40
N.C. Gen. Stat. Ann. § 23-48
N.Y. Local Finance Law § 85.80
Ohio Rev. Code Ann. § 133.36
53 Pa. Cons. Stat. Ann. § 11701.261
R.I. Gen. Laws §45-9-7

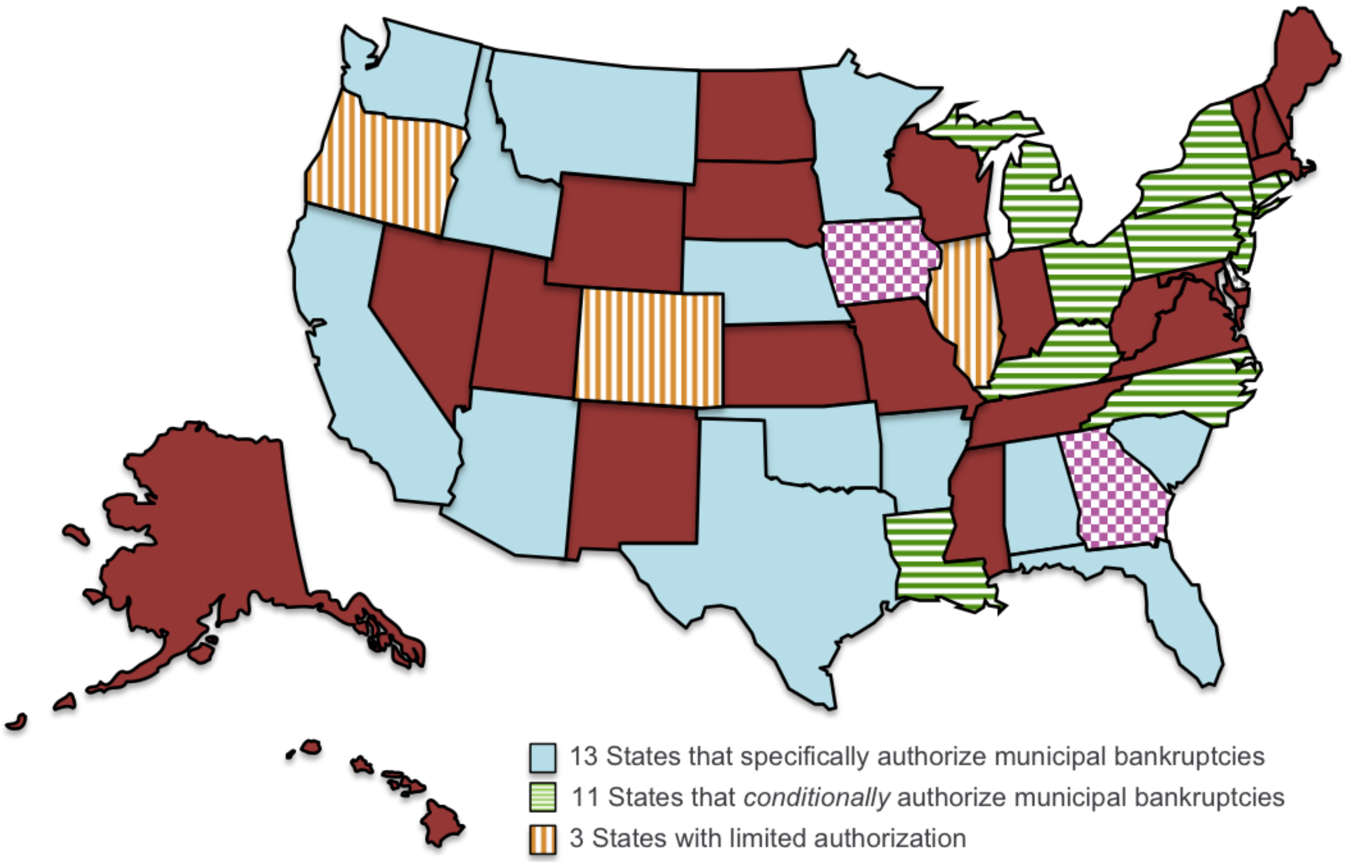
<u>3 States with limited authorization</u>

- Colorado has enacted legislation specifically authorizing its beleaguered special taxing districts to file a petition under Chapter 9. Section 32-1-1403 of the Colorado revised statutes states that "any insolvent taxing district is hereby authorized to file a petition authorized by federal bankruptcy law and to take any and all action necessary or proper to carry out the plan filed with said petition…" (CRS § 37-32-102 (Drainage & Irrigation District))
- Oregon permits Irrigation and Drainage Districts to file (Or. Rev. Stat. § 548.705)
- Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 3855/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

<u>2 States prohibit filing but one has an Exception</u>

- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

General Analysis of State Specific Authorization for Municipalities to File a Chapter 9 Case (cont’d)



- 13 States that specifically authorize municipal bankruptcies
- 11 States that *conditionally* authorize municipal bankruptcies
- 3 States with limited authorization
- 2 States prohibit filing, but one has an exception (Iowa)
- Remaining 21 States are either unclear or do not have specific authorization so there is no specific authorization

General Analysis of Chapter 9

What is a Municipality?

Under 11 U.S.C. §101 (15):

An “entity” includes a person, estate, trust, governmental unit, and United States Trustee.

Under 11 U.S.C. §101 (27):

An “governmental unit” means United States, State, Commonwealth, District, Territory, municipality, foreign state, department, agency, or instrumentality of the United States (but not a United States trustee while serving as a Trustee), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state or other foreign or domestic government.

Under 11 U.S.C. §101 (40):

A “municipality” means political subdivision or public agency or instrumentality of a state.

General Analysis of Chapter 9 (cont'd)

<u>Steps to File for Chapter 9</u>

- State and local law is followed to document proper authorization.
- Voluntary petition is filed in the Federal District Court where municipality is located.
- The chief judge of the Court of Appeals for the district where case commenced designates the judge to hear the case.
- Commencement of the case constitutes an "order for relief" (this is clarified in new Bankruptcy Bill).
- After notice and hearing, the Court may dismiss the petition if the Debtor did not file the petition in good faith or if the petition does not meet the requirements of the title.

General Analysis of Chapter 9 Unlike a Chapter 11

- In Chapter 9, only the Debtor can file the case.
- In Chapter 9, only the Debtor can file the plan of debt adjustment.
- In Chapter 9, there is no Section 1113 criteria for sharing information with employee representatives or workers or any process of information sharing prior to rejection of union or employment contracts.
- In Chapter 9, there is no limitation on damages on real estate leases held by a Trustee for a Municipal Building Authority (real estate lease).
- In Chapter 9, municipal bond and note payments made pre-petition, even within 90 days of the filing, are not preferential.
- In Chapter 9, there are no priorities for pre-petition wages, benefits, accrued vacation and health care benefits. There is no $11,725 per employee priority claim.

General Analysis of Chapter 9
Limitation on the Bankruptcy Court

- The Bankruptcy Court in a Chapter 9 proceeding cannot interfere with the government and affairs of the municipality.
- Other than the lack of revenues to pay creditors, municipal services are provided and determined as to whether they will be provided by the governmental body, not by the Bankruptcy Judge.
- Unlike Chapter 11, the municipality can sell its assets, incur debt and engage in governmental affairs without necessarily having to obtain the approval of the bankruptcy court.

VI. The Myth That the Treatment of Municipal Debt Is Similar to That Corporate Debt in Bankruptcy

Myth: All municipal debt in Chapter 9 is treated just like corporate debt in Chapter 11.

