

Presentation to the California Debt and Investment Advisory Commission

Credits under Stress

Political Risk in Times of Austerity

How States and Investors Can Deal with the
Willingness to Pay vs. Inability to Pay Problem

James E. Spiotto
Chapman and Cutler LLP

October 17, 2012

© 2012 by James E. Spiotto. All rights reserved. This is part of a presentation to the U.S. Securities and Exchange Commission field hearing at Birmingham, Alabama on July 29, 2011 on the State of the Municipal Securities Market, Remarks of James E. Spiotto of Chapman and Cutler LLP, and a book entitled "Municipalities in Distress?" published by Chapman and Cutler LLP which is a 50-State Survey of State Laws Dealing with Financial Emergencies of Local Governments, Rights and Remedies Provided by States to Investors in Financially Distressed Local Government Debt, and State Authorization of Municipalities to File Chapter 9 Bankruptcy, which is available from Chapman and Cutler LLP or on Amazon.com.

3278195

Table of Contents

I.	Historical Question of Political Risk in Times of Austerity.	3
II.	State Provisions Regarding Government Debt Default Prevention	33
III.	Debt Resolution Mechanism: State Oversight, Supervision and Assistance for Emergencies of Local Governments	38
IV.	Bondholder Rights and Remedies	52
V.	How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond	56
VI.	Municipal Bankruptcy Chapter 9 Issues.	68
VII.	Chapter 9 – Legal Impact on a Bondholder of Municipal Debt.	82
VIII.	Chapter 9 (Municipal debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)	85
IX.	Lessons Learned from Recent Distressed Municipalities.	90
X.	Municipalities in Distress?	93
XI.	Scorecard for Other Mechanisms for State to Address Financial Distress of Its Local Governments	96
XII.	Conclusion	98
	Selected Examples of the 50 State Survey	102

I. Historical Question of Political Risk in Times of Austerity

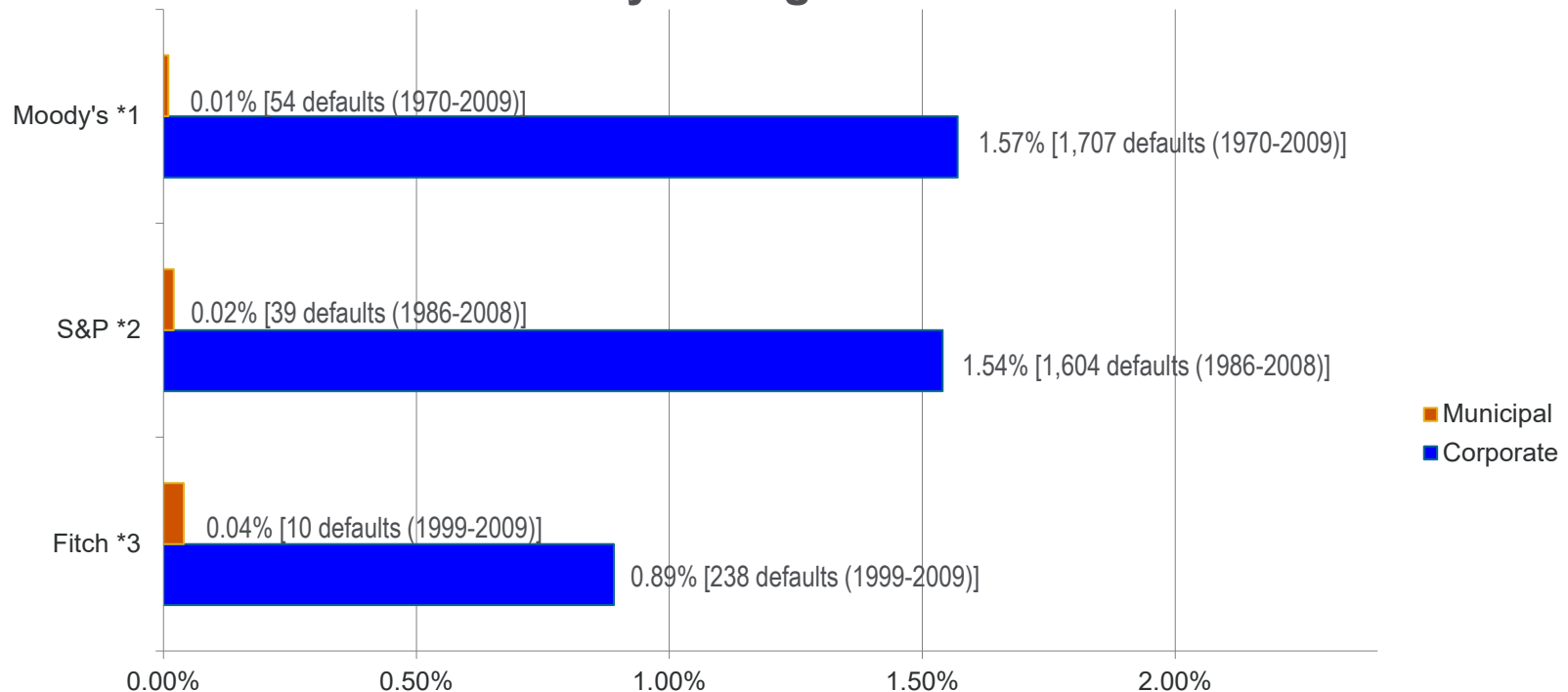
- I. Historically, while political risk of non-payment was a possibility, it was a rare occurrence, if not in reality a non-existent concern, with a few exceptions (*i.e.* Repudiation of Civil War related debt by 13 states in the late 1800's, Washington Public Power Supply System, 1983).
 - A. Historically, there is a low default rate for bonds issued by municipalities and states:
 - 1. Dr. John Peterson of George Mason University noted in his recent paper on "Municipal Defaults: Eighty Years Made a Big Difference" (2011) that, between 1970's-2000's, the municipal default rate for municipalities averaged per decade .10% to .24% (adjusted for WPPSS and Jefferson County, Alabama) not including the fact that over 80% of the defaults were conduit financings and not essential public financings. This is a far cry from corporate bond default rate on average for investment grade and non-investment grade of about 10%.

I. Historical Question of Political Risk in Times of Austerity

2. States have not defaulted on general obligations bonds since the late 1880's, with the exception of Arkansas in 1933, which was thereafter refinanced.
3. Historically, based on default rate, there is little support for the willingness to pay to be deemed a real problem since there is an absence of political risk.

I. Historical Question of Political Risk in Times of Austerity

**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

I. Historical Question of Political Risk in Times of Austerity

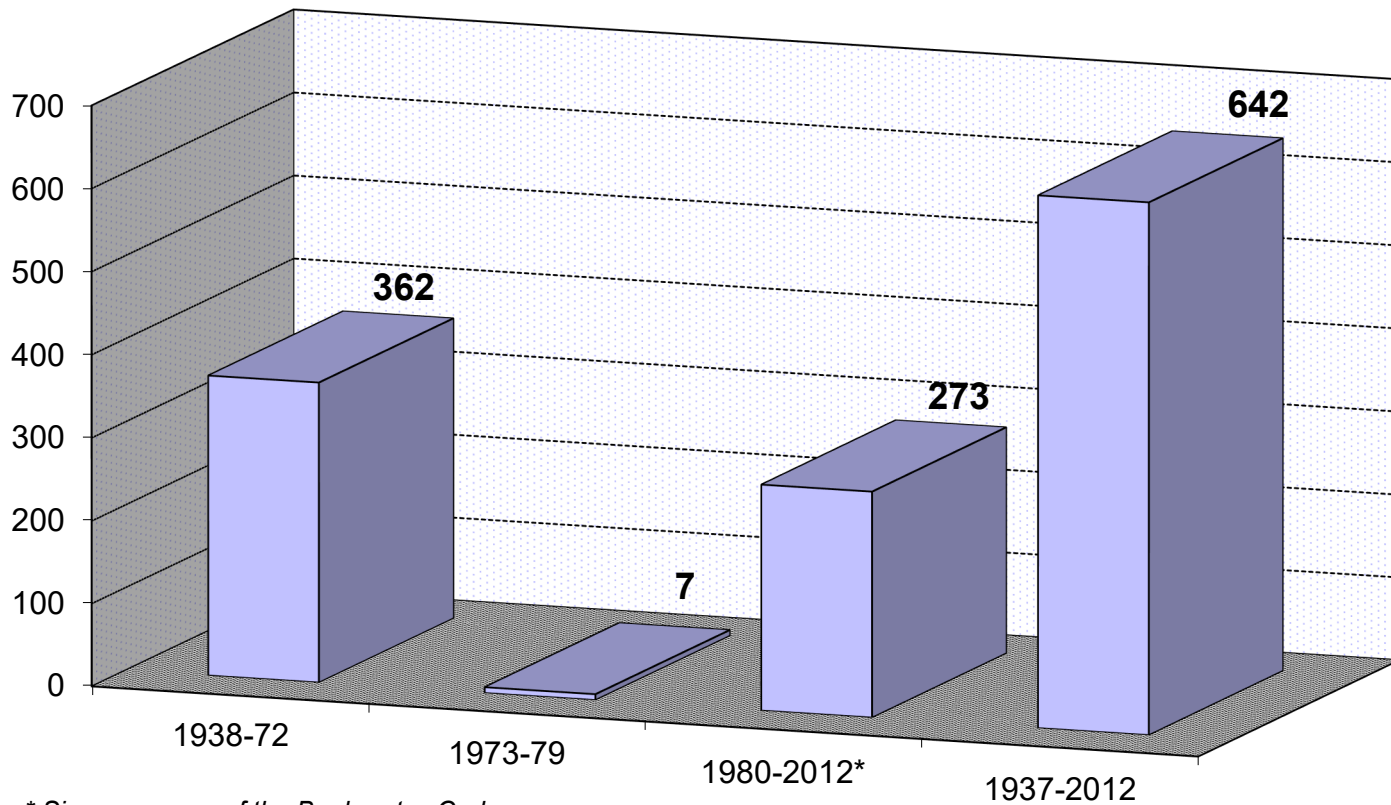
- B. Historically the use of bankruptcy by a municipality does not support any fear of political risk:
 - 1. Unlike corporations local governments rarely use Bankruptcy, Chapter 9 – generally only special tax districts and small municipalities file. No large issuers of municipal debt (with the exception of Orange County, California in 1994, Bridgeport, Connecticut in 1991, Vallejo, California in 2008, Jefferson County in 2011, Stockton, California in June, 2012 and San Bernardino, California in August, 2012) have filed in the last 30 years. There have been only 642 Chapter 9 filings since 1937. In 2008, 2009, 2010 and 2011 there were 4, 10, 6 and 13 respectively, municipal Chapter 9 filings. So far this year there have been 11 Chapter 9 filings of which only 3 have been cities, towns or counties (Stockton, Mammoth Lakes and San Bernardino). 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.

I. Historical Question of Political Risk in Times of Austerity

2. Comparing Chapter 11 corporate reorganization filings to Chapter 9 municipal debt adjustment filings reveals the historical strength, willingness to pay 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 642 Chapter 9 cases filed, most of which have been small special tax district and entities that did not issue municipal bonds.
3. Further, of the 642 Chapter 9 municipal bankruptcy filings since 1937, 163 or 25% have been dismissed or closed without a plan of adjustment filed. Since 1980, there have been 267 Chapter 9 filings by municipalities and, of those, 84 or 30% have been dismissed or closed without a plan and only 52 of the 273 have been traditional local governments (town, cities, villages and counties).

Default Statistics

FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2012 (as of 10/5/2012)

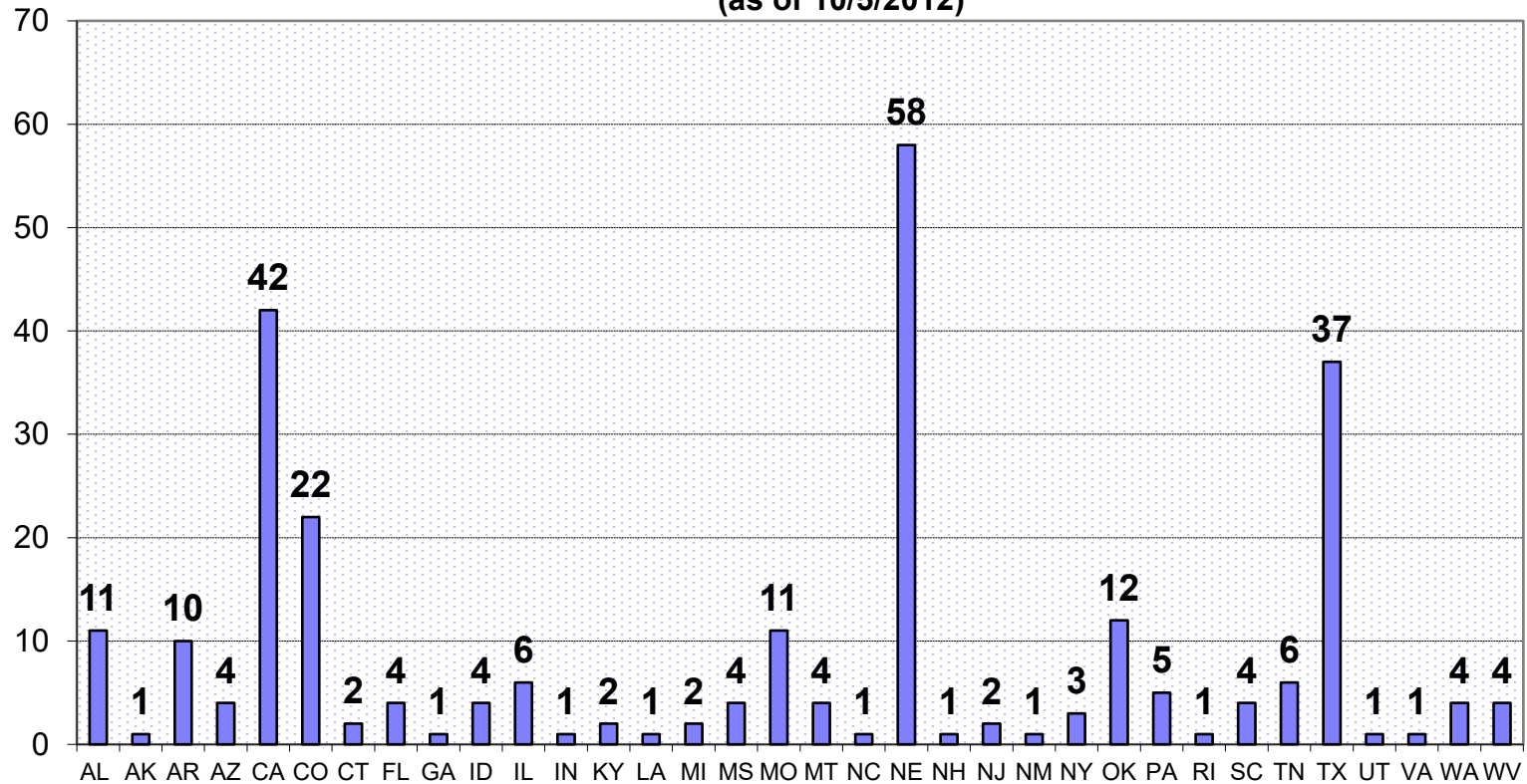


* Since passage of the Bankruptcy Code.

