Remarks Delivered to the SEC Field Hearing
Panel on "Distressed Communities"

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First of all, I would like to thank Chairman Shapiro and Commissioner Walter for scheduling this hearing in Birmingham today. The topics we will discuss are important and timely. I would also like to thank Congressman Spencer Bachus for his continuing interest in addressing the problems of our community.

The choice of Birmingham as the site of the SEC's third field hearing was presumably influenced by the financial challenges facing Jefferson County. The story of Jefferson County's problems has been widely publicized over the last three years in the local and national press, in seminars and workshops, in law review symposia and, unfortunately, in state and federal courtrooms. For example, a Google search of the words "Jefferson County teetering" produces 6,560,000 hits. Since early 2008, my law firm has assisted the County in its efforts to deal with the impact of this financial crisis and to find a workable way out. That work is ongoing, so I am sure you will understand that there may be some confidential topics I can not address today.

The goal of these field hearings and this panel in particular is to elicit "real world" information that might prove useful to the SEC and perhaps Congress as they evaluate the effectiveness of the federal securities laws and regulations applicable to public finance. Relevant questions for our panel include: What causes a city or county to find itself in financial distress? Are there early warning signs that should be recognized and perhaps disclosed? How does such stress affect the municipality's ability to access the public finance markets and to provide good disclosure? What can the SEC do to help distressed communities as they struggle to maintain or regain access to the market?

The national recession of 2008 and 2009 and the slow recovery of the past two years have not spared our cities, counties and states. Hardly a day goes by without reports of a municipality struggling to satisfy its obligations to retired employees and its debt service payments to bondholders while continuing to provide essential governmental services. *The Bond Buyer* has reported this week on the difficulties of Harrisburg, Pennsylvania, Central Falls, Rhode Island, Jefferson County, Alabama, Nassau County, New York, Vallejo, California, and the State of Illinois. A recent study provides specifics of at least 150 cities and counties facing severe financial challenges.[1] In many ways, the drama playing out in these communities is a microcosm of the debate raging in Washington with respect to the national debt ceiling.

According to the Congressional Budget Office,[2] there are approximately 3000 counties, 36,000 towns and cities, 37,400 special districts and 14,600 public school systems in the United States. Cities and counties are generally the largest in terms of the number of employees and the size of their budgets. The services they provide generally include police protection, transportation, welfare payments, and other social programs. At the other end of the spectrum, special districts are generally the smallest governmental units and usually have a specific purpose such as providing water, utilities, or waste treatment services. These different units of local government typically depend upon different sources of revenues to finance their programs and services. Most cities and counties are heavily dependent on property and sales taxes while special districts derive their revenues from fees paid by users of their services. As a result, the poor economy has had a greater effect on cities and counties. The significant differences in the size, structure, governance, and purpose of our local units of government make them vulnerable to stress from a variety of different causes:

- **Specific events** – Example: the failure of a $228 million waste/energy facility financed on the credit of the City of Harrisburg, Pennsylvania
- **Rapid deindustrialization** – Example: loss of population and tax base experienced by Detroit, Pontiac and Hamtramck, Michigan
- **Corruption and mismanagement** – Bell, California, and Orange County, California
- **Exploding employee pension and healthcare costs** – Central Falls, Rhode Island, Los Angeles, California, and Prichard, Alabama
- **Spendthrift mentality** – unsustainable programs and expenditures approved during periods of skyrocketing property values and tax base. Examples: Las Vegas, Nevada, Phoenix, Arizona, Orlando, Florida
- **Shifting demographics** – loss of upper income and middle income families, followed by an influx of lower income families with greater demands on local schools and social services. Examples: many New England and California cities
- **Disparate effects of recession** – communities with significant technology or government employment bases fared better than those dependent on construction, service and retail industries

[1] Marc S. Cohen, Kaye Scholer in Los Angeles, "Chapter 9 Municipal Bankruptcy: Municipalities Facing Financial Crisis" (February 2011)

[2] "Fiscal Stress Faced by Local Governments", Congressional Budget Office (December, 2010)

The causes of financial stress can also be classified as temporary resulting from sudden economic shocks, or more permanent as a result of structural problems. The weak economy of the past three years inevitably led to reduced local tax revenues and reduced support from state governments whose revenues have also plummeted. Those same economic conditions frequently cause an increase in the demand for city and county services. Citizens who have lost their jobs and their insurance turn to public hospitals and clinics and to public transportation. Public safety costs may rise as crime increases. As unemployment rises, demands for job training programs and other social welfare benefits increase as well. Although painful, the reduced revenues and increased costs caused by temporary economic disruptions should right themselves when economic conditions improve assuming no other structural obstacles to recovery.

Other problems may be more systemic or structural in nature, and not readily cured by an improving economy. Pension and OPEB commitments made over a long time to employees and former employees may be difficult to restructure to meet today's realities. Businesses that have closed or left the community may be replaced very slowly, if at all. Unfavorable population shifts are difficult to reverse. The lack of budgetary controls or financial discipline may cause chronic budget shortfalls. And finally, the absence of capable local officials with the ability and the willingness to make difficult but necessary decisions for the good of the community can be fatal.[3]

Closer to home, what happened in Jefferson County? How did it get in such a financial mess? Although Jefferson County and the Birmingham/Hoover MSA have been affected by the poor economy of recent years, the economic impact on the County, relative to its neighboring communities, is not the source of the problem. The County's unemployment rate for June was 10.2%, compared to a statewide rate of 9.9%. Our neighboring counties of St. Clair, Walker and Shelby had unemployment rates of 9.5%, 10.5% and 7.7%, respectively. The gross metropolitan product for the Birmingham/Hoover MSA ranks at 64 out of the top 100 in the nation. Housing prices in the MSA have declined 14.9% from their peak in the 4th quarter of 2006, while the average decline in the top 100 metro areas for the same period was 26.5% and for the U.S. as a whole was 23.3%. The median family income for the Birmingham/Hoover MSA fell 3.6% from 2008-2009, while the decline for the State as a whole was 1.6%. Nonetheless, the local median family income of $61,700 is the 2nd highest in the State and compares to $64,400 nationally.