Reality: No! Municipal debt which has a pledge of revenues/ taxes that qualifies as special revenues or is created as a statutory lien and is to be paid from the pledged funds cannot be interfered with or impaired and, as such, pledged funds as collected are to be paid to the bondholders in bankruptcy. There is no ability to claw back bond or note payments as preferences and municipal workers contracts can be rejected if burdensome and there are no priorities for workers unsecured claims.

How Is Municipal Debt Treated in a Chapter 9 Proceeding? (Priority of Payment)

Summary of Chapter 9 Priorities

	TYPE OF CLAIM	EXPLANATION
1.	Obligations secured by a statutory lien to the extent of the value of the collateral.[ab]	Debt (Bonds, Trans, Rans) issued pursuant to statute that itself imposes a pledge. (There may be delay in payments due to automatic stay - unless stay is lifted - but ultimately will be paid.)
2.	Obligations secured by Special Revenues (subject to necessary operating expenses of such project or system) to the extent of the value of the collateral.[ab] These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.	Special Revenue Bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specially levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.[c] There should be no delay in payment since automatic stay is lifted under Section 922(d).

a Chapter 9 incorporates Section 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. (But see Nos. 3 and 4) incorporates Section 364(d) of the Bankruptcy Code which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.

c A Pledge of Revenues

b Chapter 9 that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing Post-Petition Lien under Section 552 of the Bankruptcy Code.

How Is Municipal Debt Treated in a Chapter 9 Proceeding? (Priority of Payment) (cont'd)

	TYPE OF CLAIM	EXPLANATION
3.	Secured Lien based on Bond Resolution or contractual provisions that does not meet test of Statutory Lien or Special Revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof.[c]	Under language of Sections 522 and 958, liens on such collateral would not continue postpetition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or Debtor. You may expect the creditor to argue that pursuant to Section 904, the Court cannot interfere with the property or revenues of the Debtor, and that includes the grant of security to such secured creditor.
4.	Obligations secured by a municipal facility lease financing.	Under Section 929 of the Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5.	Administrative Expenses (which would include expenses incurred in connection with the Chapter 9 case itself).[d] Chapter 9 incorporates Section 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under Section 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to Section 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.

d These expenses strictly relate to the costs of the Bankruptcy. Because the Bankruptcy Court cannot interfere with the government and affairs of the municipality, general operating expenses of the municipality are not within the control of the Court, are not discharged and will remain liabilities of the municipality after the confirmation of a plan or dismissal of the case.

How Is Municipal Debt Treated in a Chapter 9 Proceeding? (Priority of Payment) (cont'd)

TYPE OF CLAIM	EXPLANATION
6. Unsecured Debt includes:	
A. Senior Unsecured Claims with benefit of subordination paid to the extent of available funds (without any obligation to raise taxes) which include any of B, C, D, or E below.	
B. General Obligation Bonds.	Secured by the "full faith and credit" of the issuing municipality. Postpetition, a court may treat general obligation bonds without a statutory lien or Special Revenues pledge as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease.
C. Trade.	Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services.[e]
D. Obligations for Accrued but Unpaid Prepetition Wages and Pensions and other Employee Benefits.	These do not enjoy any priority, unlike in a Chapter 11.[f]
E. Unsecured portion of secured indebtedness.	
F. Subordinated Unsecured Claims.	Any debt subordinated by statue or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive *pro rata* distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

e Section 503(b)(9) provides for a priority claim to be paid on Confirmation of a Plan for the value of goods provided prepetition within 20 days of the Petition Date.

f Chapter 9 does not incorporate Section 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collative bargaining agreements (making the standard less restrictive, *i.e.,* "impairs ability to rehabilitate"), or Sections 507(a)(4) and (5), which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacation, severance, sick leave or contribution to pension plans of currently $11,725 per employee.

The Role of Special Revenues

- Many municipal bonds are revenue bonds secured by a pledge of revenues derived from the project or a special tax levy.
- Section 552 of the Bankruptcy Code generally provides that property acquired post-petition is not subject to a lien resulting from any security interest created pre-petition.
- Section 928 of the Bankruptcy Code, one of the Municipal Bankruptcy Amendments, renders Section 552(a) inapplicable to revenue bonds secured by “special revenues.”
- The security interest in “special revenues” remains valid and enforceable even though such revenues are received after a Chapter 9 filing.
- Subsection (b) of Section 928 provides that in the case of project or system financing, the bondholders’ lien on “special revenues” is subject to necessary operating expenses of the project or system. Thus, these expenses can be put in front of bondholder claims.

The Role of Special Revenues (cont'd)

- "Special revenues" means—
  - (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems,
  - (B) special excise taxes imposed on particular activities or transactions,
  - (C) incremental tax receipts from the benefited area in the case of tax-increment financing,
  - (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions, or
  - (E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.

The Role of Special Revenues (cont'd)

This problem, however, has been addressed by the Municipal Bankruptcy Amendments. Section 927 of the Bankruptcy Code provides that the holder of a claim payable solely from "special revenues" of the debtor shall not be treated as having recourse against the debtor on account of such claim pursuant to Section 1111(b). The legislative history for this section recognizes that many municipal obligations are, by reason of constitutional, statutory or charter provisions, payable solely from special revenues and not from the full faith and credit of the municipality. This amendment leaves these legal and contractual limitations intact without otherwise altering the provisions with respect to nonrecourse financing. Thus, according to the Senate Report, this section avoids the potential conversion of revenue bonds into general obligation bonds.

Recent Court Test of Special Revenues / Statutory Lien Concepts

- The 1988 municipal bankruptcy amendment recognizing the post-petition effectiveness of a lien on special revenues brought needed clarity to municipal finance.
  - Absent such clarification, a risk had existed that a lien on special revenues could be avoided under Bankruptcy Code Section 552(a), effectively turning a revenue bond into a general obligation bond.
- Subsequently, given consideration of the 10th amendment to the U.S. Constitution reserving power to the States, the Orange County Bankruptcy produced a decision recognizing that liens created by a force of state statute, as opposed to a lien created by agreement of the parties, would survive a Chapter 9 filing.
- Few court rulings have dealt with such concepts.

Recent Court Test of Special Revenues / Statutory Lien Concepts (cont'd)

- However, the Bankruptcy Court in the Eastern District of California has recently entered an Order in a Chapter 9 case that, for the first time, applies these principles to a financing secured by a special pledge of *ad valorem* property taxes.
- In the Chapter 9 case of *In re Sierra Kings,* an insurance company bondholder held municipal securities of a municipal health care district issued for the purpose of financing the renovation of the hospital. The bond resolution provided that as security for the payment of the bonds, there should be levied, in addition to all other taxes, a continuing, unlimited *ad valorem* tax while the bonds were outstanding, sufficient to pay the principal of and interest on the bonds when due and that such *ad valorem* taxes should not be used for any other purpose and should not be paid to the District for any other use. The lien was established in accordance with Chapter 4 of Division 23 commencing with Section 32300 of the California Health and Safety Code and the Enabling Resolution of the District.