Default Statistics

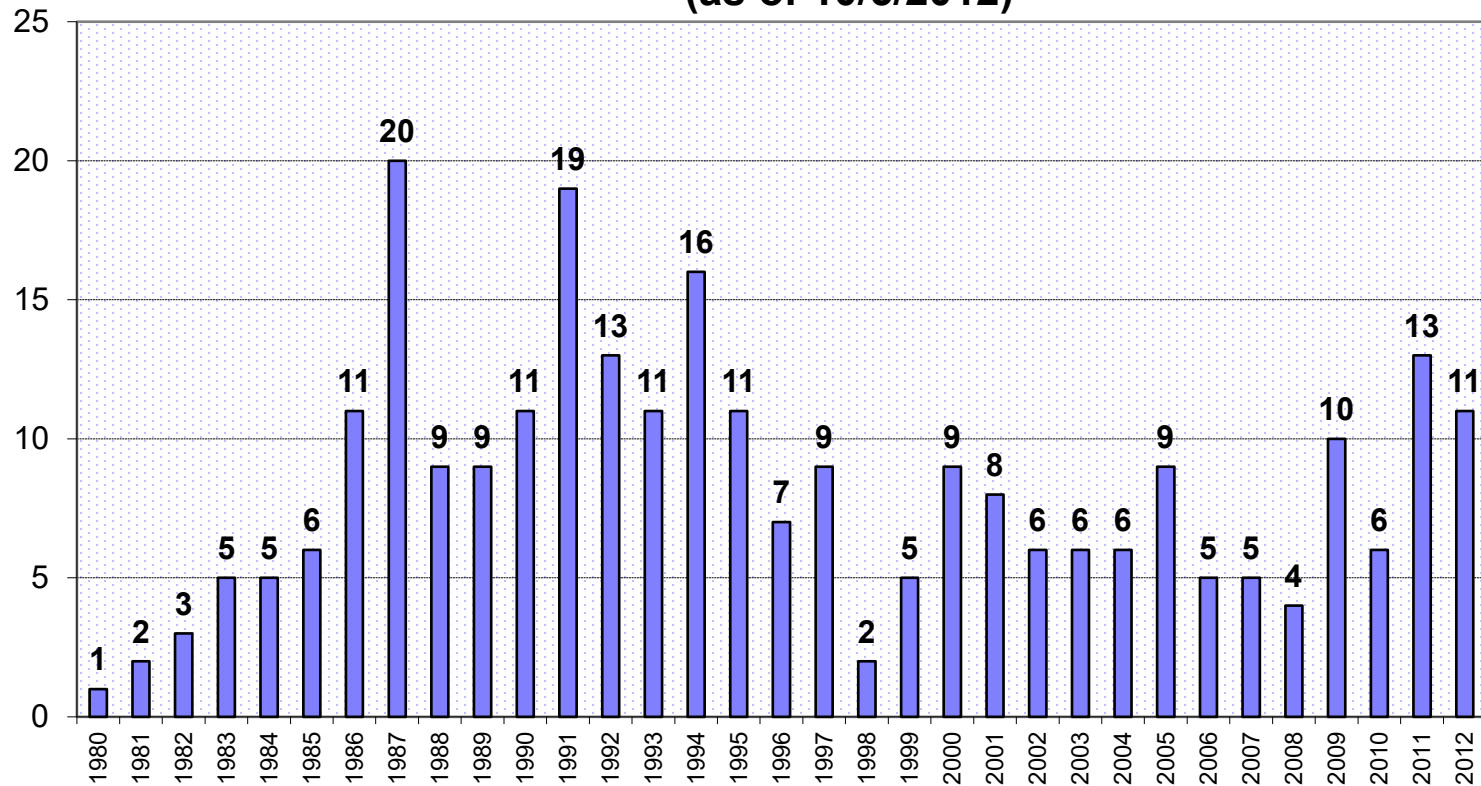
CHAPTER 9 FILINGS BY STATE • 1980-2012

(as of 10/5/2012)



Default Statistics

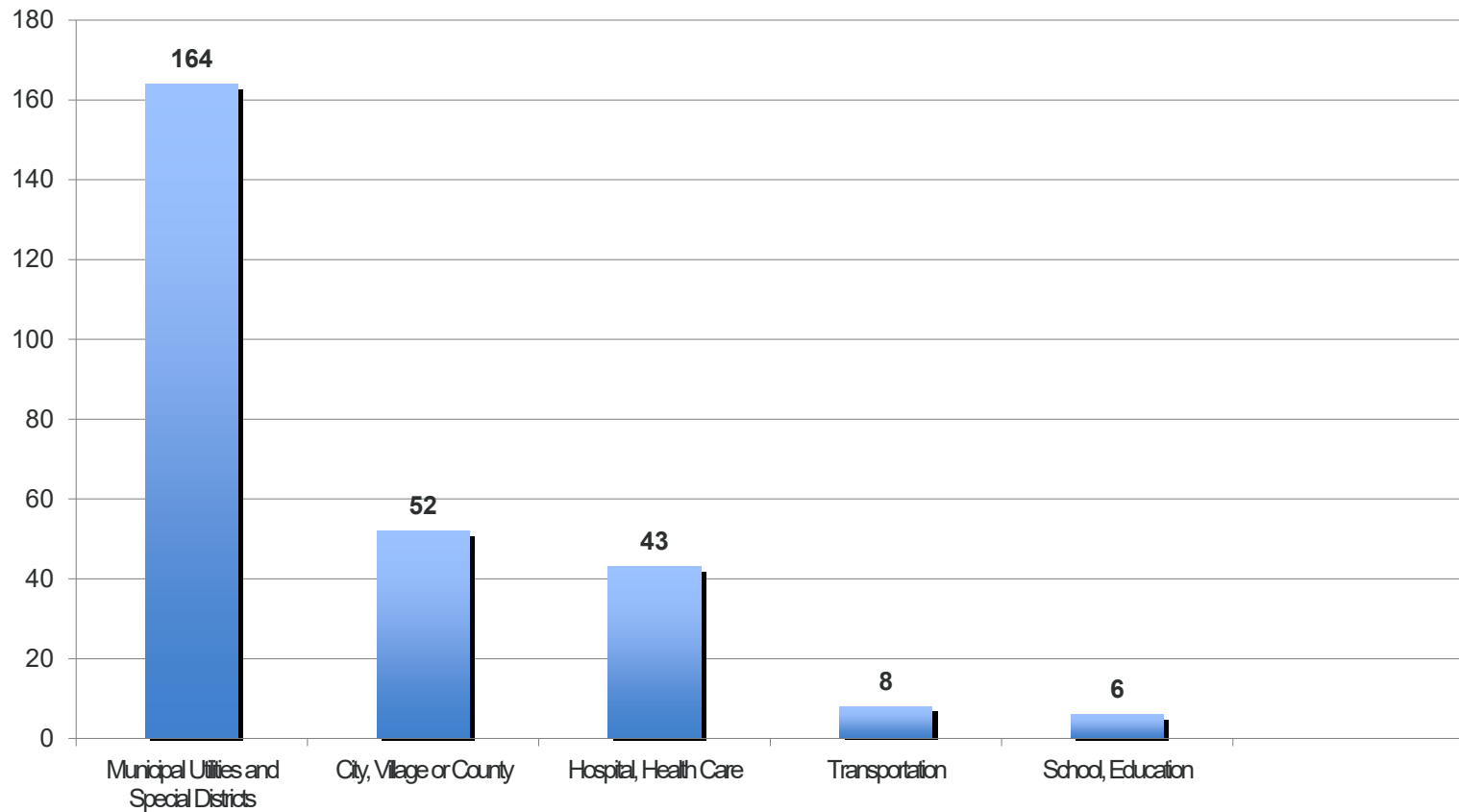
CHAPTER 9 FILINGS BY YEAR • 1980-2012
(as of 10/5/2012)



Default Statistics

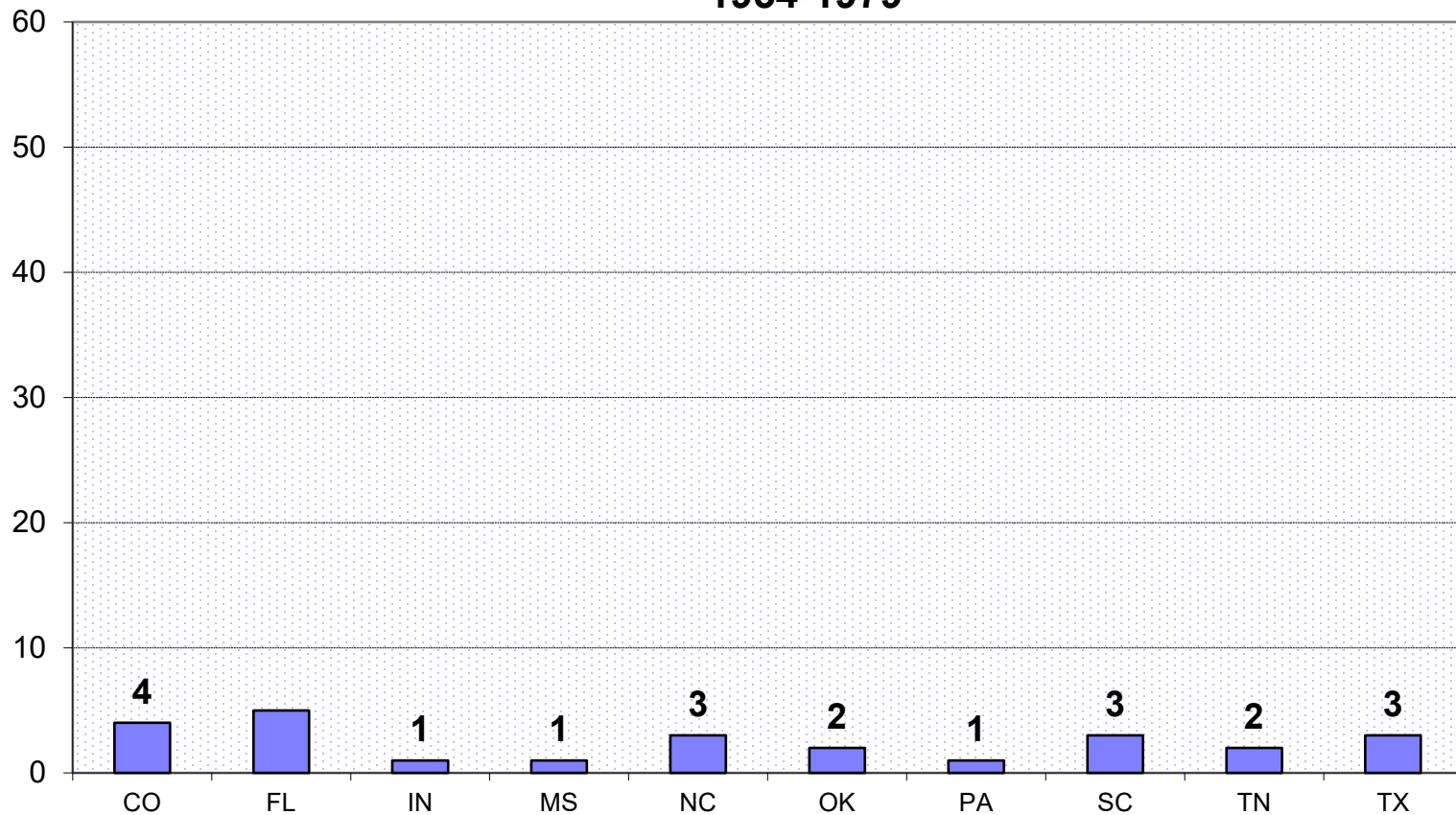
CHAPTER 9 FILINGS BY TYPE • 1980-2012

(as of 10/5/2012)



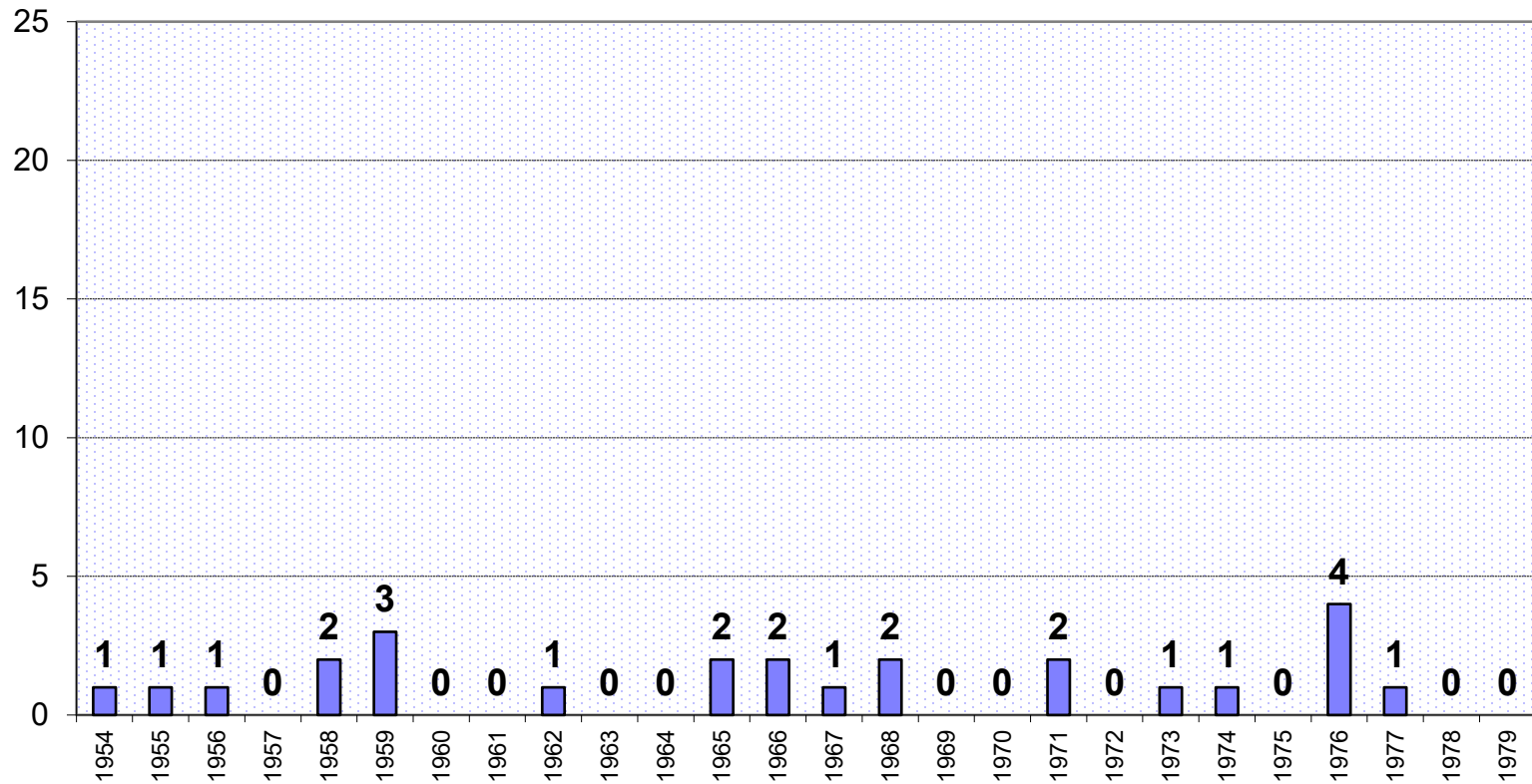
Default Statistics

MUNICIPAL BANKRUPTCY FILINGS BY STATE 1954-1979



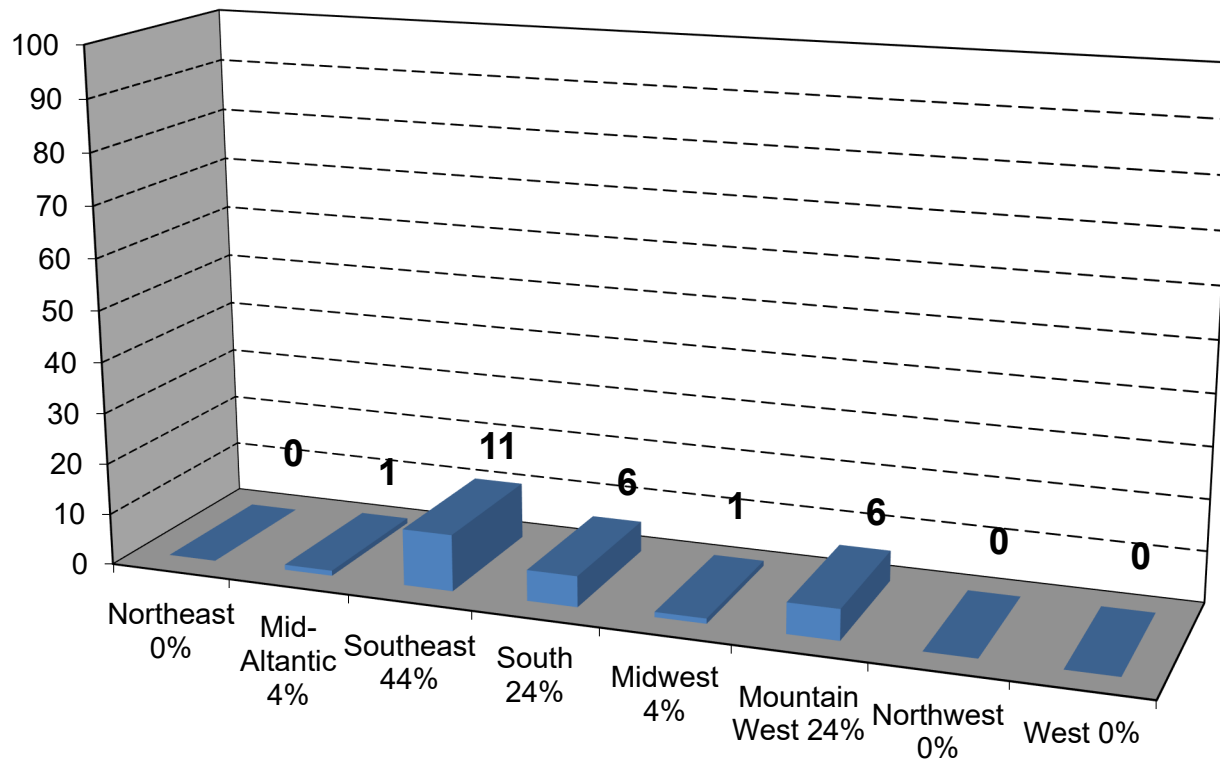
Default Statistics

MUNICIPAL BANKRUPTCY FILINGS BY YEAR 1954-1979



Default Statistics

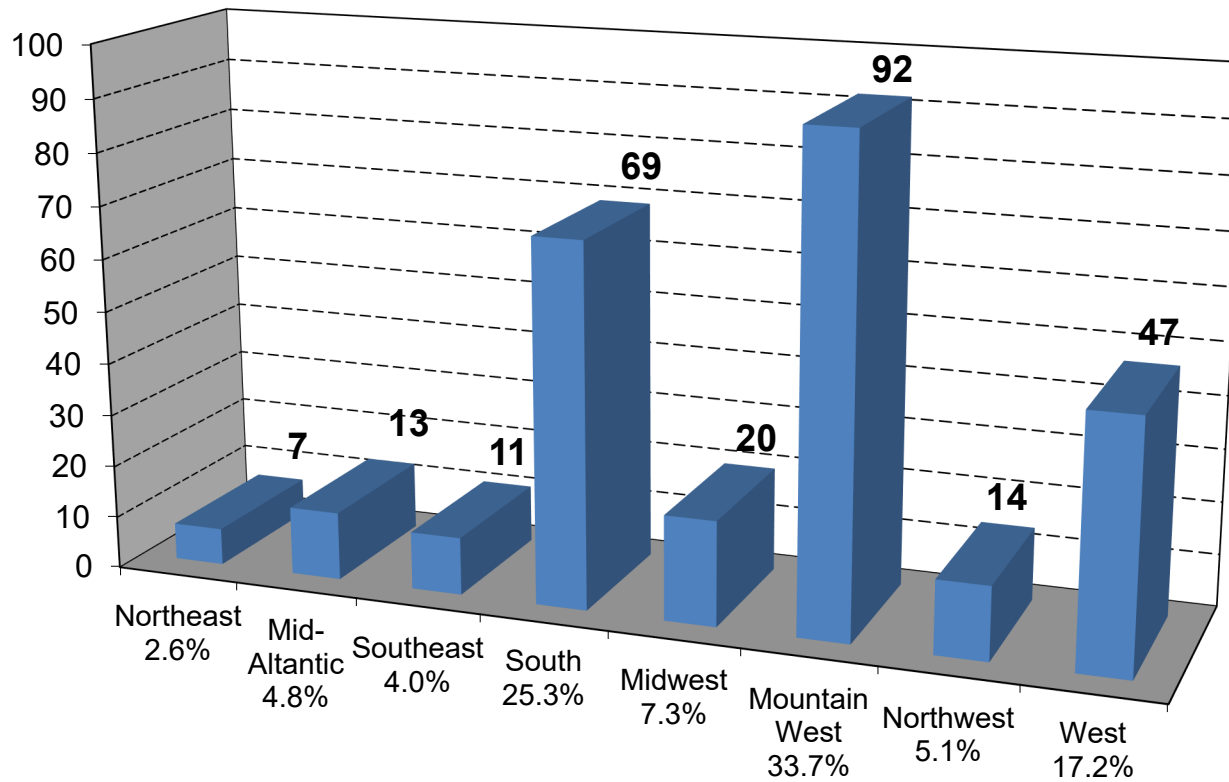
MUNICIPAL BANKRUPTCIES BY REGION 1954-1979