Rather, Jefferson County's current challenges are the result of too much debt, a fragile financing structure, and the implosion of the financial markets in late 2007 and early 2008. The County's most significant problems have been well documented in the press and elsewhere:

- conversion of $3.2 billion of sewer debt from 95% long term fixed rate debt to 93% variable rate debt in 2002 and 2003

[3] For a more authoritative summary of the fiscal pressures facing state and local governments and their potential responses, see Federal Reserve Board Chairman Ben Bernanke's address entititled "Challenges for State and Local Governments" delivered on March 2, 2011 at the 2011 Annual Awards Dinner of the Citizens Budget Commission, New York, New York. Chairman Bernanke's presentation can be found at www.federalreserve.gov/newsevents/speech/bernanke20110302a.htm

- dependence on a series of ill advised interest rate swaps that failed in early 2008 when the SIFMA VRDN index (paid by the County) spiked and 67% of 1 month LIBOR (received by the County) dropped, resulting in an implied annual basis cost to the County of $32 million

- meltdown of the bond insurance industry -- resulting in $850 million of sewer warrants, $110 million of general obligation warrants and $180 million of school warrants being tendered to liquidity banks where they are currently held at penalty interest rates

- liquidity facility agreements requiring accelerated redemption of the tendered sewer warrants over a 4-year period and the tendered general obligation warrants over a 3-year period. The annual redemption requirement for the sewer warrants (approx. $210 million) exceeded the total annual revenues of the sewer system.

- reduction of the County's underlying sewer rating from "A" in February 2008 to "D" by April 2008 as a result of the County's inability to make the accelerated redemption payments required by the liquidity facilities

- reduction of the County's underlying general obligation rating from "AA" in March 2008 to "D" by September 2008 as a result of the County's inability to make the accelerated redemption payments required by the liquidity facilities

- inability to replace or replenish a $29 million debt service reserve fund surety bond that became ineligible as a result of the ratings downgrade of the surety bond provider

- collapse of the auction rate securities market

- judicial appointment of a receiver to operate and manage the sewer system

- lawsuit resulting in a ruling that the County's occupational tax was invalidly authorized by the State Legislature; subsequent unwillingness of the Legislature to re-enact or replace the tax which accounted for 40% of the County's General Fund revenues

- SEC civil enforcement cases filed against New York underwriters and Alabama participants

- SEC settlement with the lead underwriter of the sewer financings, finding securities fraud violations, requiring the extinguishment of $650 million of swap termination payments and ordering payment of $75 million to the County as the victim of the fraud

- cloud of corruption and distrust – 22 local criminal convictions, including 4 county commissioners

Much more could be said about this story, but now is not the time or place. Jefferson County has tried for 3 ½ years to solve its financial problems without having to resort to Chapter 9 bankruptcy. Those efforts continue to this very day and will undoubtedly be the subject of much public attention in the coming days and weeks.

The SEC's mandate of protecting investors by promoting market transparency and good disclosure is consistent with the interest of issuers. Without a healthy and functioning market, issuers can not finance important projects. However, communities struggling with serious financial challenges must prioritize the problems they can realistically deal with from day to day during particularly difficult times. Fine tuning footnote 47 in the financial statements or posting the next material event notice may be temporarily brushed aside in favor of maintaining the police and fire departments and keeping the courthouse in operation. The challenge for the SEC and our communities is to strike the right balance so that investors are protected while the urgent needs of the local constituents are served.

To that end, our panel should discuss the idea of a cooperative effort by the SEC, industry participants, and issuer representatives to produce guidelines or a statement of best practices for primary and secondary market disclosure by municipal issuers that could highlight warning signs of pending financial distress. Such a project could be valuable to underwriters, analysts and investors and of great help to issuers seeking to maintain or regain their access to the market in the midst of a financial crisis. The "Task Force on Defined Benefit Public Pension Plan Disclosure" recently organized by the National Association of Bond Lawyers with participation by a long list of industry and professional groups might serve as a useful model for such a project. As a starting place, the participants might consider whether it is feasible and/or advisable to imagine an "early warning system" to detect and disclose signs of brewing financial trouble. Indicators of looming problems might include:

- budget deficits and imbalances
- decreasing fund balances or extraordinary fund transfers
- cuts to services, departments or programs
- employee furloughs or layoffs
- implementation of an early retirement program
- deferred maintenance and aging infrastructure
- hiring or spending freezes
- high unfunded pension liabilities
- bumping the legal limits of debt capacity or maximum tax rates
- material regulatory failures
- increasing healthcare costs

- burdensome long term labor contracts
- failed projects requiring financial support from the municipality
- unusual spending from a reserve or rainy day fund
- high unemployment in the service area
- decreases in property value, per capita income or population
- loss of major industries, taxpayers, or employers
- significant tax declines
- adverse results in material litigation
- local officials frequently seen in handcuffs

I appreciate the opportunity to appear with the other members of our panel today and look forward to their ideas and discussion.