Recent Court Test of Special Revenues / Statutory Lien Concepts (cont'd)

- The Sierra Kings Court has entered an order approving the agreement between the District and the bondholder (1) reaffirming the statutory lien on the *ad valorem* taxes levied or collected for the payment of the bonds and the related funds and accounts, (2) granting a replacement lien on such *ad valorem* taxes and such funds and accounts and (3) recognizing such *ad valorem* taxes as "special revenues" as defined in 11 U.S.C. §902(2)(e) of the Bankruptcy Code.
- The Reaffirmation Agreement between the District and the bondholder is incorporated into the court order. This constitutes judicial recognition that bonds, notes and other obligations which have pledged to their payment tax revenues which are "Special Revenues" or are the subject of a "statutory lien" shall be paid on time on their scheduled payment date without any interference from the Bankruptcy proceeding. In other words, the automatic stay imposed by the Chapter 9 proceeding and the Plan of Adjustment shall not interfere with the payment of the collected tax revenue or the obligations. This means that, as collected, the taxes will be paid on time without interference of the Bankruptcy proceeding to satisfy scheduled payments on the Bonds when due, and nothing in the Chapter 9 proceeding, including the Plan of Adjustment, will interfere with that.

How Is Municipal Bond Debt Treated in a Chapter 9 Proceeding?

Summary of Basic Treatment of Bonds and Notes in Chapter 9.

TYPE OF BONDS/NOTES	BANKRUPTCY EFFECTS
General Obligation Bonds	Post-petition, a court may treat general obligation bonds without a statutory lien as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease. Pre-petition, general obligation bonds are backed by the unlimited taxing power of the municipality (its “full faith and credit”) and are historically subject to conditions such as voter authorization, limitations on particular purposes, or debt limitation to a percentage of assessed valuation on the power of municipal entities to incur such debts.
General Obligation Bonds plus Pledged Revenues	Assuming that the general obligation pledge is an actual pledge of revenue and to the extent that it may be classified as a Statutory Lien or Special Revenues, this secured issuance will be respected to the degree it is consistent and authorized under state law. A Pledge of Revenues that is not a Statutory Lien or Special Revenues may be attacked as not being a valid continuing Post-Petition Lien under Section 552 of the Bankruptcy Code. This position may be questioned under Section 904 of the Bankruptcy Code given the prohibition that the Court not interfere with the Government Affairs or Revenues of the Municipality.
Special Revenue Bonds	A pledge on special revenue bonds will survive a bankruptcy filing. Pre-petition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of operations and maintenance costs) that are pledged to bondholders. The contemplated remedy for default often focuses on a covenant to charge rates sufficient to amortize the debt. Defaulted bondholders are expected to seek mandamus in court to require the municipal borrower to raise its rates.
Revenues subject to Statutory Lien	Assuming the pledge is authorized under state law through a statutory lien, the Bankruptcy Court should respect that statutory lien. Thus, as long as the revenues are subject to a statutory lien, payments to the bondholders should be protected post-petition.

How Is Municipal Bond Debt Treated in a Chapter 9 Proceeding? (cont'd)

G.O. Bond without any pledge of revenue or special constitutional priority can be treated like any other unsecured claim of vendors, workers, pension; however, in Medley, Florida in 1968, there was a distinction made to pay bond indebtedness on schedule and stretch out the payments to other unsecured creditors over a 10-year period since failure to make payment on the Bonds might cause the municipality to lose access to the market or to pay a significantly higher price for access that would justify a better treatment for bond indebtedness for the benefit of all.

As noted in *Faitoute Iron & Steel Co. et al. v. City of Asbury Park, N.J.*, 316 U.S. 502 (1942), discretion must be exercised in dealing with secured claims so that, while the Court recognized New Jersey's Depression-era Municipal Finance Commission Act of 1931 could impair municipal debt, there was recognition that a secured claims, tax anticipation and revenue notes stand on an entirely different footing from other municipal obligations and, in relation to them, no claim is affected by the Municipal Finance Commission Act. The Plan adopted by Asbury Park paid general obligation bondholders a compromise payment (less in amount and a delay in payment).

Other Issues in Chapter 9

<u>Labor Issues</u>

- Burdensome labor contracts can be rejected for cause (City of Vallejo).
- Unfunded pension liabilities are unsecured obligations and no priority for wages, vacation, pension or healthcare in Chapter 9.

<u>Non-Bonded Debt or Contracts</u>

- No priority among unsecured claims unless they qualify as administrative.
- In a Chapter 9 proceedings, the municipality may assume or reject an executory contract or unexpired lease.
- Municipal lease financing presents issue of true vs. financing lease (United Litigation).

<u>Priming of Bonded Debt by</u>

- Necessary operating expenses.

<u>Priming of Unsecured Debt by</u>

- Administrative claims.

<u>Duration of Chapter 9</u>

- Long enough to accomplish objectives. In complicated actual city or county filing, measured in years.

Other Issues in Chapter 9 (cont'd)

<u>Emergence from Chapter 9</u>

- The Court must confirm a plan if all the requirements of §943(b) are satisfied:
  - (1) the plan complies with the provisions of this title made applicable by sections 103(e) and 901 of this title;
  - (2) the plan complies with the provisions of this chapter;
  - (3) all amounts to be paid by the debtor or any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
  - (4) the debtor is not prohibited by law from taking any action necessary to carry out the plan;
  - (5) except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507(a)(1) of this title will receive on account of such claim cash equal to the allowed amount of such claim;
  - (6) any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and
  - (7) the plan is in the best interests of creditors and is feasible.

Other Issues in Chapter 9 (cont'd)

- New obligations arise under the plan and pre-confirmation obligations are discharged in accordance with the plan, the order confirming the plan and §944(b).

- While the market typically views the filing for Chapter 9 as a substantial negative, if the filing is perceived to be the result of a problem that has been dealt with, as in Orange County, the market impact has not been permanent.

Preferences in Chapter 9

- The Municipal Bankruptcy Amendments not only address the problem of revenue bondholders, but actually provide assurance to holders of all municipal bond or note obligations. Section 926(b) of the Bankruptcy Code now provides that a transfer of property to the debtor to or for the benefit of any holder of a bond or note on account of such bond or note may not be avoided under Section 547. While this section refers to "bonds or notes," there is nothing in the legislative history to support the view that this provision is limited only to instruments bearing such titles. The legislative intent appears to be that Section 926(b) should be applicable to all forms of municipal debt.

VII. The Myth That Bankruptcy Is the Only Option for Distressed States and Cities

<u>Myth</u>: State and local governments only recourse to financial distress is to file bankruptcy or to stop making debt payments to bondholders.

<u>Reality</u>: States do not presently have a bankruptcy alternative and do not seem to desire one.

State and local governments have numerous resolution alternatives for financial distress such as use of receiver or financial oversight, refinancing or control boards and commission to supervises corrective actions, refunding, transfer services to another government entity to reduce costs, budget cuts, increase in tax revenues, loans and grants from the state, use of intercepts to dedicate payment to those costs that must be paid and other options.

State and Local Governments Have a History of Addressing and Solving Financial Distressed Situations

- If a particular state does not allow its municipalities to file a chapter 9 petition, the state may, through an Intergovernmental Cooperation Act or Refinancing Authority, step in and provide (a) bridge financing or refinancing of the troubled debt; (b) transfer certain services to other governmental agencies to reduce expenditures; (c) grant funds to the municipality to bridge the financial crisis; (d) loan funds to the municipality on terms that are realistic or payable out of state tax sources that can be offset; and/or (e) use intercept of state tax payable to the municipality to ensure essential municipal services. A particular state's action will depend on the authority provided in the state's statutes, whether bridge financing or refinancing of troubled debt.