Default Statistics

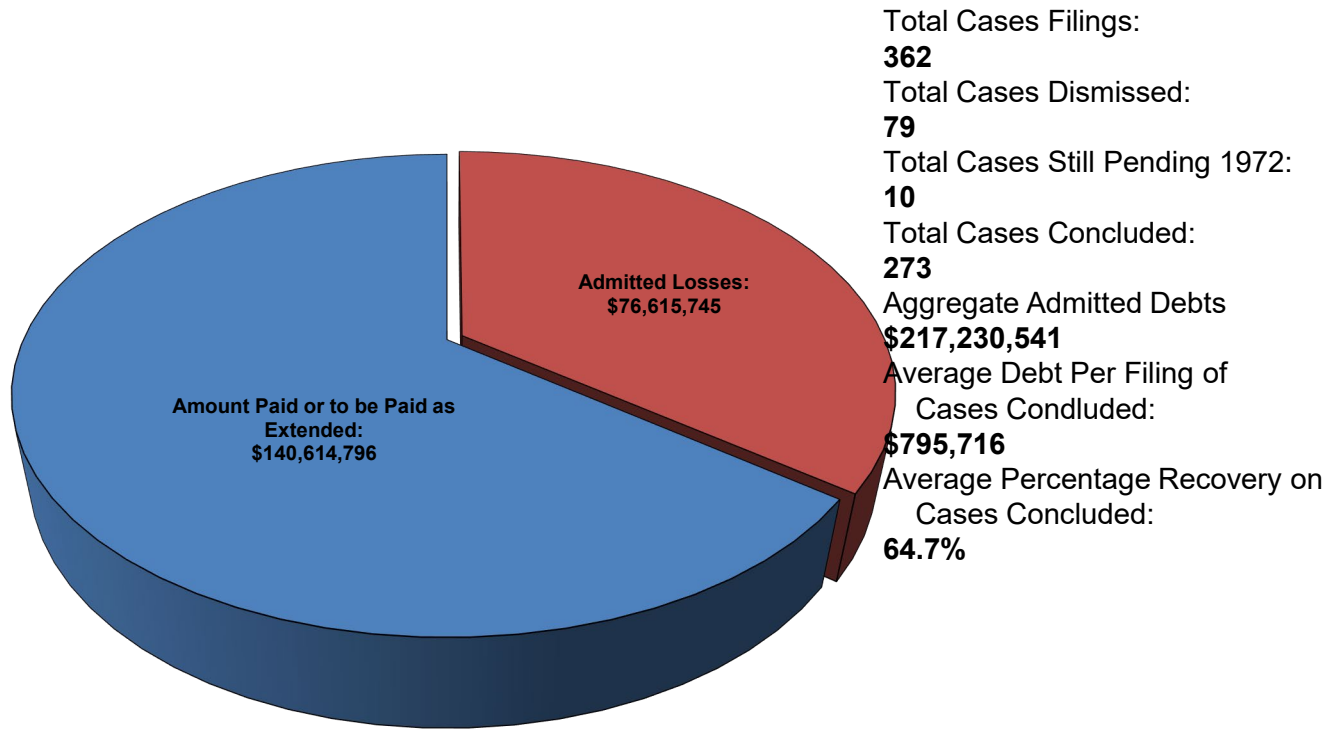
CHAPTER 9 FILINGS BY REGION • 1980-2012

(as of 10/5/2012)



Default Statistics

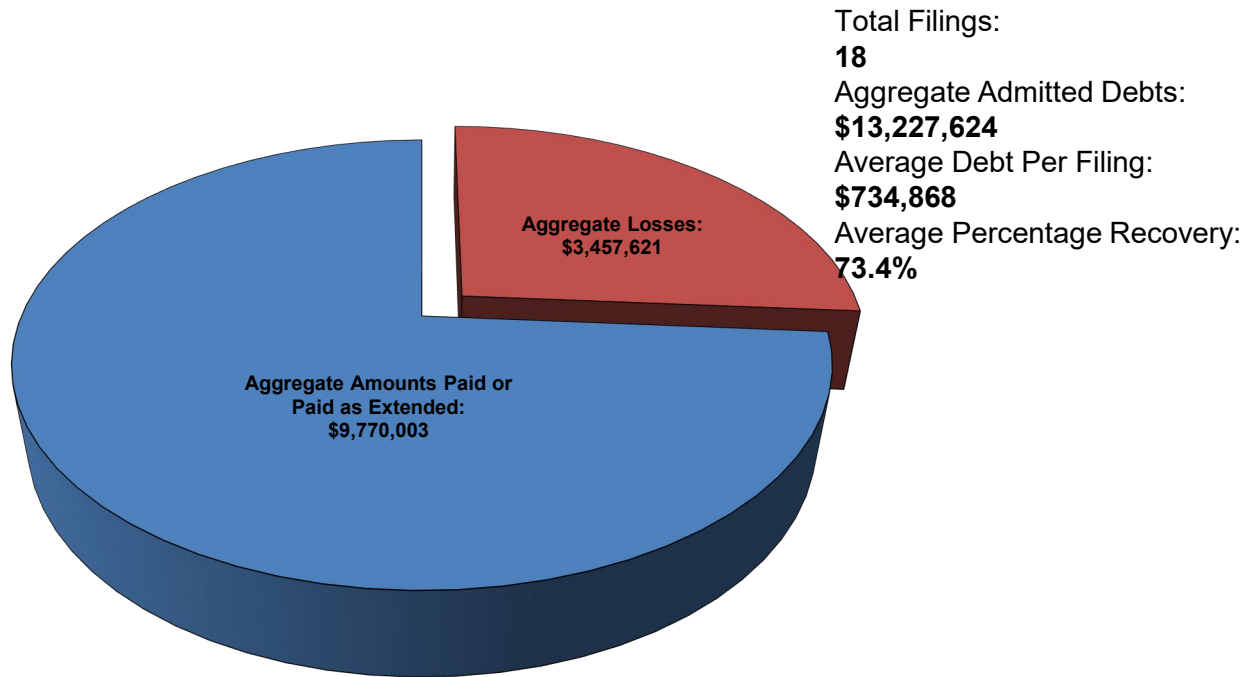
MUNICIPAL BANKRUPTCY RECOVERY 1938-1972*



* See Table 5-1, *City Financial Emergencies: The Intergovernmental Dimension*,
Advisory Commission on Intergovernmental Relations, July 1973.

Default Statistics

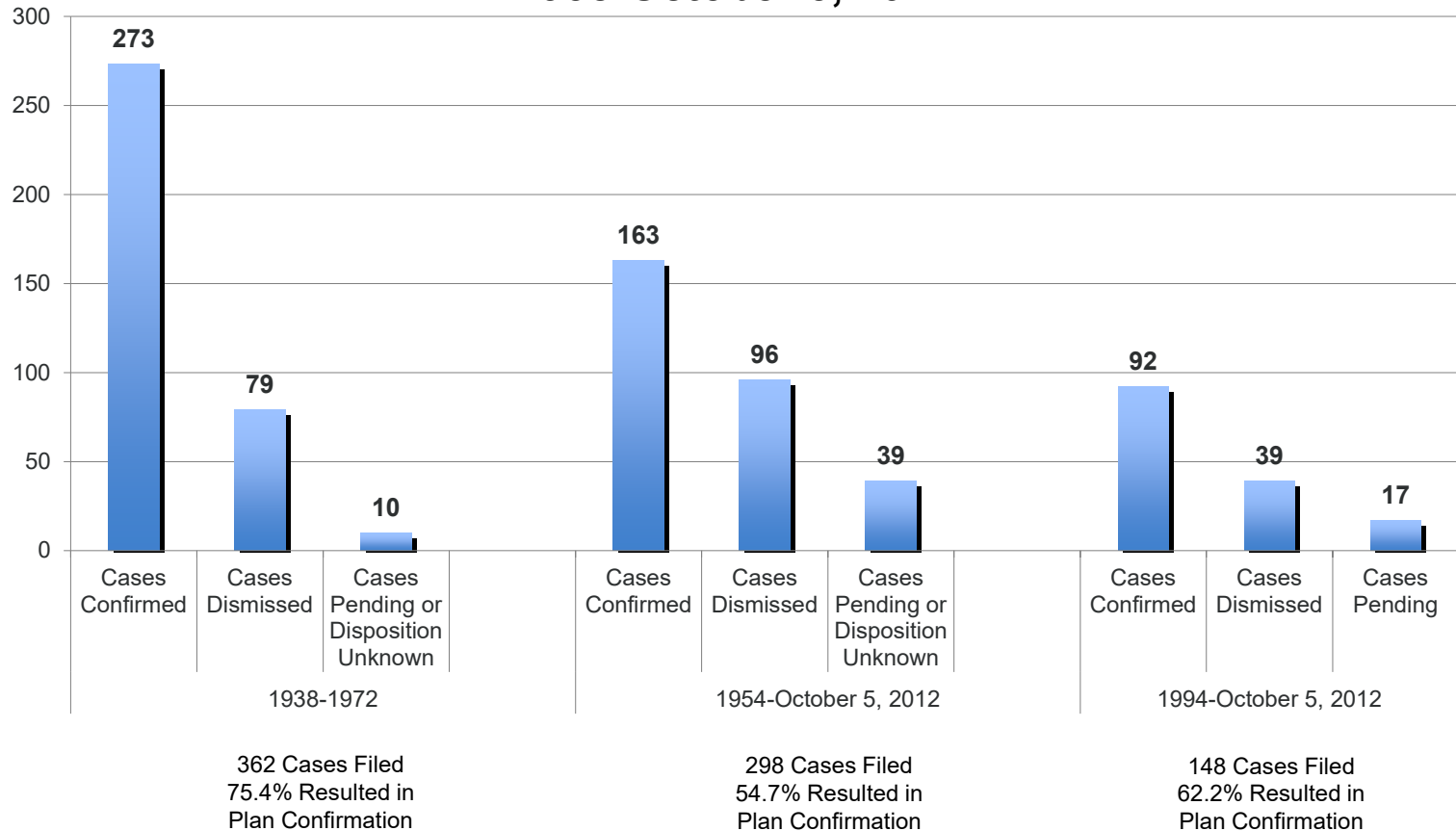
MUNICIPAL BANKRUPTCY RECOVERY 1954-1972*



* See Table 5-1, *City Financial Emergencies: The Intergovernmental Dimension*,
Advisory Commission on Intergovernmental Relations, July 1973.

Default Statistics

DISPOSITION OF CASES 1938-October 5, 2012



I. Historical Question of Political Risk in Times of Austerity

- C. Traditionally causes of municipal Bond Defaults in the U.S.A have been linked to inability to pay rather than unwillingness to pay or political risks:
1. Economic Depression.
 2. Non Essential Services.
 3. Feasibility of Projects and Industries.
 4. Fraud.
 5. Mismanagement.
 6. Unwillingness to pay.
 7. Natural and Man Made Disasters.

I. Historical Question of Political Risk in Times of Austerity

- D. Current Potential Causes of Municipal Default. Generally, 75% of all municipal bond defaults have occurred in bonds issued by municipalities to finance revenue producing enterprises (*i.e.*, highways, bridges, utilities, swimming pools, harbors, etc.). General Obligation Bonds have been 25% or less of defaults.

There are many causes of municipal default. A number of factors, while they do not in and of themselves necessarily cause default, contribute to restricted cash flow which brings about an inability to meet scheduled debt service payments.

1. Unaffordable and Unsustainable Personnel Costs.
2. Deferred Costs of Capital Improvements and Infrastructure Costs.
3. Recent and Unaddressed Natural Disasters of Manmade Disasters.
4. The Bursting of USA State and Local Government Debt Bubble.
5. Decline of Urban Areas.
6. Flight from the Rustbelt to the Funbelt.
7. Proposition Thirteen Mentality – The Popularity of Tax Caps and Limitations.
8. Lingering Legal Issues and Surprise Court Decisions.
9. Off Balance Sheet Liabilities.
10. Airports, Casinos and Sport Stadium.
11. Willingness to Pay vs. Ability to Pay – Willingness to pay traditionally has not been a problem but could be a growing problem.

I. Historical Question of Political Risk in Times of Austerity

- E. Since the Depression of the 1930's, States and Local Governments have diversified the source of tax revenues to reduce reliance on property taxes and to spread the burdens and reduce the risk of concentration.

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	<u>2.3</u>	<u>1.6</u>	<u>3.2</u>	<u>11.3</u>	<u>9.8</u>	<u>17.0</u>	<u>19.8</u>
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. Historical Question of Political Risk in Times of Austerity

We presently are recovering from a significant economic downturn:

- With unemployment hovering above 8% 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 all have seen this before and, in the past, issuances of state and local government debt financing have helped stimulate 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 have successfully led to past recoveries. Other similarly related state and local government financing may this time be just what is necessary to encourage economic growth and job creation.

I. Historical Question of Political Risk in Times of Austerity

- G. Historically, government finance officers did anything they could to avoid default due to the essential need of any government of size to access the municipal market to cover financing of infrastructure and essential services at a low cost:

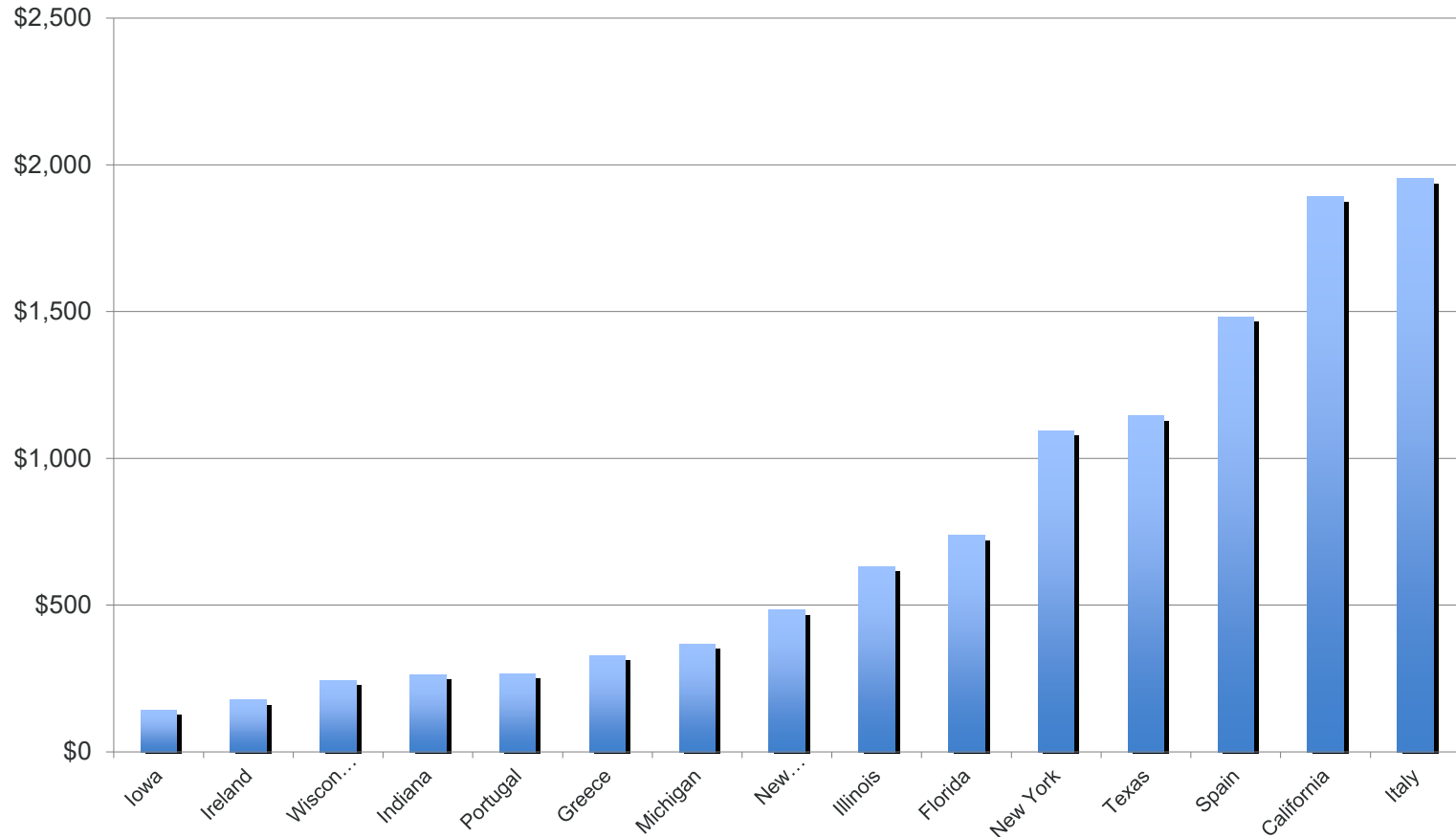
Municipalities and states fear default would lead either to limited or no access to the Municipal Bond Market or significant increase in the cost of borrowing (increased interest costs). This would limit or deprive states or municipalities of their present ability to decide locally what infrastructure improvement or what essential services they will finance and to finance such themselves rather than to obtain the consent or approval of a higher government who has the ability to obtain financing and possibly a different agenda.