State and Local Governments Have a History of Addressing and Solving Financial Distressed Situations (cont'd)

- The state courts may also be used to appoint a receiver to supervise the municipality's board. Along with this, a court of equity or legislature could withdraw the municipality's charter and liquidate its assets to distribute to creditors. This, of course, is the least politically acceptable resolution and would be a highly unlikely scenario. In any of these scenarios, a lender should enter the negotiations early to better protect its interests.
- Generally, Refinancing Authorities, Receiverships and Commissions do not deal with adjustment of debt but rather with providing funds for continued provision of municipal services (gratis or loans), refocusing municipal services to other governmental bodies and requiring a balanced budget going forward.

State and Local Governments Have a History of Addressing and Solving Financial Distressed Situations (cont'd)

- The State may, by state statute (Intergovernmental Cooperation Act or Refinance Authority), step in and provide:
  - Bridge financing or refinancing of troubled debt.
  - Transfer certain services to other governmental agencies to reduce expenditures.
  - Grant funds to the municipality to bridge the financial crisis.
  - Loan funds to the municipality on terms that are realistic or payable out-of-state tax sources that can be offset.
  - Use intercept of State tax payable to municipality to ensure essential municipal service.

State and Local Governments Have a History of Addressing and Solving Financial Distressed Situations (cont'd)

- Use of State Finance or Supervisory Board to provide Adult Supervision (such as Municipal Assistance Corporation for NYC in 1975, Chicago School Finance Authority 1978):
  - Require Balanced Budgets, provide economic discipline and reporting.
  - Issue debt in state name or separate entity to obtain market credibility and access.
  - Power to negotiate debt restructuring and quasi-judicial jurisdiction.
  - Review services or costs that can be transferred to other governmental bodies.
  - Right to intercept tax revenue and focus use on essential services and cost.
  - Power to authorize Chapter 9 if needed.
  - Monitor compliance with any restructuring plan.
  - Pennsylvania Act 47 Financially Distressed Municipalities Act. Twenty-five municipalities have been declared financially distressed since 1988 and only six have had the designation rescinded.
  - New York has Financial Control Boards.
  - Connecticut has a Commission to supervise balanced budget and financial status.
  - Ohio has a Local Fiscal Emergencies Act to deal with budget and accounting issues.

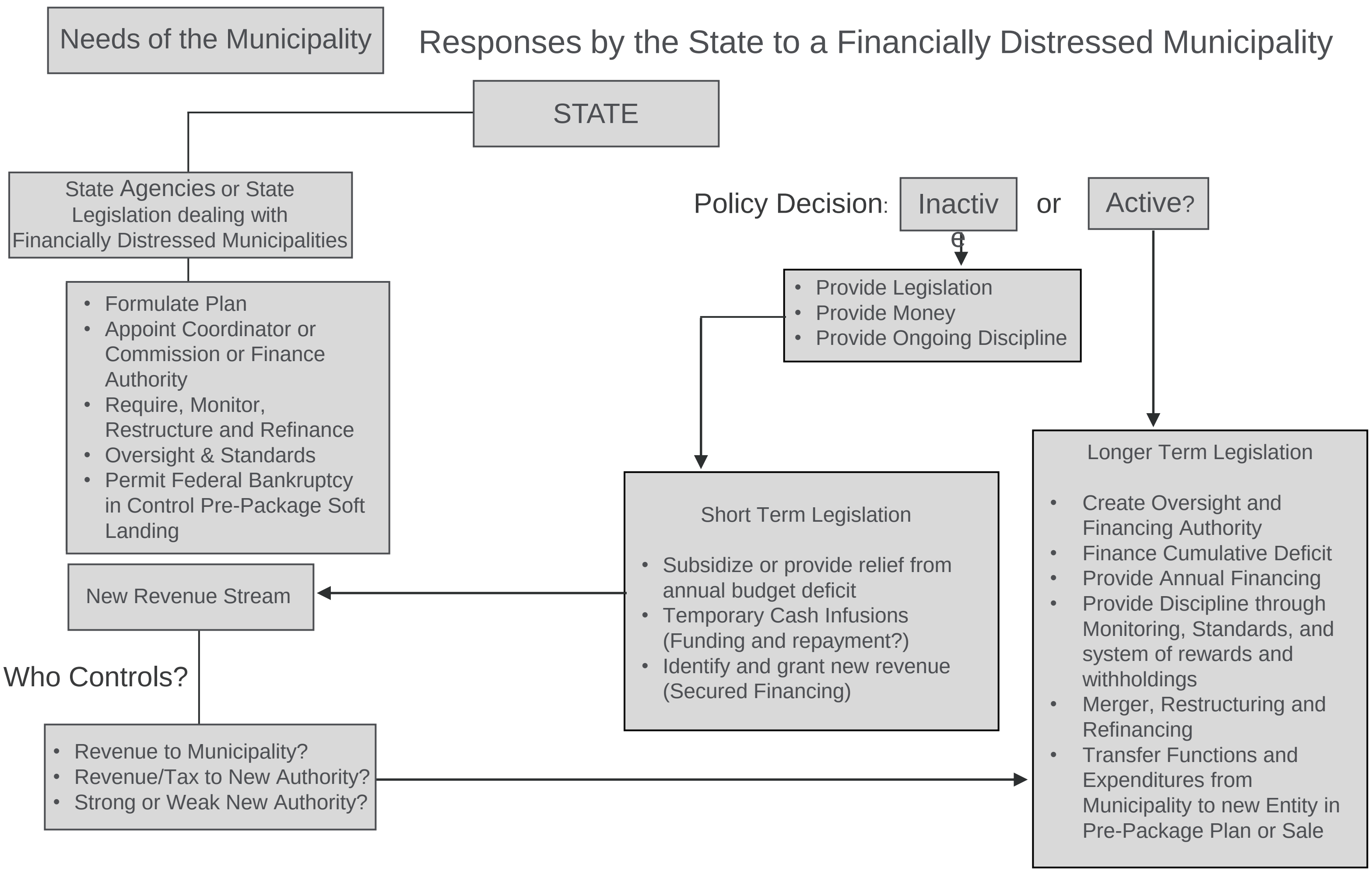
State and Local Governments Have a History of Addressing and Solving Financial Distressed Situations (cont'd)

- Use of state or court appointed receivers:
  - Provide Adult Supervision as Board.
  - Municipal receiverships go back to Fifth Century B.C. and the Greek town of Atarneus where a Greek banker took over administration due to a defaulted loan.
- Use of Court of Equity or legislature to withdraw charter of the municipal entity and liquidate assets and distribute to creditors.
- Unlike a corporation, it is very hard to liquidate a municipality or state and the least politically acceptable resolution.

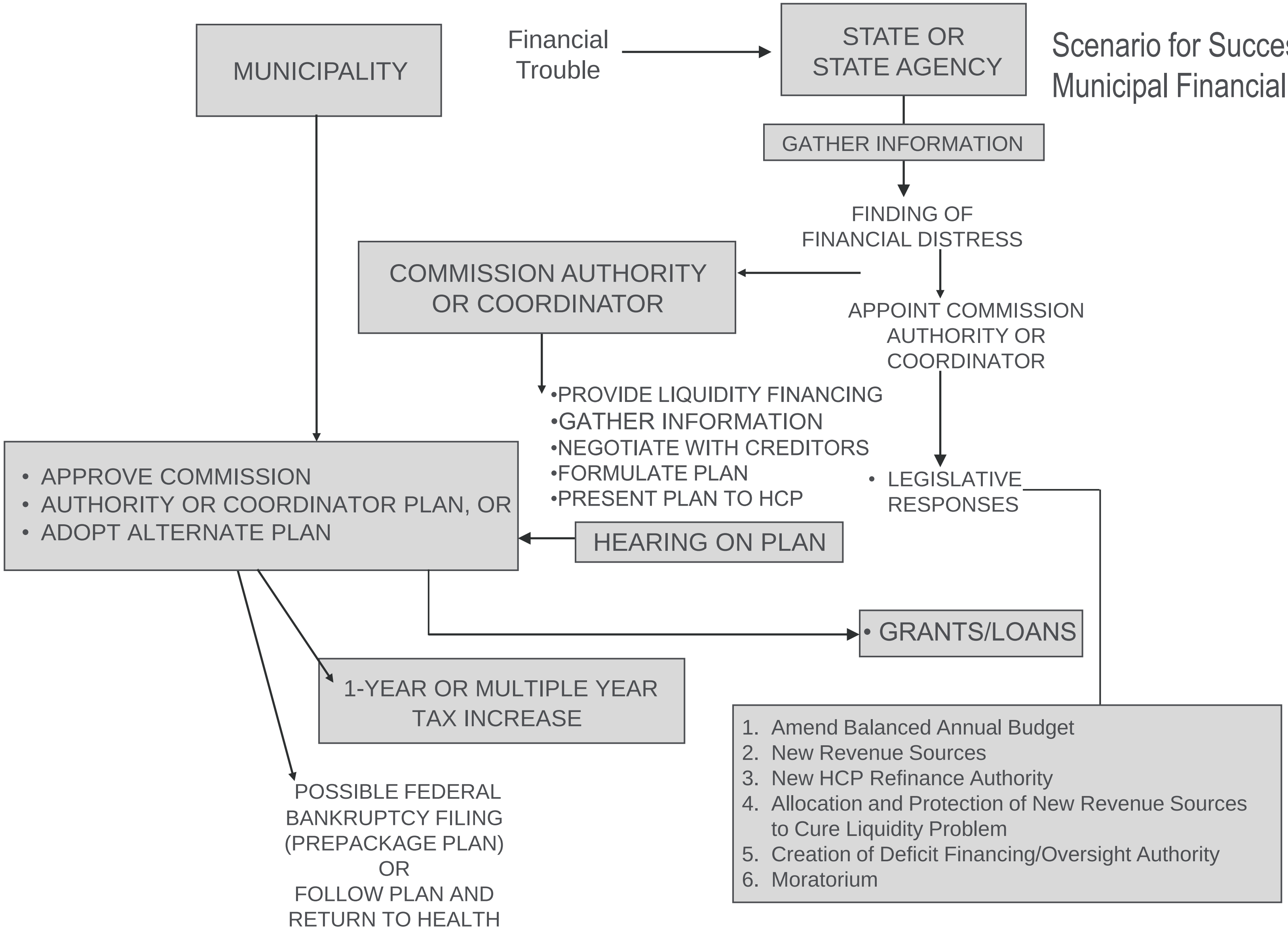
The Structure for Oversight and Emergency Financing

- Local governmental bodies experiencing financial distress often times are resolved by the resort to state created financing and oversight authorities with various degrees of formal oversight and control.
- Creation of a commission which later develops into a refinancing authority provides two basic advantages:
  - The new authority has financial credibility and access to capital markets if it has an assured source of revenue to pay debt service which is isolated from bankruptcy and other credit risk.
  - An independent authority can use a variety of fiscal tools to enforce fiscal discipline on the local government because it is removed from political pressure.

The Structure for Oversight and Emergency Financing (cont’d)



Scenario for Successful Municipal Financial Overs



Scorecard for Other Mechanisms for State to Address Financial Distress of Its Local Governments

Virtually all States have some statutes providing for:

- Ability to refund. (All states have some provision for Refunding Bonds.)
- Debt limitations (at least 49 have some form of debt limitation).
- Appointment of receivers (at least 43 states).
- Mandamus or remedies upon default to require payment of debt or levying taxes. (All 50 states have mandamus and at least 28 states have some provision for foreclosure, 23 states provide for a statutory right to such an accounting and at least 18 states have other remedies.)
- Statutory liens or special revenues. (All 50 states have some form of special revenue and at least 30 states have statutory liens.)

Scorecard for Other Mechanisms for State to Address Financial Distress of Its Local Governments (cont'd)

Active financial supervision or financial review (over half of the States):

At least 2	-	Debt Advisory Commission.
At least 8	-	Statutes providing for debt compromise or adjustment process and intercepts for payment.
At least 15	-	Active technical assistance, grants, loans, budget review.
At least 17	-	Financial control boards, refinance authorities and active outside supervision and review.

Virtually every state has some form of limitation on taxes or debt or a combination of both.

Selected Case Studies

New York City

- Questionable Accounting Practices for 10 years prior to 1975.
- Lack of Funds to meet short-term Debt Obligations.
- Federal and State Bridge Financing.
- State Municipal Assistance Corporation.

Cleveland, Ohio

- Default on $15.5 million of Board Anticipation Notes.
- Large General Fund Deficit.
- Then current Bankruptcy Legislation increased concerns with respect to Bailout Financing.
- Amended Bankruptcy Code in 1988 to allow Special Revenue Financing protected from subsequent Bankruptcy Filing.
- State Bailout.

Selected Case Studies (cont'd)

San Jose School District - California (1983)

Teacher Union Contract Dispute:

- Reduced Real Estate Tax Revenue.
- First major municipality to file for Bankruptcy since the Great Depression.
- Paid Interest to Bondholders During Bankruptcy.
- Ultimately settled with Teachers and Dismissed Bankruptcy.

Medley, Florida (1968)

- Small city of 350 residents.
- Filed for Bankruptcy Protection but promised to pay.
- Bondholders before other creditors.

Selected Case Studies (cont'd)

Washington Public Power Supply System (WPPSS) – 1983

- Projected Demand for electric power in Pacific Northwest of U.S.A. did not materialize.
- Financing of Nuclear Power Plants 4 and 5 for $2.25 billion had both legal and feasibility problems.
- Supreme Court of State of Washington holds Municipal Participants not obligated to pay – (6/15/83).
- Legal and Financial meltdown.
- Issue of lingering legal problem – need for clear, objective and validated statutory basis for financing.
- Necessity of legal validation.

Selected Case Studies (cont'd)

The Colorado Special Districts

- Financing for infrastructure for Real Estate Developments – streets, sewers, utilities and the like.
- Over-Development and Lack of Demand.
- Wrong Economics – lack of feasibility.
- Municipal Debt Adjustment – Chapter 9 proceedings.

Selected Case Studies (cont'd)

City of Bridgeport, Connecticut – 1991

- Financial distress of City due to business and residents leaving core city and reducing the tax base.
- State of Connecticut enacted special legislation to discipline financing and limit expenditures to actual revenue.
- Mayor disputes State's effort and contests budget restraints files for Bankruptcy – Municipal Debt Adjustment.
- City elects new Mayor and works with State as Bankruptcy is dismissed on technical reason.
- Balanced budget enforced by State.

Selected Case Studies (cont'd)

City of Philadelphia – 1991 – (Model Legislation for Emergency Financing) — Long Term

Operating Deficit of $200 million:

- Refinancing and Bridge Financing as well as restructuring of operation and responsibilities.
- Statutory Authority for Emergency Financing and Restructuring:
  - State Authority.
  - Membership on Authority Board – representative.
  - Compliance with Constitution Provision:
    - Ability to tax.
    - Ability to direct and oversight.
    - Ability to fund.
  - Use of Intergovernmental Agreements and transfer of Service Obligation.
  - Refunding of Past Obligations.
  - Development of near Term and 5 year.