I. Historical Question of Political Risk in Times of Austerity

- H. Our states enjoy a favorable GDP and Debt to GDP and Debt to Revenue Ratios compared to other Sovereigns on a global basis.
- Will any U.S. state become the next Greece, Ireland, Portugal, Spain or Italy, one of the PIIGS?
 - 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.

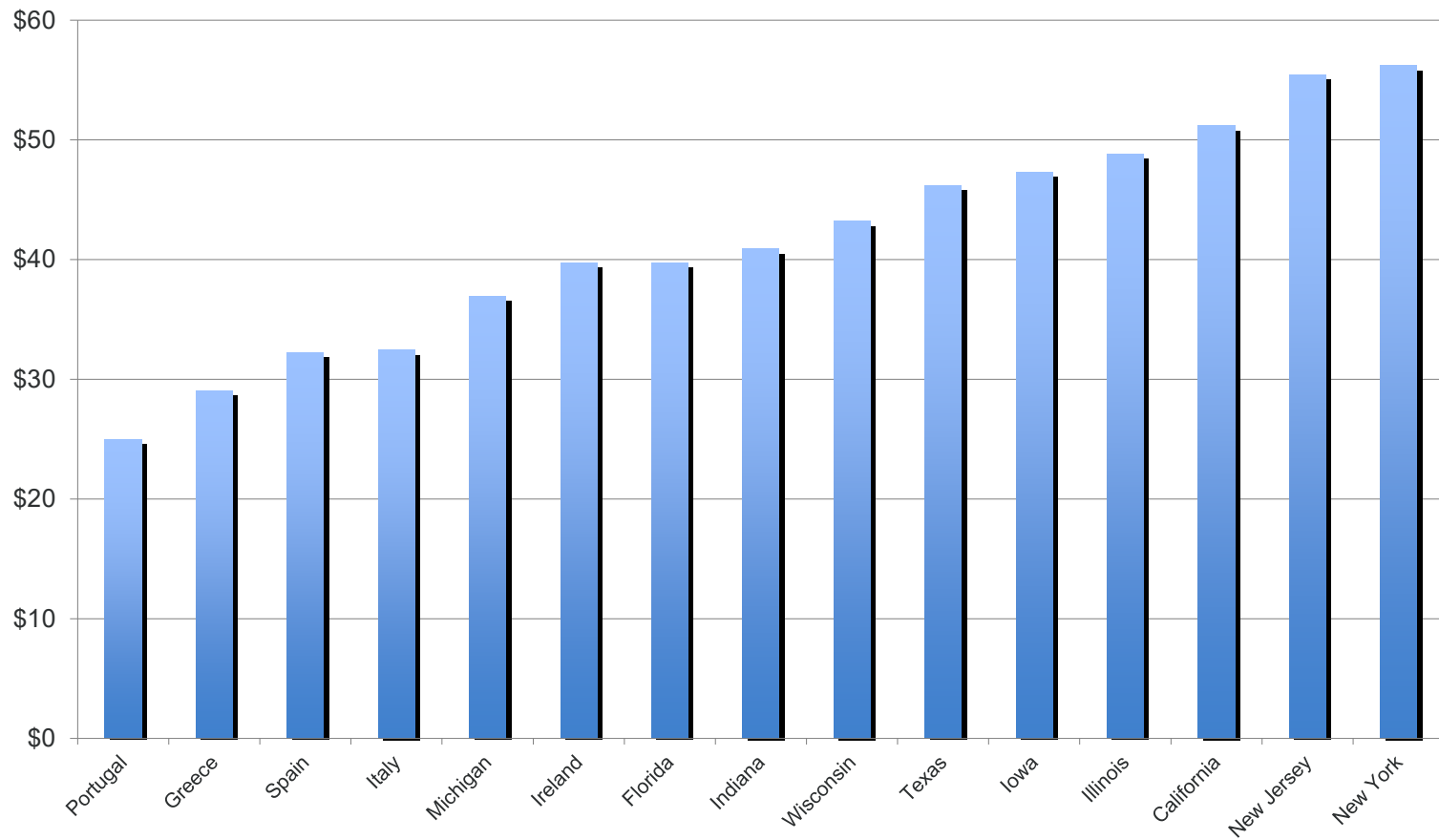
GDP of Selected U.S. States and European Countries

Billions of 2009 USD



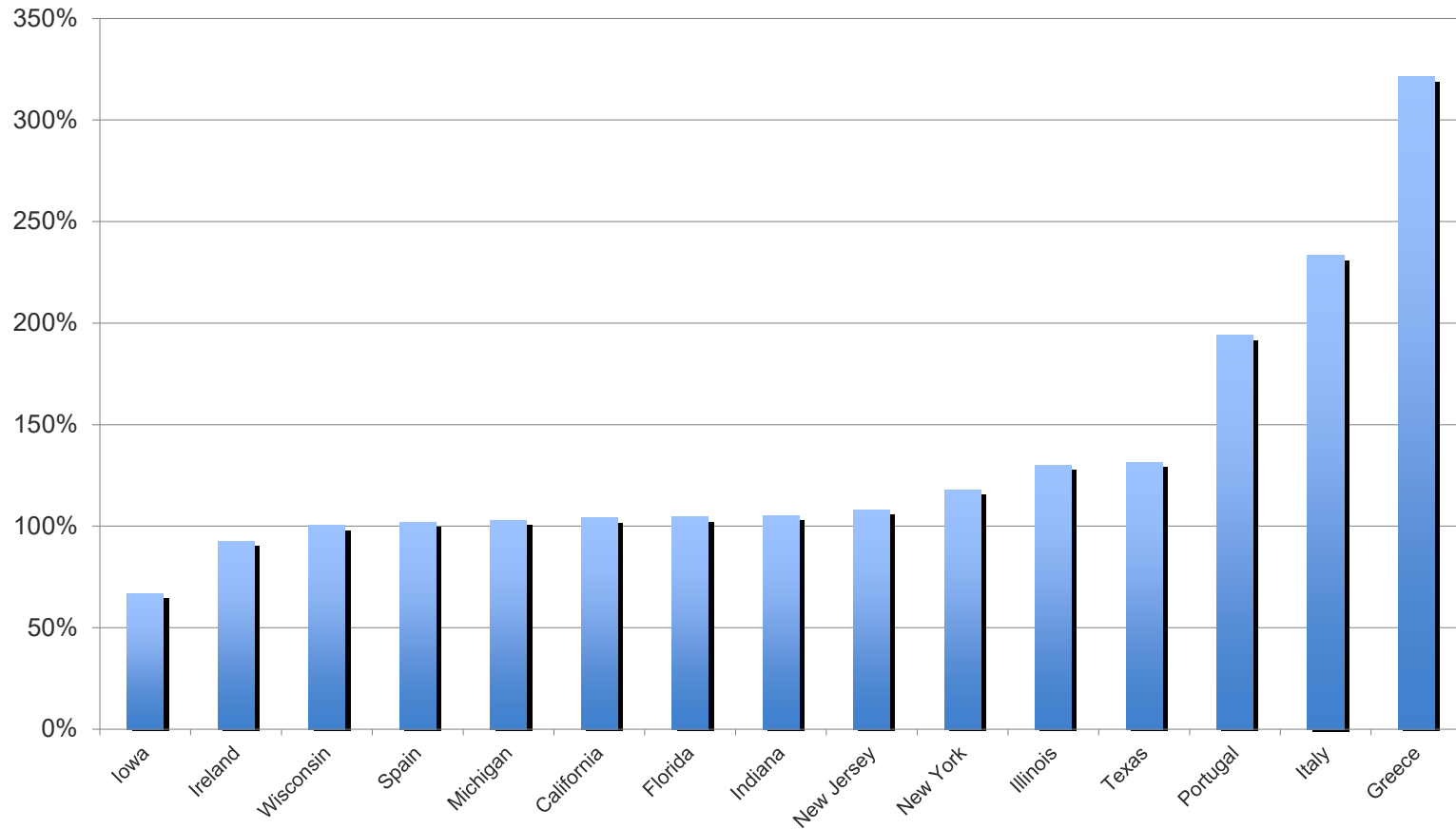
Source: US Bureau of Economic Analysis; OECD.

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



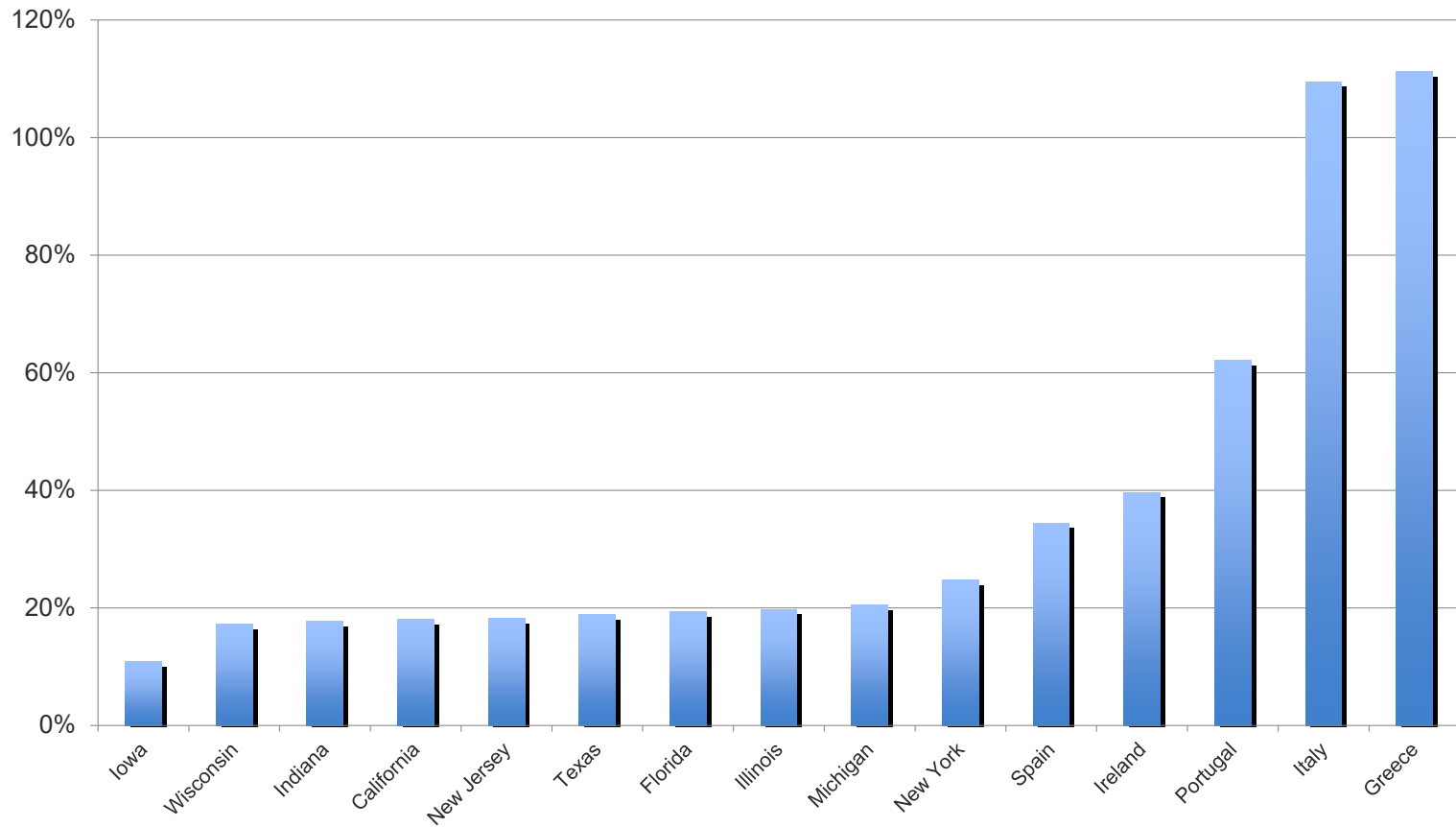
Source: US Bureau of Economic Analysis; US Census Bureau; OECD.

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.

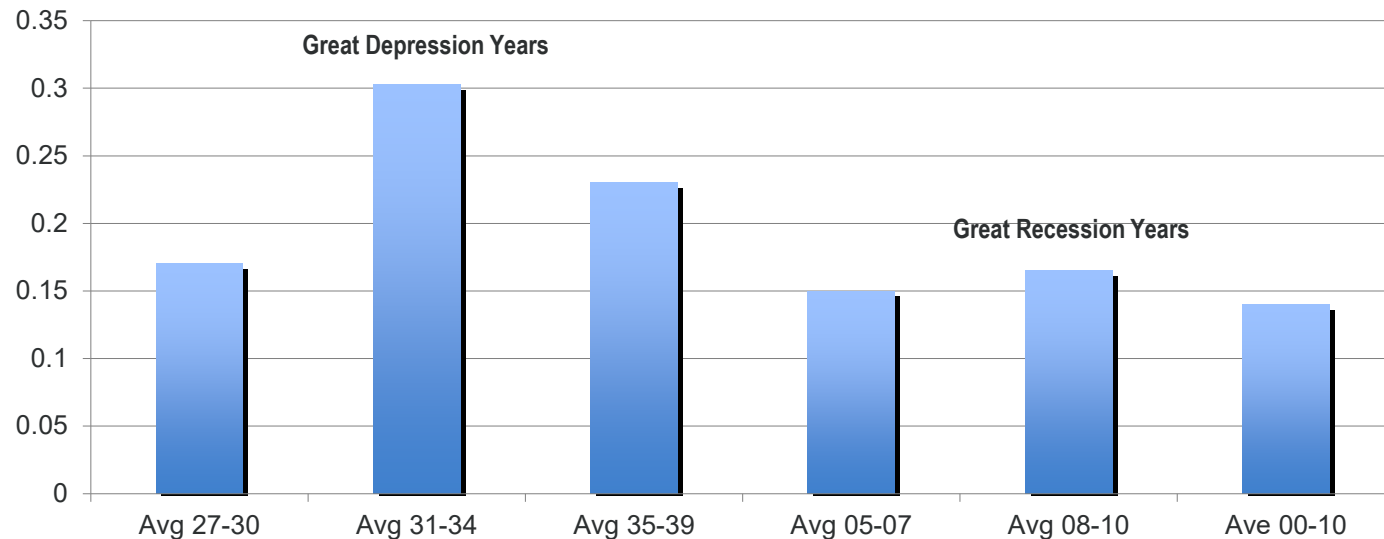
Debt-to-GDP Ratio of Selected U.S. States and European Countries (2008 figures)



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

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

Ratio of State-Local Debt to GDP: Late 1920s, 1930s, and 2000s



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.

I. Historical Question of Political Risk in Times of Austerity

- I. Selected Case Studies of Past Financial Emergencies of Municipalities
 1. The New York and Cleveland Experiences (Problems of Financial Controls and State and Federal Bailouts).
 2. The San Jose School District and Medley, Florida Cases (Excessive Labor Costs or Judgments).
 3. Washington Public Power Supply System (Projects Fail When Expected Demand Evaporates).
 4. The Colorado Special Districts (Failed Special Projects).
 5. City of Bridgeport, Connecticut (City Troubled by Flights of Population and Business and the Use of Intercept).
 6. City of Philadelphia (Successful Legislation and State and Local Cooperation Avoid Disaster).
 7. Orange County, California (Creative Financing to Solve Tax Revenue Shortfalls).