Selected Case Studies (cont'd)

Financial Recovery Plan:

- Budget Development, Review and Approval.
- Collective Bargaining Agreement Review and Approval.
- Limit Availability of Federal Bankruptcy.
- Create New Revenue Sources.
- Intercept of State Revenue to City for Proper Disposition.

Selected Case Studies (cont'd)

Orange County, California – 1994

- Fourth Largest County in U.S.A. by population.
- Annual Budget of $4 billion.
- Unwise Leveraged investment policy to make up for increasing costs and limited revenue sources.
- Derivative Problem – reasonableness of municipal investment.
- Filed Bankruptcy and ultimately paid Bondholders in full (delay in payment).

Selected Case Studies (cont'd)

City of Vallejo, California – 2008

- While case still pending, has already produced important ruling on Chapter 9 eligibility (insolvency determined by cash flow analysis).
- Motion to Reject Collective Bargaining Agreements met by unions agreeing to modifications of benefits given court ruling that the contracts can be rejected.
- Plan of Adjustment filed and confirmation hearing set with Chapter 9 exit anticipated by July 2011.

Central Falls Problems Leads to Change in Rhode Island Receivership Law for Municipalities

- In 2010, Central Falls, a financially troubled Rhode Island town, sought a court-appointed receiver under the then-existing law.
- A judge appointed an outside lawyer as temporary receiver and gave him oversight over the town’s finances, including vendor contracts.
- State officials and others worried the move could have a ripple effect beyond Central Falls disrupting the municipal bond market and alarming rating agencies.
- As a result, a new bill was enacted that prohibits cities and towns in Rhode Island from entering judicial receivership and that calls on the State to intervene earlier when communities are in financial trouble.
- The new law introduces levels of state oversight for struggling municipalities.

Central Falls Problems Leads to Change in Rhode Island Receivership Law for Municipalities (cont'd)

- The first level allows the state director of revenue to appoint a fiscal overseer for communities in financial distress.
- The overseer would have the authority to review all proposed contracts, approve the annual budget and supervise expenditures. If the town is still unable to produce a balanced budget, the law authorizes the creation of a budget commission.
- And if problems still persist, the state can appoint a receiver, who besides having oversight of the city or town has authority to file for federal bankruptcy protection.
- The bill was written to apply retroactively so as to cover Central Falls.
- In May 2011, the Rhode Island Senate approved (May 26, 2011) legislation and on July 2, 2011 the governor signed into law the legislation that required municipalities to guarantee lenders and holders of bonds and notes the first lien right to property taxes (ad valorem) and general revenues in the event of a bankruptcy or financial distress – an effort to improve the ability of Rhode Island municipalities to borrow money in challenging financial markets.

Harrisburg, Pennsylvania Default Threatens G.O. Market

- In September of 2010, the Pennsylvania city announced it would miss a payment on general obligation bonds, which were insured by Assured.
- This followed an earlier default on conduit bonds for a failed incinerator project and sparked talk of widespread trouble in the municipal bond market, including general obligation bonds. These defaults continue.
- The Governor of Pennsylvania responded with an advance on state aid to meet the $3.3 million in bond payments.
- Harrisburg's default would have increased borrowing costs or make credit unobtainable for other Pennsylvania municipalities and school districts, and jeopardize the city's attempts to devise a recovery plan.
- Under the governor's plan, Harrisburg will immediately receive three state grants for fire protection and pension assistance worth a total of $3.6 million that has been scheduled for later this year.

Harrisburg, Pennsylvania Default Threatens G.O. Market (cont'd)

- The early transfer enabled Harrisburg to meet a September 15 due date for its 1997 Series F bonds, which it had told a trustee August 30 it would skip. The state is also working with the city and private lenders to secure a short-term tax- and revenue-anticipation note for operating funds.
- If the city counsel does not agree on an asset sale or other plan to shore up Harrisburg's finances, local decision-making will be taken over by the state through Pennsylvania's Act 47 municipal recovery program or a bankruptcy court.
- The state will also give Harrisburg $350,000 in grants and a $500,000 loan to hire a financial consultant to develop options for financial recover, potentially including the sale and lease of assets such a parking garages and meters.
- In December 2010, Harrisburg enters into Act 47 the state's program for a distressed city to prepare a fiscal recovery plan.

Harrisburg, Pennsylvania Default Threatens G.O. Market (cont'd)

- Counsel hired to consider whether Chapter 9 was the best alternative – the answer was NO.
- Harrisburg considering the sale of the incinerator and negotiating workout of the failed incinerator financing.
- Act 47 fiscal recovery plan was prepared for the city proposing sale of city assets, a wage freeze and changing workers contracts to help pay debt related to a troubled incinerator project that is five times the city's general fund budget.
- July 19, 2011 Harrisburg city council rejects the Act 47 fiscal recovery plan in a 4-3 vote.

VIII. The Myth That States Required a Bankruptcy Option

Myth: States need the ability to go bankrupt and have no standing debt resolution mechanisms.

Reality: Since the late 1800's, no state has defaulted on its general obligation bonds with the exception of Arkansas in 1933 which was refinanced. State should not use and do not need a bankruptcy alternative especially because it would raise constitutional issues of the power of the federal court and a stigma on the states ability to borrow. There are a number of sovereign debt resolution mechanisms that can be used in addition to balancing the budget, cutting expenses and raising taxes. Bankruptcy affects all creditors of a state even those that are on good standing and desired to continue as is. Bankruptcy does not provide any additional sources of revenue while clouding the ability to borrow.

What About Sovereign Debt Resolution Mechanism for the States?

- Other Sovereign Debt Restructuring Mechanism ("SDRM").
  - Composition of Creditors (Provide a Forum for Creditors to meet to reach consensus as to what can be paid and what should be forgiven).
  - Use of Contractual Restructuring Approval – The use of Collective Action Clauses where by a Majority or Super Majority of Creditors to that contract have the power to bind all holders to a debt restructuring and forgiveness. (Not a capital market acceptable provision) – Question of International enforceability.
  - Arbitration Clauses – Again arbitration does not have the transparency and creditor participation that Sophisticated institution may require. (Many questions, including who can pull the trigger – in voluntary arbitration and what law will govern.)
  - "Club" Approval – London Club or Paris Club but there is a question of whether it involves (and binds) all of the relevant parties especially in a more diverse world.

What About Sovereign Debt Resolution Mechanism for the States? (cont'd)

- Bankruptcy Court for Sovereigns.
- Use – IFM – SDRM "Dispute Resolution Forum" – to verify and reconcile claims and possibly continue with Sovereign Debt Restructuring Court as a Sovereign Debt Tribunal with:
  - Independence.
  - Expertise.
  - Neutrality.
  - Certainty/Predictability.
  - Attempt to reach volition of parties.
  - Restructuring Plan must have vote of majority of creditors.
  - The ultimate hammer of a Sovereign Debt Tribunal deciding what the payout will be if Restructuring Plan cannot be approved.

Should States Be Authorized to File for Bankruptcy as a Sovereign Debt Resolution Mechanism

The simple answer is NO!

Why?