I. Historical Question of Political Risk in Times of Austerity

- J. Recent Examples of Financial Emergencies of Municipalities (These will be discussed in more detail in the Lessons Learned section).
 - 1. City of Vallejo, California (The consequences of too rich benefit programs.)
 - 2. Central Falls, Rhode Island (Bondholders come first.)
 - 3. Harrisburg, Pennsylvania (Eligibility.)
 - 4. Jefferson County, Alabama (The scope of special revenues.)
 - 5. Stockton, California (The use of neutral evaluator in California.)
 - 6. San Bernardino, California (The importance of sufficient cash on hand and liquidity for municipalities.)
 - 7. Atwater, California (Are there alternative methods of dealing with liquidity issues and unsustainable and unaffordable labor costs?)

II. State Provisions Regarding Government Debt Default Prevention

A. Use of Debt Limitation and Tax Limitation:

1. All states except Tennessee impose some sort of limitation on the Amount of Debt:
 - Florida and Alaska have some indirect control on debt, *i.e.* Alaska has a limit on taxes that a municipality can levy – ad valorem taxes in excess of 3 percent assessed value and Florida has limitation on ad valorem taxes to finance or refinance capital projects – requires voter approval.
2. Municipal Debt limits range from a percentage of a valuation of assessed property to a monetary amount.

II. State Provisions Regarding Government Debt Default Prevention

3. States handle debt for essential services differently than non essential:
 - Arizona – 15% limit with voter approval for nonessential 20% for essential.
 - Kansas – Bonds for sewer systems to acquire or enlarge municipal utility and street improvement not counted in debt limitation.
 - Idaho – 2/3 voter approval to exceed limitation.
 - Puerto Rico – Limits may not be less than 5 percent or greater than 10 percent aggregate tax valuation of property in a municipality.
 - Rhode Island – Debt limit but measured net of tax anticipation bonds and amount of any sinking fund.

II. State Provisions Regarding Government Debt Default Prevention

4. There have been recent attempts in some States to tighten local debt limits while others strengthen protections:
 - Colorado 2010 – Amendment to greater limit the ability of local government to borrow funds was defeated by 73%.
 - Rhode Island 2011 – Payment of Bond debt will have first priority lien on revenues of a municipality in order to assure the municipal market of the dedication to payment so that access and cost of financing not threatened.

II. State Provisions Regarding Government Debt Default Prevention

5. Generally Revenue Bonds paid from the revenues of a municipal enterprise (water, sewer, bridge, tollway, electric system) are exempt from debt limits. So also are the tax increment financing and appropriation bonds.

II. State Provisions Regarding Government Debt Default Prevention

B. Refunding Bonds are permitted in all States:

- Every State provides some form of Refunding Bonds.
- Refunding Bonds provide the ability and the benefit of refunding high interest rate debt in a low interest market.
- States place restrictions on the extent and purpose of the refunding such as:
 - to reduce debt service,
 - eliminate restrictive covenants,
 - to pay bond and note anticipation obligations, and
 - to adjust lease rentals.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- A. At least twenty-three States have implemented some form of municipal debt supervision or restructuring mechanism to aid municipalities:
- These range from Debt Advisory Commissions (e.g. California) and Technical Assistance Programs (Florida) which provide guidance for and keep records of issuance of municipal debt to the layered approach of Rhode Island and Michigan of oversight, commission and fiscal manager or receiver.
 - Examples of State Oversight, Supervision and Assistance for Fiscal Emergencies of Local Government.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

	STATE	INTERVENTION PROVISION
1.	Arizona	School District Receivership.
2.	California	Debt and Investment Advisory Commission.
3.	District of Columbia	Financial Responsibility and Management Assistance Authority.
4.	Florida	Bond Financial Emergencies Act; Division of Bond Finance and Local Government Financial Technical Assistance Program.
5.	Idaho	Debt Readjustment Plans.
6.	Illinois	Financially Distressed City Law; Financial Planning and Supervision.
7.	Indiana	Distressed Political Subdivision Protections and Township Assistance.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

	STATE	INTERVENTION PROVISION
8.	Kentucky	County Restructuring Provisions.
9.	Maine	Board of Emergency Municipal Finance.
10.	Massachusetts	<i>Ad hoc</i> State Intervention.
11.	Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act.
12.	Minnesota	Back-up Payment Procedures for Municipalities and School Districts.
13.	Nevada	Local Government Financial Assistance and Audit Enforcement Act.
14.	New Hampshire	Emergency Financial Assistance

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

	STATE	INTERVENTION PROVISION
15.	New Jersey	Local Government Supervision Act; Municipal Rehabilitation and Economic Recovery Act of 2002; Special Municipal Aid Act.
16.	New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board.
17.	North Carolina	Local Government Finance Act.
18.	Ohio	Fiscal Watch; Fiscal Emergency; Fiscal Emergencies and Financial Planning and Supervision Commission.
19.	Oregon	County Public Safety Emergency and Fiscal Control Board; Municipal Debt Advisory Commission.
20.	Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

	STATE	INTERVENTION PROVISION
21.	Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission.
22.	Texas	Municipal Receivership.
23.	Wisconsin	Deficiency Protection for Public Improvement Bonds.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

B. States recognize the use of a Municipal Receiver:

- The Rhode Island Experience and The City of Central Falls:
 - Overseers.
 - Budget Commission.
 - Receiver.
 - Chapter 9.
- Texas' use of judicially appointed Receiver vs. Financial Control Board, emergency financial managers, coordination overseers and Refinance Authorities.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

C. Financial Control Boards and Active Supervision

Examples:

- The New York Experience.
- The Pennsylvania Experience.
- The Michigan Experience.
- The Massachusetts *Ad Hoc* Experience.
- The California Experience – Neutral Evaluator.
- Development of the Municipal Protection Commission.

D. The Structure For Oversight and Emergency Financing:

- Grants from Federal, State and Regional Governmental bodies.
- Loans from Federal, State and Regional Governmental Bodies.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- State Intercepts of Tax Revenue.
- Involvement in Local Government Budget Process.
- Required Financial Performance and Targeted Levels of Essential Governmental Services.
- State Legislative Assistance in Tax Revenue and Powers.
- Backup by Moral Obligations of the State.
- Considerations Regarding the Appointment of Authority Members.
- Acceleration of Loans and Obligations if Performance Triggers are violated.
- Dealing with the Press.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- What Powers are essential for State Oversight and Assistance.
 - Exploration of Transfer of Certain Governmental Services (and related costs) to other Governmental Bodies.
 - Consolidation of Regional Essential Governmental Services.
- E. A State Municipal Refinancing or Restructuring Board (could be pursuant to special legislation) Would Supervise a Distressed Local Government and be able to:
- Require balanced budgets, provide economic discipline and reporting;

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- Issue debt in state name or separate entity to obtain market credibility and access;
- Have power to negotiate debt restructuring and quasi-judicial jurisdiction;
- Review services or costs that can be transferred to other governmental bodies;
- Have right to intercept tax revenue and ensure payment for essential services and necessary operating costs;
- Have power to authorize Chapter 9 if needed;
- Bridge financing or refinancing of troubled debt;
- Transfer certain services to other governmental agencies to reduce expenditures;

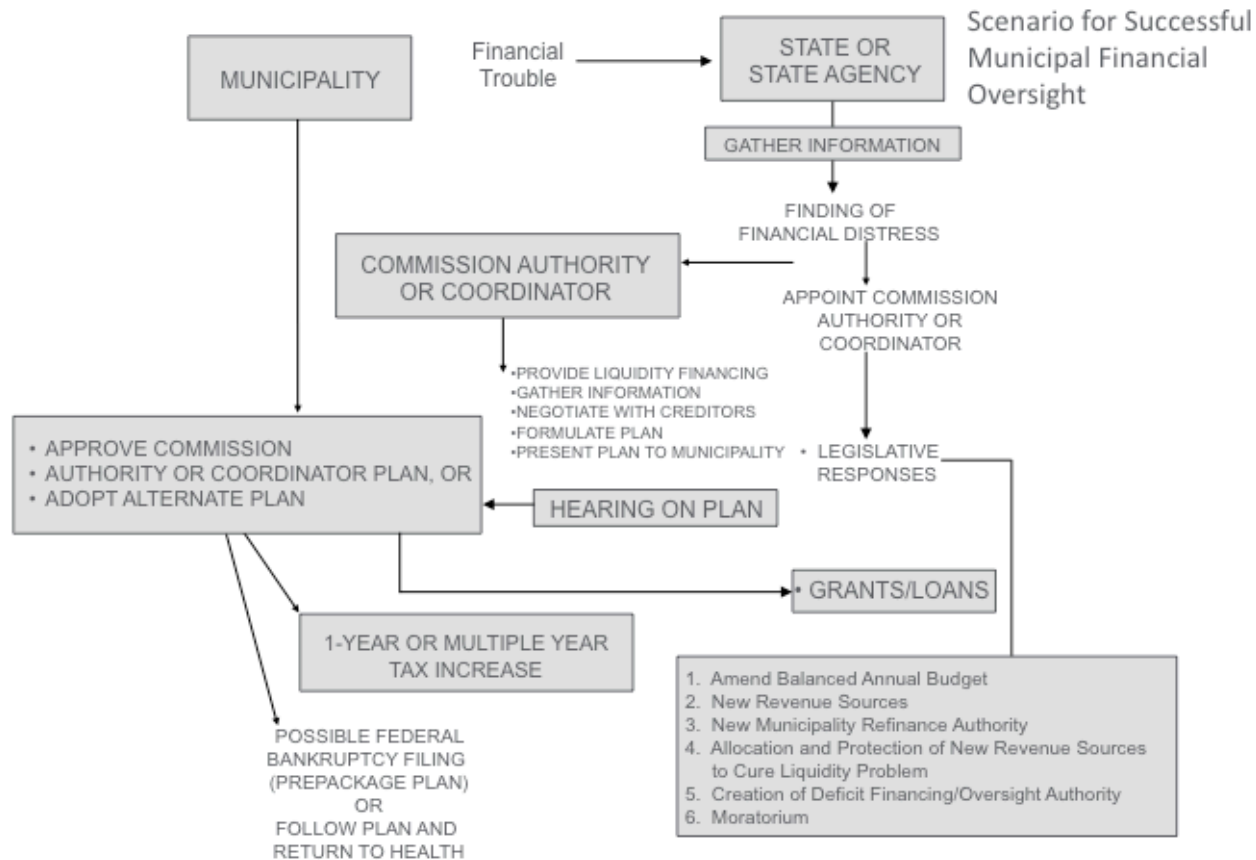
III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- Grant funds to the municipality to bridge the financial crisis;
- Loan funds to the municipality on terms that are realistic or payable from out-of-state tax sources that can be offset;
- Use intercept of state tax payable to municipality to ensure essential municipal service;
- Private Public Partnerships - Lease and Sale of Municipal Properties to provide bridge financing and cash flow relief;
- Vendor Assistance Program – Providing Vendor Payments through securitization financing of payables. Payment from dedicated tax revenues over time. Provide current cash flow relief from current or future Vendor payments;

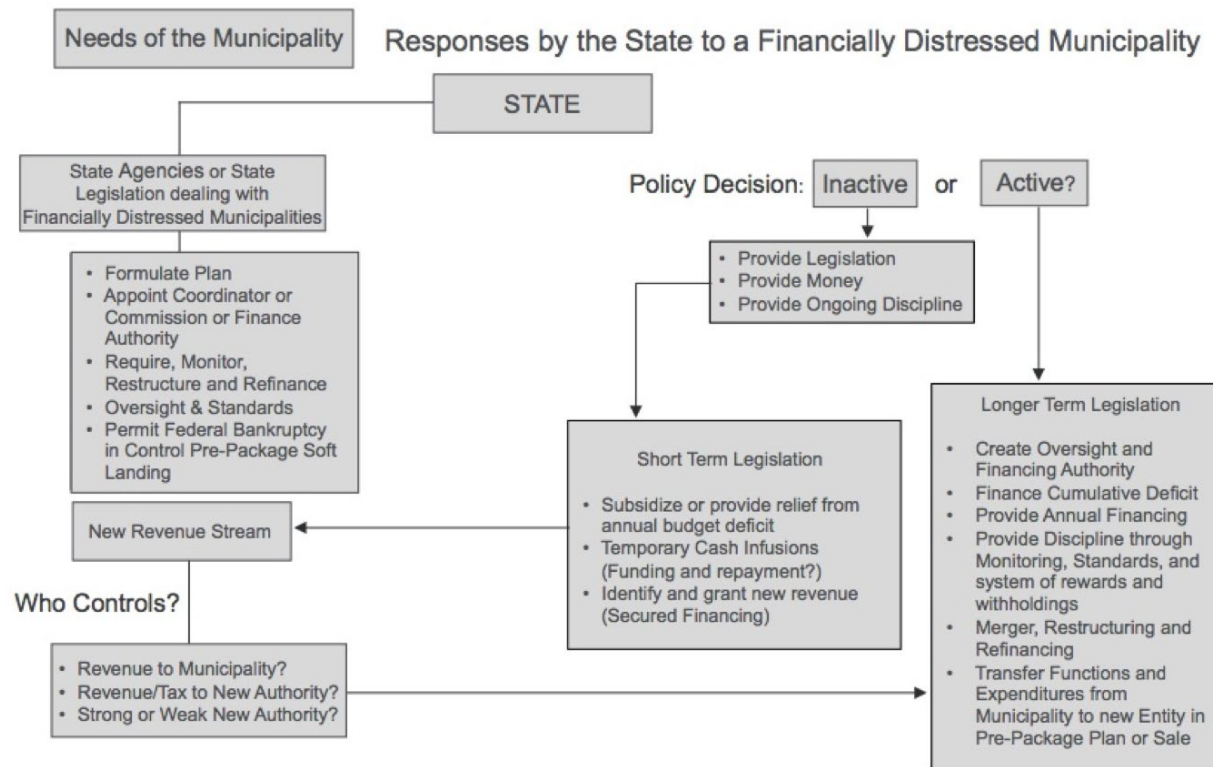
III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments

- Explore Consolidation on a Regional Basis of Certain Governmental Services; and
 - Monitor compliance with any restructuring plan to ensure compliance and prevent financial erosion.
- F. Examples of Structure for Municipal Financial Oversight and State Supervision of Financially Distressed Municipal.

III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments



III. Debt Resolution Mechanisms: State Oversight, Supervision and Assistance for Emergencies of Local Governments



IV. Bondholder Rights and Remedies

- A. The critical differences between Revenue Bonds and General Obligation Bonds, Lease Appropriation Bonds and Conduit Financings:
- Revenue Bonds are generally only payable from the Pledged Revenue, Specific tax source or revenue related to the Municipal enterprise financed and no other recourse to the issuing Municipality.
 - General Obligation Bonds are backed by the full faith and credit of the Municipality and may also have a contractual or statutory pledge of revenue.
 - Upon default Bondholder may institute lawsuits requesting the debt be immediately paid or certain actions be taken by the Municipality or be required to specifically perform under the documents.

IV. Bondholder Rights and Remedies

- Municipal Lease or Appropriation Backed Bonds (Non-recourse to municipality's full faith and credit but recourse to annual appropriation or leased property. Note: cannot legally bind successor legislature to appropriate funds).
- Conduit Financing (Non-recourse to municipality, must be for a general public purpose and the credit support is the non-profit or corporate entity benefitted).
- Upon default on Lease Appropriation Bonds the remedies are limited to those set forth in the documents and applicable law and generally limited to the municipality's loss of use of the leased facility and ability to relet the facility. In Conduit Financing the remedies are generally limited to the not-for-profit or corporate entity benefitted without recourse to the municipality.

IV. Bondholder Rights and Remedies

- B. Upon Default (breach of covenant or failure to make payment of principal or interest), Bondholder may institute a lawsuit for a money judgment, mandamus, specific performance, or equitable relief such as for injunction or an accounting or for foreclosure on collateral (if permitted) or other relief.
- Mandamus – all States would permit a bondholder upon default to petition for mandamus that in essence requires a Municipal official to levy taxes to pay an obligation. The problem is constitutional and statutory debt limits and time, cost and delay.
 - Receiver – 46 States and Puerto Rico permit bondholders to petition a Court to appoint a Receiver upon default especially in the case of a default on the Revenue Bond for financing of a Municipal Enterprise.

IV. Bondholder Rights and Remedies

- Accounting – At least 22 States and the District of Columbia and Puerto Rico allow for Bondholders or Representative to bring an action for an accounting to require the local government to account for how bond funds have been spent.
- Foreclosure – At least 28 States permit some form of foreclosure on mortgaged or secured real property upon default on a financing of that facility or structure generally related to conduit financing.
- Injunction – At least 15 States permit bondholder to obtain some form of injunctive relief upon default to protect and preserve their rights and remedies.
- Other Relief.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

A. The Perceived Strength of General Obligation Debt.

Since the Late 1800's, no state has defaulted on its General Obligation Debt (except Arkansas in 1933 which debt was promptly refinanced).