- States have not asked for it or perceived they need it.
- No State has defaulted in payment of its obligations including G.O. Bonds, since its late 1800's and repudiation of Debt incurred after the Civil War (except Arkansas in 1933 which default on G.O. Bonds).
- States have weathered the financial storms since then including the Great Depression.
- Bankruptcy for States raises constitutional and practical problems.
  - Each State is a Sovereign and as such is not subject to the jurisdiction of another Sovereign such as the federal government.
    - It is not only a Tenth Amendment issue but also the nature of Sovereign.

Should States Be Authorized to File for Bankruptcy as a Sovereign Debt Resolution Mechanism (cont'd)

Bankruptcy like Chapter 9 affects all creditor relationships – those that work and are desired to continue and those that are a problem.

- Why tip over good working relationship.
- Further Federal Bankruptcy Court cannot interfere with the revenues government and affairs of another Sovereign – § 904 of Chapter 9 – U.S. Supreme Court Decisions and Tenth Amendment.
- State Bankruptcy cannot provide interim financing or new revenues, new tax sources or an expeditious resolution of the major problem affecting the State.
- A State Bankruptcy will be an expensive and time consuming experience, expensive, intrusive into certain creditor relationships that should not be disturbed.

Should States Be Authorized to File for Bankruptcy as a Sovereign Debt Resolution Mechanism (cont'd)

The discussion or existence of State Bankruptcy can cause concern or panic in the capital markets given the unprecedented threat of a State not honoring in full its obligations.

- The existence of a State Bankruptcy Option will cause a cloud or stigma on State access to the financial markets and increase borrowing costs.
- Compare 10-year U.S. Treasury Notes to Greek 10-year notes and the increased borrowing cost of almost 10% additional costs a year or the equivalent of almost pay twice the principal amount over 10 years.

IX. The Myth That Unfunded Pension Obligations Are a Present Danger to Every State and Municipality

Myth: Unfunded pension fund liabilities are a present threat to virtually every state and municipality and create a present danger of increased defaults now.

Reality: Unfunded pension obligations are not liabilities that need to be paid now and should not push over any municipality tomorrow. But failure to address the issue today a far as what is sustainable and affordable without sacrificing essential governmental services could be a tsunami of a problem years from now. The use of a public pension authority should be considered to act as a quasi independent judicial body to determine what is sustainable and affordable and what pension promises are unrealistic and unable to be paid without sacrificing essential government services.

Unfunded Pensions and OPEB

- Is New Jersey settlement with SEC on lack of full disclosure on unfunded pension liability a “wake up call” or the “first shoe to drop”?
- Is unfunded pension liability due to lack of accounting standards – (a GASB issue) or lack of mandated funding to actuarially required contribution?
- Are pension underfunding liabilities real debt obligations of the state or local governments or just non-enforceable promises?
  - Illinois Legislation.
  - South Dakota, Colorado, Minnesota Legislation.
- How do unfunded pension liabilities rank in priority of payment in a Chapter 9 proceedings with special revenues, statutory liens, revenue pledge and G.O. debt? What about the Sierra King Health Care District order?
- Will pension underfunding cause an immediate default or Chapter 9 filing? Is it a slow death?

Can Pension Benefits and OPEBs Be Rolled Back or Reduced?

Different Approaches. States take different approaches in analyzing the pension rights of public employees and whether those rights can be modified. The chart set forth below summarizes some of these:

CATEGORIZATION OF CERTAIN STATE PUBLIC EMPLOYEE PENSION PROVISIONS

Specific state constitution prohibiting impairment of public employee pensions	General constitutional prohibition against impairment of contracts (applicability to pensions depends on whether the courts view pensions as contractual obligations; also, states that do not have their own Contract Clause oftentimes rely on the Contract Clause of the U.S. Constitution):	State statute or case law prohibiting impairment of public employee pensions
Alaska, Hawaii, Illinois, Michigan, New Hampshire, New York	Arkansas, Georgia, Indiana, Nebraska, New Jersey, Oklahoma, Rhode Island, Tennessee, West Virginia	Alabama, Arizona, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Idaho, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, South Dakota, Texas, Utah, Vermont, Virginia, Washington, Wisconsin, Wyoming

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

B. States that by Specific Constitutional Provisions Prohibit Impairment. In certain States, there are Constitutional prohibitions specifically preventing any reducing or eliminating of pension benefits - State Constitutions prohibit altering (reducing or eliminating) state and local governmental contractual obligations to employees for pension benefits — a "vested" right (*See e.g.*, Illinois, New York, Michigan, etc.).

C. States that Prohibit Impairment on General Basis (General Constitutional Provisions). Some States rely on either the Federal or State Constitution language prohibiting the impairment of a contract in order to preclude a reduction in pension rights. These states include Georgia, Indiana, Oklahoma, Rhode Island and West Virginia.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

D. Use of State Statutes to Protect Pension Rights. Some states have enacted statutory provisions which preclude local governments that establish pension and other post-employment benefits from diminishing or impairing those rights (*See e.g.*, Connecticut, Massachusetts and Maine).

E. Generally, the Constitutional or Statutory Provisions Relate to Pension Rights as Compared to OPEBs. Some Courts have extended the protection against reduction in benefits to OPEBs and some have not:

   1. Accordingly, changes of pension benefits can only be done voluntarily or through Court-ordered process.
   2. Unions and employees generally do not easily agree to changes in pension benefits or OPEB:
      - Voluntarily change may only be possible if the situation is desperate and there is imminent loss of jobs and income, including benefits.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

3. The analysis states have undertaken in determining whether OPEBs can be modified are instructive:
   a. A divided Michigan Supreme in *Studier v. Michigan Public School Employees' Retirement Board*, 698 N.W. 2d 350 (Mich. 2005), determined that the term "accrued financial benefits" in the Michigan Constitution refers only to benefits that increase over time such as retirement benefits and not health insurance benefits which are not protected by State or Federal constitutions:
      i. The Michigan State Constitution provides:

         "The accrued financial benefits of each pension plan and retirement system of the State and its political subdivisions shall be a contractual obligation thereof and shall not be diminished or impaired thereby."
      ii. The Michigan decision is in accord with earlier decisions in Colorado, Georgia and Tennessee. For example, Colorado has distinguished between quasi-pension type benefits protected from modification and ancillary benefits such as payments of health insurance premiums.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

b. In 2003, Alaska's Supreme Court reached the opposite conclusion, namely, that a health benefit increase is constitutionally protected like retirement plans and cannot be changed and must be honored as a contractual obligation and cannot be reduced or eliminated without consent or just compensation. States that have sided with Alaska are New Jersey, Oklahoma, California and West Virginia.

c. Similarly, in *Calabro v. City of Omaha*, 247 Neb. 955, 531 N.W.2d 541 (1995), the Supreme Court of Nebraska considered whether the elimination of a supplemental cost-of-living benefit provided to plaintiffs by the City of Omaha unconstitutionally violated the firefighters' contract rights. The Court first determined that the supplemental cost-of-living benefit constituted a pension in which the plaintiffs obtained a vested, constitutionally protected contractual right because this supplemental benefit was directly related to the pension plan, and, in order to receive this benefit, the employee also had to qualify for the pension plan. The Court then determined that the elimination of this supplemental benefit resulted in the unconstitutional impairment of the plaintiffs' contract rights. Cases are now pending in Colorado and Minnesota over the constitutionality of laws that reduced the cost of living increase (*e.g.*, Colorado from 3.5% to 2%).

d. By statute, the State of Maine distinguishes between those provisions of the public employee pension protected by the non-impairment clause and those that are not.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

F. A Non-Impairment Law Is Not Intended to Stretch Pensions Beyond Their Elastic Limits.

Pensions can be and need to be changed, but within certain structures:

1. Right to modify must be clear in legislation, employment agreements and union contract (Rhode Island).
2. Adverse conditions which could lead to the failure of pension plans and the purpose of the legislation justify amendment (Vermont).
3. To balance adverse consequence of actuarially necessary changes to strengthen or improve the pension plan (Colorado, West Virginia).
4. Reasonable modifications that bear material relationship to theory of pension system and successful operation (Massachusetts).
5. Certain legislation that by its nature cannot bind successive legislation and can be changed (Georgia).
6. Contractual pension rights may be altered if changes are related to maintaining a healthy pension system as a whole. Changes that disadvantage members must be accompanied by comparable new advantages (California).