1. **What is a G.O.?** A government in issuing General Obligation Debt is perceived by the market as “pledging” its full faith and credit (taxing power) to the payment of that Debt. But the devil is in the details and wording of the authorizing legislation or resolution.
2. **Are There Tax Limits?** Most states have constitutional or statutory debt or tax limitations (see 50 State Survey in “Municipalities in Distress?”). Accordingly, some General Obligation Debt is limited by those restrictions.
3. **Are There No Tax Limits?** Some states provide (generally with required voter approval) “unlimited” General Obligation Debt which has been authorized as not having any limitation on the tax pledge.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

4. **Specific Pledges and Statutory Liens.** While General Obligation Debt may have the promise of the government to levy taxes sufficient to pay the obligations (its full faith and credit), there is a distinction between General Obligation Debt that has no specific pledge or dedication of a specific tax source for payment and General Obligation Debt that has a dedication by pledge (security interest) or statutory lien of a specific dedicated source of payment. General Obligation Bonds that have both the “full faith and credit taxing power of the government” and a specific pledge or statutory lien on a specific property or revenue source for payment of the debt are sometimes referred to as “double barrel” bonds.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

5. **The Devil is in the Details and the Disclosure.** Specific attention should be paid to whether there is a general statement that the government pledges its full faith and taxing power to pay the General Obligation Debt or whether there is specific language in the authorizing resolution or legislation that dedicates specific property, revenues or tax source for payment of the debt or a specific state statute that creates and grants, by its express provisions governing the issuance of such debt, a lien on property or revenues for the payment of the debt without any further action by the government. Full and accurate disclosure of this is key to understanding whether a G.O. debt has something more.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

6. **G.O.s That Are Not G.O.s?** If a state reserves to itself the full power to tax and the municipalities have no power to tax and the state must pass specific legislation authorizing that municipality to be able to levy any tax, can such a municipality in such a state be really recognized as capable of issuing General Obligation Debt? If the municipality cannot levy taxes on its own, and has no power to do so, what is the benefit of a promise to levy a tax if the municipality has no power to levy if the state does not so authorize (see Alabama where only the state can authorize the levy of a new tax)?

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

B. State Constitution or Law Mandating Priorities, Set Asides, Appropriations and Statutory Liens for General Obligation Debt.

1. **Priorities.** Some states set forth either in their constitution or law that there is a specific priority for the payment of General Obligation Debt for the state or even a municipality’s general obligation bonds (see California — constitutional priority for the state’s G.O. Debt second only to education funding; Hawaii — first charge on state’s general fund; also Louisiana, Missouri, Tennessee, Texas and Wisconsin).

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

2. **Set Asides.** Some states require a monthly or periodic set aside of revenues to assure payment of General Obligation Debt when it comes due. The Set Aside may be required by state constitution or statute. If there is a failure to follow the mandated Set Aside, the bondholders may choose to enforce the Set Aside of funds by mandamus or other judicial relief. (States with some form of Set Aside are: Illinois — monthly payments of 1/12th of principal coming due in next 12 months and 1/6th of interest coming due in next six months; Vermont from General Funds when debt become due; Minnesota; also Delaware, Georgia, Louisiana, Maine, Michigan, Mississippi, Montana, New York, Pennsylvania, Rhode Island and Virginia — if state fails to timely pay the General Obligation Debt.)

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

3. **Mandated Appropriations.** Some states mandate that the state must appropriate sufficient revenues to pay General Obligation Debt or if the state lacks funds to pay General Obligation Debt when it becomes due the state must then so appropriate sufficient funds. (See **I.** Alaska, Arizona, Arkansas, Connecticut, Delaware, Florida, Georgia, Idaho, Illinois, Maine, Maryland, Minnesota, Mississippi, Missouri, Nevada, North Dakota, Ohio, Oklahoma, Oregon, South Dakota, Tennessee, Utah and Wisconsin — to appropriate sufficient funds to pay debt when due; **II.** Iowa, Kansas and South Dakota — irrepealable tax to pay bond debt; and **III.** New Jersey, South Carolina and Washington — to appropriate if failure to pay general obligations when it comes due.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

4. **Statutory Liens.** Some states provide by statute that the state or local government, upon issuing debt pursuant to a specific state statute, automatically has a lien granted on specified property or tax revenue for the payment of the debt so incurred. As discussed in the Municipal Bankruptcy section, this statutory lien remains unaltered in a chapter 9 proceeding and there is a continuing right to be paid after the filing of a chapter 9. This was recognized in the Orange County Chapter 9 in 1994 and Sierra Kings Health Care District Chapter 9 in 2009 (relating to General Obligation Bonds). (There are 32 states with statutory lien provisions. See the 50 State Survey that follows and “Municipalities in Distress?”)

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

5. **Special Revenue Pledges.** Every state provides for some form of special revenue bonds and, in certain cases, the special revenue pledge can be granted for General Obligation Debt. A special revenue pledge is one that promises to pay the debt from a pledge or dedication of revenues from a specific source or governmental enterprise, special excise taxes, incremental tax receipts for tax incremental financing, revenues derived from a particular governmental function, taxes levied to finance a project or system (except for general sales, property and income taxes levied for general purposes). As noted in the Municipal Bankruptcy section, a Special Revenue Pledge is to be unaltered by a chapter 9 Municipal Bankruptcy and the timely payment of the Pledged Revenues by the municipality is required by the Bankruptcy Code. Both the Sierra Kings Health Care District Chapter 9 (Eastern District of California) and the Jefferson County Chapter 9 (Northern District of Alabama) reaffirmed the unaltered status and timely payment of Special Revenue Pledges in a chapter 9 proceeding.

V. How to Determine If a General Obligation Bond Is Really a “General Obligation” Bond

C. **A 50 State Survey of Priorities, Required Set Asides and Appropriations, Statutory Liens and Special Revenue Pledges for General Obligation Debt.**

1. **The Preliminary Results of a 50 State Survey.** Chapman and Cutler LLP is conducting a 50 State Survey of the Priorities, Required Set Asides and Appropriations for payment of General Obligation Debt, as well as the applicable Statutory Liens and Special Revenue Pledges. This is a preliminary report on the findings and is subject to further review and change as the study is completed. The following is a chart summarizing by state whether there is any provision in that state relating to priorities for payment or mandated set aside of revenues or appropriations of revenues for the payment of General Obligation Debt or whether there is permitted a statutory lien or special revenue pledge.

VI. Municipal Bankruptcy Chapter 9 Issues

A. What is Chapter 9?

- Exclusive chapter of the Bankruptcy Code that provides a method for municipalities to adjust debt:
 - The chapter of the Bankruptcy Code providing for municipal debt adjustment to a level that is affordable (which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts).
 - The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. Although Congress took care to draft the legislation so as not to interfere with the sovereign powers of the states guaranteed by the Tenth Amendment to the Constitution, the Supreme Court held the 1934 Act unconstitutional as an improper interference with the sovereignty of the states. Congress enacted a revised Municipal Bankruptcy Act in 1937. The law has been amended several times since 1937.

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

Summary of Chapter 9 Priorities

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
1. Obligations secured by a statutory lien to the extent of the Pledged Revenue collected. ^{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 Pledged Revenue collected. ^{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 § 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* numbers 3 and 4.

b Chapter 9 incorporates § 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 that is not a Statutory Lien or Special Revenue Pledge may be attached as not being a valid continuing Post-Petition Lien under § 552 of the Bankruptcy Code.

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

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
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 .

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

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
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 statute 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 <i>pro rata</i> 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 § 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collective bargaining agreements (making the standard less restrictive, i.e., “impairs ability to rehabilitate”) or § 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.

VI. Municipal Bankruptcy Chapter 9 Issues

- Not a tool for elimination of municipal debt:
 - Since a municipal unit is intended to continue to provide governmental services in perpetuity and is not intended to liquidate its assets to satisfy creditors but rather continue to function as a municipality, the primary purpose of Chapter 9 is to allow the municipality to continue operating and keep creditors away while it adjusts or refinances creditor claims.
 - Adjustment of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.
 - More appropriate to refer to Chapter 9 as municipal debt adjustment rather than municipal bankruptcy.
- It is voluntary, a municipality cannot be forced into bankruptcy.

VI. Municipal Bankruptcy Chapter 9 Issues

- B. Who is eligible to file Chapter 9 – only those municipalities that are specifically authorized by their State law can file.
- To be a Debtor in a Chapter 9, an entity must be:
 - An entity that is a municipality (political subdivision, public agency or instrumentality of State – States are a co-Sovereign with the Federal Government and cannot file for Chapter 9);
 - Specifically authorized under State law to be a Debtor. Twelve States have Statutory Provisions in which the State specifically authorizes filing (AL, AZ, AR, ID, MN, MO, MT, NE, OK, SC, TX, WA), another twelve States authorize a filing conditioned on a further act of the State, an Elected Official or State entity or neutral evaluator (CA, 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

VI. Municipal Bankruptcy Chapter 9 Issues

21 are either unclear or do not have specific authorization (California, one of the 12 states that conditionally authorized Chapter 9 by municipalities, has new legislation enacted on October 9, 2011, adding the requirement that, before being able to file Chapter 9, a municipality must first either (i) use a neutral evaluator or (ii) declare a fiscal emergency finding there is jeopardy to the health, safety or well being of its residents and it is unable to pay its obligations within the next 60 days);

- Insolvent:

- Proving insolvency can be challenging. As Municipality has to prove it is not paying its debts or is unable to pay its debts when they come due;

VI. Municipal Bankruptcy Chapter 9 Issues

- 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.

VI. Municipal Bankruptcy Chapter 9 Issues

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

12 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
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.

12 States that conditionally authorize municipal bankruptcies:

Cal. Gov't Code § 53760
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

3 States with limited authorization

■ 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)

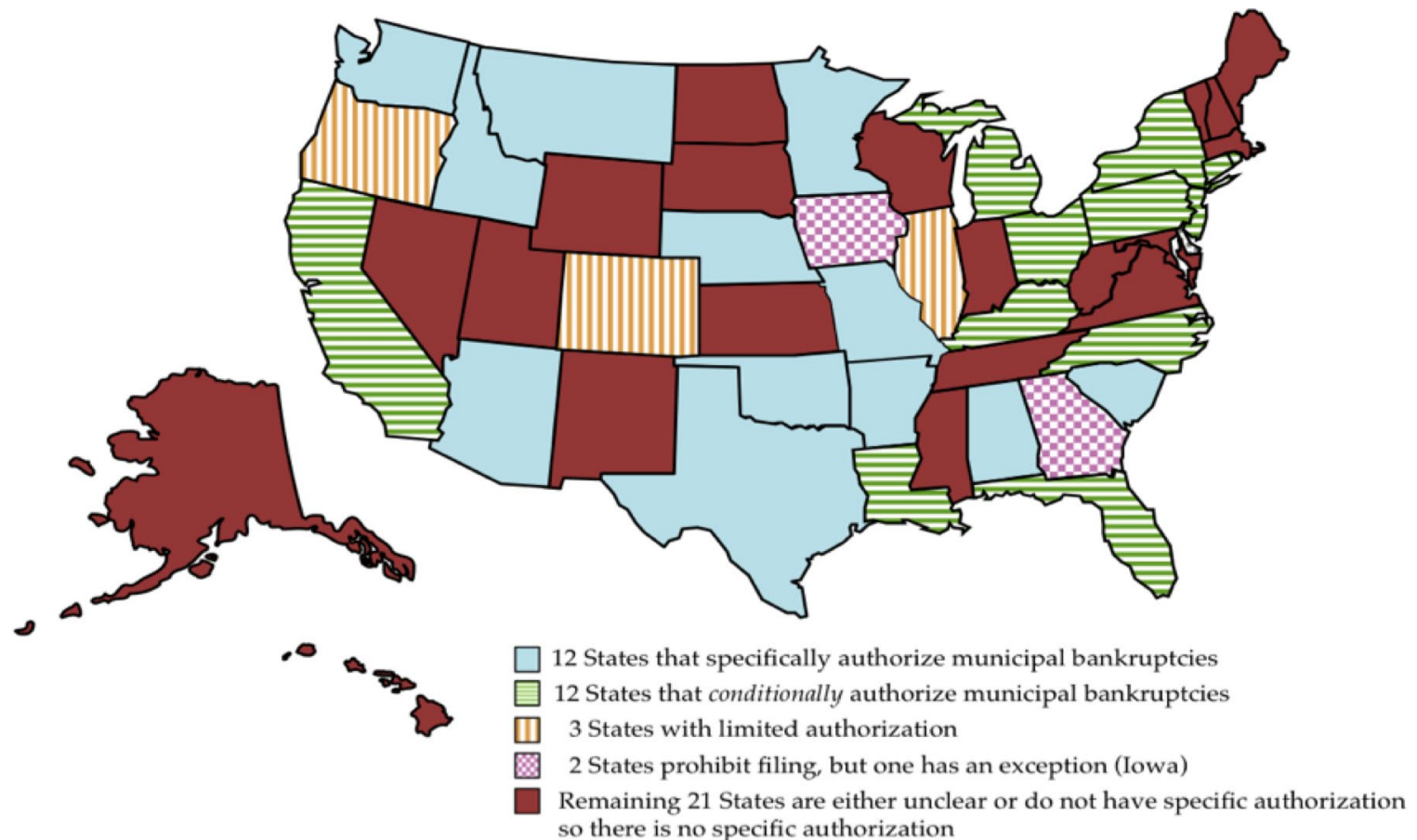
■ Illinois – specific authorization solely for the Illinois Power Agency (20 Ill Comp. Stat. Ann. 3855/1-20(b)(15)). The Local Government Financing and Supervision Act permits that commission to recommend that the Legislature authorize a filing but it is not specific authorization (20 Ill. Comp. Stat. Ann. 320/9(b)(4))

2 States prohibit filing but one has an Exception

■ 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)

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



VI. Municipal Bankruptcy Chapter 9 Issues

C. When Has It Been Used?

- To adjust the level of debt obligations of a municipality so the debt is sustainable and affordable:
 - Historically municipalities generally have used Chapter 9 to restructure or adjust legal judgments or obligations to employees (such as pension and health care benefits) and not as a method to eliminate municipal debt.

VI. Municipal Bankruptcy Chapter 9 Issues

- To restructure burdensome labor contracts:
 - Due to statutory limitations placed upon the power of the court in a municipal debt adjustment proceeding, the court is not intended to be involved in the municipality's government or affairs or municipal operations while the municipal debtor's pre-petition debt obligations are undergoing adjustment. The municipal debtor as a sub-sovereign of the state has powers to use its property, raise taxes, and make expenditures as it sees fit. It is also permitted to adjust burdensome contractual relationships under the power to reject executory contracts and unexpired leases, subject to bankruptcy court approval, and it has the same avoiding powers as other debtors. Municipalities may also reject collective bargaining agreements and retiree benefit plans without going through the usual procedures required in chapter 11 cases.

VI. Municipal Bankruptcy Chapter 9 Issues

- To avoid or restructure legal settlements and judgments.
- Losses on or poor investment strategies.
- To restructure pension and health care related liabilities.
- To restructure contractual obligations.
- To restructure debt on a failed enterprise or proprietary project.
- To restructure tax-exempt debt.

VI. Municipal Bankruptcy Chapter 9 Issues

- To be used as a last resort when all other compromise and restructuring efforts fail to reduce debt obligations of municipalities so that essential governmental services can continue to be provided:
 - A municipality has authority to borrow money during a chapter 9 case as an administrative expense. 11 U.S.C. § § 364, 901(a). This ability is important to the survival of a municipality that has exhausted all other resources. A chapter 9 municipality has the same power to obtain credit as it does outside of bankruptcy. The bankruptcy court does not have supervisory authority over the amount of debt the municipality incurs in its operation. The municipality may employ professionals without court approval, and the professional fees incurred are reviewed only within the context of plan confirmation.

VI. Municipal Bankruptcy Chapter 9 Issues

- B. The use of dedicated revenue or tax sources (Special Revenues or Statutory Liens) to pay the Bonds and other methods to ensure that willingness to pay is not or should not be a factor.
 - 1. In General Obligation Bonds, the use of additional pledge of dedicated revenue such as unlimited *ad valorem* tax pledge to have the taxing authority mandated to levy taxes sufficient to pay principal and interest on the Bonds and pay the collected funds to the Bond Trustee or paying agent. This could be “Special Revenues” or “Statutory Liens” or both. There would be by covenant and bond resolution or statute that specifically provides the dedication of those revenues or taxes to the payment of the Bonds with provisions that ensure the revenues and taxes cannot be used for any other purposes until the Bonds are paid in full. There are 28 states with Statutory Liens for general obligations/*ad valorem* debt. All states provide for some form of Special Revenue that is intended to be unimpaired by the filing of a Chapter 9.

VI. Municipal Bankruptcy Chapter 9 Issues

C. How are Bonds and Notes Treated in Chapter 9?

TYPE OF BONDS/NOTES	BANKRUPTCY EFFECTS
General Obligation Bonds	<p>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.</p> <p>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.</p>
General Obligation Bonds plus Pledged Revenues	<p>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 and unimpaired and paid during a Chapter 9 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.</p>
Special Revenue Bonds	<p>A pledge on special revenue bonds will survive a bankruptcy filing.</p> <p>Pre-petition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of necessary operating costs in the case of a gross revenue pledge) that are pledged to bondholders. Special revenues are intended to be unimpaired and to be paid timely during a Chapter 9. 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.</p>
Revenues subject to Statutory Lien	<p>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.</p>

VII. Chapter 9 – Legal Impact on a Bondholder of Municipal Debt

- Creditors are subject to automatic stay upon filing of Chapter 9 petition.
- Automatic stay prohibits collection efforts by creditors.
- Automatic stay impacts holders of general obligation bonds or unsecured debt greater than in Chapter 11 because municipalities are afforded great freedom in the use of revenues and assets to perform their governmental functions.
- Bonds or obligations secured by special revenues are exempt from automatic stay (for a statutory lien a lift stay motion may have to be filed) but the tax revenue pledge to pay those bonds is not to be used for any other purpose or otherwise impaired.
- Bonds secured by statutory lien and special revenues are intended to have the lien as pledged tax revenue continue after the filing of a Chapter 9 unlike a corporate pre-petition lien on account receivables or inventory that is terminated as to property created after filing a Chapter 9,

VII. Chapter 9 – Legal Impact on a Bondholder of Municipal Debt

- Special Revenue Bonds
- Revenues Subject to Statutory Lien
- A pledge on special revenue bonds will survive a bankruptcy filing.
- Assuming the pledge is authorized and created by state law (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.

VII. Chapter 9 – Legal Impact on a Bondholder of Municipal Debt

- General Obligation Bonds
 - Post-petition, a court may treat general obligation bonds without a pledge of a statutory lien or special revenues as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease.
- 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 lien on the tax revenues will continue to the extent taxes are collected.
 - A contractual pledge of tax revenue provided for by the bond document that is not a statutory lien or special revenue will have any tax revenue collected before filing paid to the bondholders but after filing that lien is terminated.

VIII. Chapter 9 (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)

IN A CHAPTER 9

- Only the municipality can initiate a Chapter 9 if authorized by state law.
- Only the municipality can file a Plan of Debt Adjustment.
- The Plan of Debt Adjustment can only adjust debt. It cannot liquidate the municipality.

IN A CHAPTER 11

- The corporation (voluntary) or its creditors (involuntary) can initiate a Chapter 11 case if the corporation is a moneyed entity (not a non-for-profit) and insolvent.
- The corporate debtor (during the exclusive period) or any creditor (after the exclusive period) may file a Plan of Reorganization or Liquidation.
- A corporate plan can be for reorganization or liquidation.

VIII. Chapter 9 (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)

IN A CHAPTER 9

- A Labor Agreement can be rejected in a Chapter 9 if the Labor Agreement burdens the municipality and the equities balance in favor of rejection. This is a lower standard than a Chapter 11.
- There is no limitation on damages on real estate leases held by a Trustee or Municipal Building Authority for a lease financing and the lease financing will be treated as a secured debt financing.

IN A CHAPTER 11

- Section 1113 of the Bankruptcy Code sets forth the requirements for sharing information with employee representatives and workers and the process of information sharing, and the proposal by the debtor prior to the rejection of the Labor Agreement. It is a higher standard than Chapter 9.
- There is a limitation of the greater of one year's rent or 15% of the remaining terms of the lease not to exceed three years for lease damages in a corporate Chapter 11. It is not treated as secured debt of the corporate debtor if it is a true lease.

VIII. Chapter 9 (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)

IN A CHAPTER 9

- Payments to defease or pay current interest or principal on bonds or notes within the 90 day preference period before a Chapter 9 filing are not capable of being voided or deemed a preference.
- There are no priorities ahead of unsecured claims for prepetition claims due to employee wages, pensions, accrued vacations, healthcare and other employment benefits.

IN A CHAPTER 11

- Payment of principal or interest not secured by collateral could be voided or deemed a preference during the 90 day period prior to filing a Chapter 11 if the holder would receive more than what it would be entitled to in a Chapter 7 liquidation.
- There is a priority ahead of unsecured claims of up to \$11,725 per employee for pre-petition wages, benefits, accrued vacation and healthcare benefits.

VIII. Chapter 9 (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)

IN A CHAPTER 9

- “Special Revenues” and “Statutory Liens” are not limited or terminated by a Chapter 9 filing and are intended to continue to be paid to secured creditor and are unimpaired by the Chapter 9 filing (there is no Chapter 11 provisions comparable).
- A Bankruptcy Court cannot interfere with any restrictions or requirements of state law regarding a municipality’s exercise of its governmental powers (including payment of statutory liens). The Bankruptcy Court cannot interfere with the property, revenue and affairs of the municipality.

IN A CHAPTER 11

- Accounts receivable and inventory created post petition are not covered by the pre-petition lien of a secured lender and the pre-petition lien is terminated except for “proceeds” of the pre-petition lien.
- The corporate debtor cannot take any action outside the ordinary course of business without Bankruptcy Court approval.

VIII. Chapter 9 (Municipal Debt Adjustment) Is Unlike Chapter 11 (Corporate Reorganization)

IN A CHAPTER 9

- The municipality can sell its assets, incur debt, borrow money and engage in governmental affairs without the necessity of having to obtain the approval of the Bankruptcy Court.

IN A CHAPTER 11

- The corporate debtor cannot borrow money, sell assets or expand or contract its business without Bankruptcy Court approval.

IX. Lessons Learned from Recent Distressed Municipalities

A. Lessons Learned from the City of Vallejo Case:

- Rejection of Labor Agreement.
- Adverse Effect on Municipal Services.
- Payment of Special Revenue Debt.
- Settlement of Lease Appropriation Bonds.
- Chapter 9 is Very Expensive.
- Chapter 9 is Complicated and Time Consuming.
- Exit of Business Taxpayers During Bankruptcy.
- No Real Increase in Chapter 9 Filings.
- Created the Motivation for a “Neutral Evaluator.”

B. Lessons Learned from the Central Falls, RI Bankruptcy:

- City’s Attempt to Have a Court Appoint a Receiver was a Shock to the Market.
- Statutory Lien for all Public Debt of Municipalities to Prevent Negative Contagion.
- Expedited Process – Confirmed Plan and Exited Chapter 9 Proceedings in 12 Month – Fastest Chapter 9 for a City, Town and County in Last 10 Years.
- Issues Related to State Pension Funds and Ability to Adjust Municipal Obligations.
- Rhode Island’s First Lien for Bondholders May Create a Trend.

IX. Lessons Learned from Recent Distressed Municipalities

C. Lessons Learned from the City of Harrisburg, PA:

- Financial Problems Should be Addressed Promptly.
- Chapter 9 Filing By Municipalities Need to be Specifically Authorized by the State.
- Finance Only That Which the Municipality Itself Needs.
- In the End if the City Does Not Develop a Feasible Recovery Plan the State Should.
- Raise the Issue of Not Honoring (or Paying) General Obligation Debt and Willingness to Pay.

D. Lessons Learned from Jefferson County, AL:

- Refinancing Cures All Ills.
- A Municipality Needs the Power to Legislate and Levy Needed Taxes.
- Special Revenues are to be Unimpaired by a Chapter 9 Filing.
- Benefits of Statutory Lien and Special Revenue Status.
- Also Raise Issue of General Obligation Debt and Willingness and Ability to Pay.

IX. Lessons Learned from Recent Distressed Municipalities

E. Lessons Learned from Detroit, MI:

- Major Cities in Distress Need Help from the State.
- Financial Problems of Major Cities Only Get Worse if Not Addressed.
- Labor Costs Must be Sustainable and Affordable and Not Interfere with Providing Essential Governmental Services.
- The Need to Transfer Burdensome Costs of Certain Services to Other Governmental Bodies.
- Local “Buy-In” is Necessary for a Successful Recovery Plan.
- There Must be a Permanent Fix Not a Band Aid.

F. Lessons Learned from Stockton, San Bernardino and Atwater, CA:

- The Neutral Evaluator has not resulted so far in out of court resolutions.
- Unfunded pension obligations that are not sustainable and affordable need to be addressed and adjusted.
- Priorities of claim (including unfunded pension obligations) should not threaten future ability to borrow or viability of the municipality.
- Impairing public bond debt will have serious consequences.
- The need for an alternative to Chapter 9 that adjusts unsustainable and unaffordable municipal obligations.

X. Municipalities in Distress?

Chapman and Cutler LLP has just published a book entitled *Municipalities in Distress?*, which is an analysis of State Laws Dealing with Financial Emergencies of Local Governments (50-State Survey of State Law providing (1) Oversight, Supervision or Assistance to Financially Distressed Municipalities, (2) Rights and Remedies Provided by States to Investors in Financially Distressed Local Government Debt and (3) State Authorization of Municipalities to File Chapter 9 Bankruptcy).

This Survey result may be briefly summarized by the following chart:

X. Municipalities in Distress?

Analysis of 50 State Survey of Rights and Remedies Provided by States to Investors in Municipal Bond Debt and Authorization to File Chapter 9 Bankruptcy													
(This is an analysis of a 50 State Survey by Chapman and Cutler LLP)													
General Overview of Municipal Insolvency Provisions													
STATE	MUNICIPAL BANKRUPTCY AUTHORIZATIO N	DEBT LIMITATIO N	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDIN G BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTIN G	FORECLOSUR E	INJUNCTIO N	MANDAMU S	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTOR Y LIENS
ALABAMA	Y	X		X	X			X	X	X		X	
ALASKA	N				X	X (taxing limits); (appointment of trustee)		X		X		X	X
ARIZONA	Y	X	X (School District Receivership)	X	X			X		X	X (any action necessary)	X	
ARKANSAS	Y	X		X	X	X (taxing limits and appointment of an assessor)				X		X	X
CALIFORNIA	Conditional (Use of a Neutral Evaluator or declaration of fiscal emergency)	X	X (California Debt and Investment Advisory Commission)	X	X	X (negotiations)	X	X	X	X	X (bondholder action and any other action and special tax bonds)	X	X
COLORADO	Limited	X		X	X		X		X	X	X (bondholder action)	X	X
CONNECTICUT	Conditional	X		X	X	X (appointment of a trustee; revenue set-aside)			X	X	X (bondholder action/garnishment and contractual remedies)	X	X
DELAWARE	N	X			X					X		X	
DISTRICT OF COLUMBIA	N	X	X (District of Columbia Financial Responsibility and Management Assistance Authority)		X		X		X	X	X (declare all bonds due and payable)	X	
FLORIDA	Conditional		X (Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program)	X	X		X		X	X		X	X
GEORGIA	N (specifically prohibited)	X		X	X	X (debt compromise)				X	X (court action to enforce collection)	X	
HAWAII	N	X		X	X		X	X		X		X	
IDAHO	Y	X	X (debt readjustment plans for certain districts)	X	X	X (Bond Guaranty Act)	X	X		X		X	X
ILLINOIS	Limited	X	X (Financially Distressed City Law and Financial Planning and Supervision)	X	X			X	X	X	X (appropriate relief)	X	X
INDIANA	N	X	X (Distressed Political Subdivision and Township Protections)	X	X	X (redemption bonds)	X	X	X	X		X	X
IOWA	N, with exception	X		X	X	X (moratorium)				X		X	X
KANSAS	N	X		X	X		X	X		X		X	X
KENTUCKY	Conditional	X	X (county restructuring)	X	X	X (taxing limits); (appointment of trustee)	X		X	X		X	X
LOUISIANA	Conditional	X		X	X			X		X		X	X
MAINE	N	X	X (Board of Emergency Municipal Finance)	X	X	X (earmarking)		X		X	X (attachment and any action necessary)	X	X
MARYLAND	N	X		X	X					X		X	X
MASSACHUSETTS	N	X	X (ad hoc state intervention)	X	X	X (state bond payment intervention)				X		X	X
MICHIGAN	Conditional	X	X (Emergency Financial Management and Local Government and School District Fiscal Accountability Act)	X	X					X		X	X
MINNESOTA	Y	X	X (Back-Up Payment Procedures for Municipalities and School Districts)		X	X (back-up payment procedures for municipalities and school districts)				X	X (appropriate remedies to enforce bondholder rights)	X	
MISSISSIPPI	N	X		X	X	X (municipal borrowing)	X	X	X	X	X (other appropriate remedies)	X	X
MISSOURI	Y	X		X	X		X	X		X	X (other appropriate remedies)	X	
MONTANA	Y, but no counties	X		X	X					X	X (limited remedy and interest penalty; suits in equity)	X	
NEBRASKA	Y	X		X	X	X (debt compromise)		X		X		X	
NEVADA	N	X	X (Local government Financial Assitance and Audit Enforcement Act)	X	X	X (third-party agreements)	X	X	X	X		X	X

X. Municipalities in Distress?

STATE	MUNICIPAL BANKRUPTCY AUTHORIZATION	DEBT LIMITATION	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDING BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTING	FORECLOSURE	INJUNCTION	MANDAMUS	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTORY LIENS
NEW HAMPSHIRE	N	X	X (Emergency Financial Assistance)	X	X	X (emergency financial assistance)				X	X (contractual remedies)	X	
NEW JERSEY	Conditional	X	X (Local Government Supervision Act; Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act)	X	X		X	X		X		X	X
NEW MEXICO	N	X		X	X					X		X	
NEW YORK	Conditional	X	X (Emergency Financial Control Board, Municipal Assistance Corporation; New York Financial Control Board)	X	X	X (appointment of a trustee)	X	X		X		X	X
NORTH CAROLINA	Conditional	X	X (local government debt monitoring; local government fiscal management)	X	X			X		X		X	X
NORTH DAKOTA	N	X		X	X					X		X	X
OHIO	Conditional	X	X (fiscal watch; fiscal emergencies; and financial planning and supervision commission)	X	X		X	X	X	X	X (general remedies provision, including appointment of trustee and action to declare bonds not paid from property taxes immediately payable)	X	
OKLAHOMA	Y	X		X	X	X (settlement of debt)	X			X		X	
OREGON	Limited	X	X (County Public Safety Emergency and Fiscal Control Board and Municipal Debt Advisory Commission)	X	X	X (Municipal Debt Advisory Commission & refunding bond cram-down)		X		X		X	
PENNSYLVANIA	Conditional	X	X (Financially Distressed Municipalities Act; Intergovernmental Cooperation Act)	X	X	X (appointment of a trustee)	X			X		X	
PUERTO RICO	N	X		X	X	X (first lien provisions)	X			X		X	
RHODE ISLAND	Conditional	X	X (fiscal overseer; municipal receiver; budget commission)	X	X	X (bond issuance requirements; bond payment guarantee)	X	X		X		X	
SOUTH CAROLINA	Y	X		X	X		X	X		X	X (any appropriate action)	X	X
SOUTH DAKOTA	N	X		X	X					X		X	X
TENNESSEE	N			X	X		X			X		X	X
TEXAS	Y	X	X (municipal receivership)	X	X			X		X		X	X
UTAH	N	X		X	X					X	X (contractual remedies)	X	
VERMONT	N	X		X	X			X		X		X	X
VIRGINIA	N	X		X	X					X	X (any contractual remedy)	X	X
WASHINGTON	Y	X		X	X	X (designation of trustee)		X	X	X		X	
WEST VIRGINIA	N	X		X	X		X	X	X	X		X	X
WISCONSIN	N	X	X (Deficiency Protection for Public Improvement Bonds)		X	X (deficiency protection)		X		X		X	
WYOMING	N	X		X	X		X	X	X	X		X	
TOTAL *		49		23	47	52	24	23	28	15	52	17	30

*These numbers include both the District of Columbia and Puerto Rico and totals may differ from other materials that only review the 50

XI. 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 states have some form of debt limitation).
- Appointment of receivers (at least 46 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, 21 states provide for a statutory right to such an accounting and at least 22 states have other remedies.)
- Statutory liens or special revenues. (All 50 states have some form of special revenue and at least 32 states have statutory liens.)

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

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 23 - Financial control boards, refinance authorities and active outside supervision and review or other default resolution remedies.

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

XII. Conclusion

- While Political Risk so far for the Municipal Bond Market has not been a real concern, hard times make hard cases. The best protection against being subject to the unwillingness to pay or Political Risk is to follow the best practice of oversight and assistance by various States and reduce or eliminate the opportunity for there to be any question as to whether a payment is to be made or the need for a Chapter 9 proceeding for municipal debt adjustment to be filed. The state and local governments can provide additional assurance by:
 - (A) not authorizing the use of Chapter 9 bankruptcy,
 - (B) hard wiring payment of the Bonds with Statutory Liens or Special Revenues that are dedicated to be used only to pay that Bond or Note,
 - (C) providing in covenants and statutes that the collection of taxes must be paid to first to Bonds and Notes and sufficient taxes are required to be levied to pay such Bonds and Notes timely,
 - (D) provide by statute or constitution provisions a requirement of a balanced budget with teeth for increase taxes or expense cuts if there are successive deficit budgets,

XII. Conclusion

- (E) provide by state statute a first lien on all *ad valorem* taxes and revenues to ensure payment of municipal bonds and notes as Rhode Island has recently enacted,
- (F) provide effective remedies and prompt judicial action to ensure payment of Bonds or Notes,
- (G) provide state supervision and oversight and adult supervision as well as early detection triggers for financial distressed municipalities,
- (H) provide the ability of the state to transfer or combine costly and currently unaffordable services from a distressed municipality to other government entities, and
- (I) provide initial and secondary market disclosure of the ongoing financial status of the municipality and any financial distress as well as whether (A)-(H) above have been provided as protection.

XII. Conclusion

- The Survey of 50 States reveals various approaches being taken to provide protection to Bondholders and provides some degree of tax or debt limitations, oversight, supervision, especially for distressed municipalities and protection for investors in debt issues by financially challenged local government. There are only 12 States that generally authorizes the filing of Chapter 9 without further action or approval of the state or a state official, and such filings are so few, only 638 since 1937 and, for the most part, small special tax districts and few municipalities of any size.

XII. Conclusion

- One of the key ingredients to the success of state and local governments is their ability:
 - (A) to decide locally what infrastructure, improvements, roads, sewers, bridges, schools, public works and parks should be provided for their constituents,
 - (B) to make that decision on a local basis and
 - (C) to implement that decision because they have access to the capital markets at a low cost.
- This access to the capital markets is a unique attribute of local government in the United States and is one that is admired and desired by sovereigns and subsovereigns throughout the world and has made all the difference.
- Historically, financial distress for state and local government has occurred but rarely has it led to the failure to pay for debt that funded essential governmental services.
- There are current situations that may test the long-term viability of the historical premise. Namely it is hoped that Harrisburg, Jefferson County and Stockton are rare aberrations rather than indicative of a growing trend.
- Time and market discipline will determine whether willingness to pay will be a non-issue as it has in the past.