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

G. The Non-Impairment Laws Are Not All-Encompassing and Have Been Held Not to Reach:

- benefits that accrue in the future,
- reduction in mandatory retirement age,
- reduction in hours or salary,
- loss of benefits for non-compliance with the plan, and
- dismissal of public employee,

even though such may indirectly affect the pension benefits received.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

H. Pension Obligations Can, in Very Extreme Circumstances, Be "Discharged" Where Necessary to Serve an Important Public Purpose:

- If the state and local governments cannot fund pension obligations since there are not sufficient tax revenues to pay for essential government services and pay pension obligations.
- This is an inability (insolvency) not an unwillingness to pay.
- Pension obligations cannot be enforced if to do so would frustrate the essential purpose of the governmental body and sacrifice the required services it must provide.
- The U.S. Supreme Court has supported the ability of the state to set up municipal receiverships or other quasi-judicial mechanism to discharge obligations that cannot be paid given the dire financial condition and the need to continue governmental services for the financially embarrassed governmental body.

Can Pension Benefits and OPEBs Be Rolled Back or Reduced? (cont'd)

– In the case of *Faitoute Iron & Steel Co. v. City of Asbury Park,* 316 U.S. 502 (1942), the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on non-consenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors. *Id.* at 504. After certain bondholders dissented, the court determined that the plan helped the city meet its obligations more effectively. *Id.* **"The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city's debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired."** *Id.* at 511. The court then found that the plan protected creditors and was not in violation of the Contract Clause. *Id.* at 513. *See also U.S Trust v. New Jersey*, 431 U.S. 1, 25-28 (1997).

A Solution Is Required to Avoid the Inevitable Meltdown

If the problem of pension underfunding is not solved, competing interests will be aligned against each other:

- The Workers Demand for Full Funding Now. On the one hand, workers will insist that the pension obligations are in fact debt of the unit of state or local governments and consider seeking a writ of mandamus to require the State or municipality to levy taxes or take other action to satisfy the debt obligation.

A Solution Is Required to Avoid the Inevitable Meltdown (cont'd)

- The Demand to Invalidate Unjustified Pension Obligation. Taxpayers and other creditors, including the holders of the state or local governments' general obligation bonds, will seize on the debt argument. They will likely insist that in committing to make the pension and OPEB payments, the State or municipality violated state constitutional debt limitations which, under state law, such State or municipality does not have the power to violate, or the government has frustrated its fundamental purpose by threatening the ability to provide essential governmental services. As a consequence, any undertaking assumed in violation of state law is invalid. (It has already begun in California as the Superior Court of Sacramento, California has ruled in invalidating bonds issued under the State Pension Bond Act. *See Pension Obligation Bonds Committed ex rel. California vs. All Persons Interested in the Matter of the Validity of the California Pension Obligation Bonds To Be Issued*, No. 04AS04303 (November 15, 2005). This ruling was upheld on appeal to the California Court of Appeals, 152 Cal. App. 4th 1386, 62 Cal. Rptr. 3d 364 (2007).)

A Solution Is Required to Avoid the Inevitable Meltdown (cont'd)

– <u>The Only Way Out Is Change</u>. Given the dynamics, there likely will be no winners in this battle. Significantly increasing taxes can lead to a revolt on the part of the taxpayer if not a death spiral to state or local governments. A real resolution is required, not a bailout. The urgency of the situation will be exacerbated by the retirement of the baby boomers. As noted, techniques to correct the situation include yearly Annual Required Contributions (ARC) at a level deemed actuarially sound, the transition from any pension plan that is not affordable or is doomed to fail (unsustainable defined benefit plans versus flexible plans where benefits can vary based on the affordable contribution by government and the variable contribution by employees that may vary the benefits), the freezing of current benefits and the adoption of new programs which specifically include the right to modify if necessary and require increased contributions by employees. Finally, the issuance of pension bonds with dedicated sources of payment pursuant to enabling legislation must be considered.

The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem

Likewise given the Pension Underfunding Crisis, Public Pension Funding Authorities can provide a supervised forum to assist in determining critical issues such as:

- What contribution increases are necessary by both public employers and employees:
  - Can taxes be raised to fund pensions?
  - Are intercepts of state revenue necessary to provide a source of funding?
- Can the annual Actuarially Required Contribution ("ARC") for pension be made or is it unreasonable, unaffordable and not sustainable?
- Will continued funding of ARC cause the government to be unable to fund the costs of essential governmental services?

The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem (cont'd)

- What cost-cutting measures are required to achieve sustainable and affordable benefits that do not interfere with providing essential government services:
  - What past employment benefits are affordable and what ones, if any, are not?
  - What adjustments to past employment benefits are mandated to avoid a government function meltdown or GFE?
- What is the minimum acceptable funding percentage for funding pension benefit ("Target Percentage")?

The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem (cont'd)

The Public Pension Funding Authority ("Authority") would have jurisdiction over pension underfunding issues on a voluntary basis. Government and its workers desiring the supervised approach would be able to petition for the Authority's determination that they qualify for assistance. Likewise. the Authority would have mandatory jurisdiction over governmental pensions if the Target Percentage of acceptable minimum funding is not reached or there is or in the Authority's determination is an imminent threat of a GFE, the inability of the government to provide essential governmental services due to the annual cost of funding the ARC for pension and post-employment benefits. The Public Pension Funding Authority mission is to be the supervising forum for the determination of critical issues resulting from underfunded pension plans:

- Whether past employment benefits (pension and OPEB) are affordable and sustainable while paying the cost of essential governmental services.

The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem (cont'd)

- What recommendations, if any, for tax increases by the government to provide additional funding?
- What recommendation of reduction in Pension or OPEB benefits are mandated in order to prevent a government function emergency or meltdown?
- Recommend tax increases to fund additional pensions contributions and require the local home rule units legislative body (city council, et al.) to consider a tax increase or have a non-home rule government have a referenda over a tax increase with full information available on the Authority's determination of the recommendation of tax increases, the affordability of current and future pension costs and whether any pension costs adjustments are necessary.

The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem (cont'd)

- Determine whether an intercept of state tax revenue should be implemented to pay required benefit.
- Determine whether arbitration (voluntary or involuntary) should be engaged in.
- Determine whether contributions are necessary from both public employees or employers.
- Determine what cost-cutting measure or adjustment of pension benefits are necessary to achieve affordable benefit and allow the continued funding of the cost of essential governmental services.

The Civic Federation Pension Committee has developed an Illinois Municipal Public Pension Authority proposal to provide the oversight, supervision and determination of a public pension authority for Illinois municipalities.