Selected Examples of the 50 State Survey

California	
Municipal Bankruptcy Authority	<p>Any county, city, district, public authority, public agency or other entity, without limitation, that is a “municipality” as defined under the Bankruptcy Code or that qualifies as a debtor under any other federal bankruptcy law applicable to local public entities may file a petition under Chapter 9 of the Bankruptcy Code. Unless an entity is specifically identified above, it is not authorized to file a municipal bankruptcy petition.ⁱ</p> <p>The California governor, however, recently signed into law a provision restricting the ability of California municipalities to file a chapter 9 petition. Under the provision, a municipality, as identified in the previous paragraph, may file a petition only if it meets one of two conditions.</p> <p>The first option is that the municipality participate in a “neutral evaluation process,” otherwise known as mandatory mediation, with interested parties. If the process does not resolve all pending disputes with creditors, the municipality may file a chapter 9 petition. A neutral evaluation process may not last more than 60 days from the date a neutral evaluator is chosen, unless the municipality or a majority of participating interested parties elect to extend the process for up to an additional 30 days. The neutral evaluation process shall not last for more than 90 days following the date the evaluator is selected unless the local public entity and majority of interested parties agree to an extension. Further, the local public entity will be required to pay 50 percent of the costs of the neutral evaluation, and the creditors will be required to pay the balance, unless otherwise agreed to by the parties.</p> <p>The second option is for the municipality to declare a “fiscal emergency” and adopt a resolution at a noticed public hearing that includes findings that the financial state of the local government jeopardizes the health, safety, or well-being of its residents absent bankruptcy protections before filing a petition. The resolution must declare that the municipality is or will be unable to pay its obligations within the next 60 days.ⁱⁱ</p> <p>Between 1980 and December 31, 2011, 39 entities in California have filed petitions under the municipal bankruptcy provisions of the Bankruptcy Code.</p>
Debt Default Prevention	<p>California Debt and Investment Advisory Commission</p> <p>The California Debt and Investment Advisory Commission provides technical assistance on debt issuance and public fund investments to local public agencies and professionals in the public finance field. The commission serves as a clearinghouse for public debt issuance information and to assist state and local agencies with monitoring, issuing and managing debt.</p>

Selected Examples of the 50 State Survey

California (cont'd)	
Debt Default Prevention <i>continued</i>	<p>Further, all public debt issuers in California are required to submit information to the commission 30 days before the proposed sale date of the debt. No later than 45 days from the actual date of sale, issuers must submit a report on the final sale to the commission, which includes, but is not limited to, the issuer's name, type of sale, principal amount, type of debt instrument, sources of repayment, purpose of the financing, the issuance's rating and the members of the finance team.ⁱⁱⁱ</p> <p>Debt Limitation</p> <p>No county, city, town, township, board of education or school district may incur debt exceeding in any year the income and revenue of that year, without a two-thirds vote. Debt may be incurred for public school purposes by majority vote.</p> <p>The California Code contains further limitations. For instance, for a school district or community college district the total amount of bonds issued for certain purposes as defined in the statute may not exceed 1.25 percent of the taxable property in the school district or community college district, or school facilities improvement district. For a county, the total amount of bonded indebtedness may not at any time exceed 5 percent of the taxable property in the county. If a water conservation, flood control, irrigation, reclamation or drainage works, improvements, or the construction of select county roads is included in a proposition, the total indebtedness may exceed 5 percent but cannot exceed 15 percent of the taxable property of the county.^{iv}</p> <p>Negotiations</p> <p>At least one provision of the California Code provides that if a district is in debt, it has no power to impair or destroy any of its indebtedness without bondholder consent. The district may make arrangements with creditors to surrender the indebtedness at less than par and may levy an assessment for bondholder payment.^v</p> <p>Refunding Bonds</p> <p>The governing body of certain municipal entities may issue refunding bonds to refund outstanding notes.^{vi}</p>

Selected Examples of the 50 State Survey

California (cont'd)	
Debt Default Prevention <i>continued</i>	School District Budget Requirements Certain California school districts are required to submit a budget to the county superintendent, which may disapprove the budget in certain situations. Should a disapproval occur, the county superintendent may call for the formation of a budget review committee. The budget review committee will then work with the school district to create an approvable budget. After the appointment of a budget review committee, if the school district still fails to create an allowable budget, the county superintendent may take over certain functions of the school district. ^{vii}
Mechanisms for Resolution after Default ^{viii}	Receivership In certain situations, California law allows for the appointment of a receiver with respect to revenue bonds where a default has occurred. ^{ix}
Remedies on Default	Accounting In certain default situations, bondholders may bring a proceeding in any court of competent jurisdiction to require the authority in question to account as if it were a trustee of an express trust. ^x Bondholder Action In certain situations, bondholders may bring any appropriate suit on default. ^{xi} Foreclosure In certain situations generally involving special revenue bonds, bondholders may foreclose on a project when a default has occurred. ^{xii} Injunctive Relief In certain situations, California law authorizes bondholders to bring any action or suit in equity to enjoin any act that may be unlawful or that may violate the rights of bondholders. ^{xiii} Mandamus In certain situations, bondholders or their trustee may bring a court action to compel the local governing body to perform a ministerial action that it has refused to undertake, such as refusing to collect taxes or fees where the underlying bond authorization requires such a collection. ^{xiv} Any Other Remedies Certain provisions of California law allow for a bond resolution to set forth the rights and remedies of holders of the bonds. ^{xv}

Selected Examples of the 50 State Survey

California (cont'd)	
Other Bondholder Protections	<p>Special Revenue Bonds</p> <p>As provided by § 922(d) of the Bankruptcy Code, payments to bondholders holding special revenue bonds would not be stayed on the filing of a municipal bankruptcy petition and payments to holders could continue. Whether an issuance would qualify as a special revenue bond depends on the provisions of the authorizing statute with respect to the bonds at issue.^{xvi}</p> <p>Special Tax Bonds</p> <p>In certain situations, on approval of two-thirds of eligible voters voting, in the case of community facilities districts, the district may incur bonded indebtedness and establish or change appropriations limits. The proceeds of the bonds issued are pledged and committed to pay or repay the principal and interest on the bonds.^{xvii}</p> <p>Statutory Liens</p> <p>Were a municipal entity to file a petition under Chapter 9 of the Bankruptcy Code, bondholders holding bonds to which statutory liens have attached would continue to receive payment on those bonds. For a statutory lien to apply, the authorizing law of the bond issue must contain such a lien.^{xviii}</p>
California Notes	

- i CAL. GOV'T CODE § 53760. California courts have determined that the term "municipality" should not be narrowly construed, although an entity under government control is not necessarily a municipality. *In re County of Orange*, 183 B.R. 595 (Bankr. C.D. Cal. 1995) (finding Orange County Investment Pool not a municipality eligible to file a Chapter 9 proceeding). The court described a "public subdivision" as "any county or parish or any city, town, village, borough, township, or other municipality," the common thread of which is "their ability to exercise various sovereign powers such as the power to tax, the power of eminent domain or the police power." *Id.* at 602. Public agencies are "incorporated authorities, commissions, or similar public agencies organized for the purpose of constructing, maintaining and operating revenue producing enterprises." *Id.* The Bankruptcy Code defines "municipality" as any political subdivision or political agency or instrumentality of a state.
- ii CAL. GOV'T CODE §§ 53760; 53760.1; 53760.3; 53760.5; and 53760.7 (as amended and added by CAL. A.B. 506 (signed into law on October 9, 2011)).

Selected Examples of the 50 State Survey

California Notes (cont'd)

- iii CAL. GOV'T CODE § § 8855-8859 (establishing California Debt and Investment Advisory Commission); CAL. GOV'T CODE § 6586.7 (requiring reporting to the commission by issuers under the Marks-Roos Local Bond Pooling Act of 1985); CAL. GOV'T CODE § 53359.5 (reporting requirements).
- iv CAL. CONST. art. XVI, § 18; CAL. EDUC. CODE § 15102 (school district); and CAL. GOV'T CODE § 29909 (counties).
- v See CAL. WAT. CODE § 50901 (reclamation districts).
- vi See, e.g., CAL. GOV'T CODE § § 43720-43747. This provision applies to any city, except a city and a county, if the city has outstanding bonded indebtedness or a judgment against it, or if any department, board or special fund of the city has any outstanding bonds and the bonds were created for a purpose for which the city could have authorized and issued the bonds. The interest on the bonds cannot exceed 8 percent per year. Until the legislative body has sufficient amounts set aside to pay all principal and interest on the bonds as they become due, the legislative body must levy and collect a tax sufficient to make such payments. Another provision allows for local agencies, including any city, county, city and county, or municipal or public corporation or district authorized to acquire, construct, own or operate an enterprise to issue refunding bonds. CAL. GOV'T CODE § § 54660-54662 (Refunding Bonds for Revenue Bond Law of 1941). See also CAL. HARB. AND NAV. CODE § 3917 (Harbor Development Bond Law of 1958).
- vii CAL. EDUC. CODE § § 42122-42129 (Budget Requirements). The county superintendent may: (1) develop and adopt, in consultation with the school district's superintendent and governing board, a fiscal plan allowing the district to meet its financial obligations; (2) cancel purchase orders, prohibit the issuance of nonsalary warrants, and otherwise stay or rescind any action that is inconsistent with the budget adopted; (3) monitor and review the operation of the school district; (4) determine the need for additional staff; (5) require the school district to encumber all contracts and other obligations; (6) determine any financial problem areas; and (7) withhold compensation of the members of the governing board and the district superintendent for failure to provide requested financial information. CAL. EDUC. CODE § 42127.3.
- viii In January, 2011, the Town of Chowchilla, California, defaulted on its January bond payment with respect to bonds issued to renovate its city hall. Chowchilla had in summer 2010, drawn down on its reserves to make an earlier bond payment.
- ix See, e.g., CAL. GOV'T CODE § 15842 (state building construction revenue bonds); CAL. GOV'T CODE § 91537 (industrial development authorities); CAL. WAT. CODE § 36361 (California water districts); and CAL. WAT. CODE § 36364 (California water districts action to secure payment of revenue bonds). The state code may be more expansive, and the statutory authority for each individual bond issuance should be reviewed before assessing whether a receiver may be appointed.

Selected Examples of the 50 State Survey

California Notes (cont'd)

- x See, e.g., CAL. GOV'T CODE § 15842 (state building construction revenue bonds); CAL. GOV'T CODE § 54643 (Revenue Bond Law of 1941); and CAL. GOV'T CODE § 67620 (San Francisco Bay Area Transportation Terminal Authority). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether an accounting may be pursued.
- xi See, e.g., CAL. GOV'T CODE § 91537 (industrial development authorities); CAL. GOV'T CODE § 66540.48 (San Francisco Bay Area Water Emergency Transportation Response and Disaster Recovery Act); CAL. EDUC. CODE § 81960 (Community College Revenue Bond Act of 1961); CAL. EDUC. CODE § 90072 (The State University Revenue Bond Act of 1947); CAL. EDUC. CODE § 92491 (The State University Revenue Bond Act of 1947); CAL. GOV'T CODE § 6569 (joint exercise of powers: power to issue revenue bonds); CAL. GOV'T CODE § 15843 (state building construction revenue bonds); CAL. GOV'T CODE § 26370 (revenue bonds for county improvements); CAL. GOV'T CODE § 26470 (revenue bonds for county incinerators); CAL. GOV'T CODE § 50770 (revenue bonds for public improvements); CAL. GOV'T CODE § 54702.8 (cities, counties and other agencies: employee rental housing); CAL. GOV'T CODE § 64118 (California Transportation Financing Authority); CAL. PUB. RES. CODE § 26034 (California Alternative Energy and Advanced Transportation Financing Authority); CAL. PUB. RES. CODE § 32205 (California Urban Waterfront Restoration Financing Authority Act); CAL. PUB. UTIL. CODE § 13106 (Municipal Utility District Act electric system improvements); CAL. PUB. UTIL. CODE § 30981 (Southern California Rapid Transit District); CAL. PUB. UTIL. CODE § 100492 (Santa Clara Valley Transportation Authority); CAL. PUB. UTIL. CODE § 102602 (Sacramento Transit District); CAL. PUB. UTIL. CODE § 103602 (San Mateo County Transit District); CAL. PUB. UTIL. CODE § 105262 (Sonoma-Marín Area RAIL Transit District); CAL. PUB. UTIL. CODE § 120702 (transit development boards); CAL. PUB. UTIL. CODE § 125716 (North County Transit District); CAL. PUB. UTIL. CODE § 132370.10 (transportation consolidation for San Diego); CAL. PUB. UTIL. CODE § 170082 (San Diego County Regional Airport Authority); CAL. STS. & HIGH. CODE § 31171 (El Dorado County Toll Tunnel Authority Act); CAL. STS. & HIGH. CODE § 35417 (Parking District Law of 1951); and CAL. UNCOD. WATER DEER, Act 400 § 33 (Kings River Conservation District Act). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether a bondholder action may be brought.
- xii See, e.g., CAL. GOV'T CODE § 91537 (industrial development authorities). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether bondholders may foreclose on a project.
- xiii See, e.g., CAL. GOV'T CODE § 15842 (state building construction revenue bonds); CAL. GOV'T CODE § 91537 (industrial development authorities); CAL. GOV'T CODE § 6569 (joint exercise of powers: power to issue revenue bonds); CAL. GOV'T CODE § 54644 (Revenue Bond Law of 1941); and CAL. GOV'T CODE § 67620 (San Francisco Bay Area Transportation Terminal Authority). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether injunctive relief may be pursued.

Selected Examples of the 50 State Survey

California Notes (cont'd)

- xiv See, e.g., CAL. GOV'T CODE § 15841 (state building construction revenue bonds, allowing bondholders to appoint a trustee to enforce rights of bondholders, including requiring board to collect moneys adequate to carry out the agreement); CAL. GOV'T CODE § 91537 (industrial development authorities); CAL. GOV'T CODE § 66540.48 (San Francisco Bay Area Water Emergency Transportation Response and Disaster Recovery Act); CAL. PUB. UTIL. CODE § 10.1 (West Bay Rapid Transit Authority Act); CAL. EDUC. CODE § 17186 (California School Finance Authority); CAL. EDUC. CODE § 81960 (Community College Revenue Bond Act of 1961); CAL. EDUC. CODE § 90072 (The State University Revenue Bond Act of 1947); CAL. EDUC. CODE § 92491 (The State University Revenue Bond Act of 1947); CAL. EDUC. CODE § 94148 (California Educational Facilities Authority Act); CAL. GOV'T CODE § 6569 (joint exercise of powers: power to issue revenue bonds); CAL. GOV'T CODE § 15444 (Health Facilities Financing Authority Act); CAL. GOV'T CODE § 26370 (revenue bonds for county improvements); CAL. GOV'T CODE § 26470 (Revenue Bonds for County Incinerators); CAL. GOV'T CODE § 50770 (revenue bonds for public improvements); CAL. GOV'T CODE § 54642 (Revenue Bond Law of 1941); CAL. GOV'T CODE § 54702.8 (cities, counties and other agencies: employee rental housing); CAL. GOV'T CODE § 64118 (California Transportation Financing Authority); CAL. GOV'T CODE § 66540.48 (San Francisco Bay Area Water Emergency Transportation Response and Disaster Recovery Act); CAL. GOV'T CODE § 67620 (San Francisco Bay Area Transportation Terminal Authority); CAL. GOV'T CODE § 92308 (California Passenger RAIL Financing Commission Act); CAL. HARB. & NAV. CODE APPX. § 66 (San Diego Unified Port District and Humboldt Bay Harbor, Recreation and Conservation District); CAL. PUB. RES. CODE § 26034 (California Alternative Energy and Advanced Transportation Financing Authority); CAL. PUB. RES. CODE § 32205 (California Urban Waterfront Restoration Financing Authority Act); CAL. PUB. UTIL. CODE § 13106 (Municipal Utility District Act electric system improvements); CAL. PUB. UTIL. CODE § 30981 (Southern California Rapid Transit District); CAL. PUB. UTIL. CODE § 100492 (Santa Clara Valley Transportation Authority); CAL. PUB. UTIL. CODE § 102602 (Sacramento Transit District); CAL. PUB. UTIL. CODE § 103602 (San Mateo County Transit District); CAL. PUB. UTIL. CODE § 105262 (Sonoma-Marín Area Rail Transit District); CAL. PUB. UTIL. CODE § 120702 (transit development boards); CAL. PUB. UTIL. CODE § 125716 (North County Transit District); CAL. PUB. UTIL. CODE § 132370.10 (transportation consolidation for San Diego); CAL. PUB. UTIL. CODE § 170082 (San Diego County Regional Airport Authority); CAL. STS. & HIGH. CODE § 31171 (El Dorado County Toll Tunnel Authority Act); CAL. STS. & HIGH. CODE § 35417 (Parking District Law of 1951); CAL. WAT. CODE § 11708 (conservation, development and utilization of state water resources); CAL. WAT. CODE § 36360 (California water districts, bondholders holding at least 25 percent in outstanding unpaid bonds may bring an action to compel the district to fix and collect sufficient charges to pay the principal and interest on the bonds); and CAL. UNCOD. WATER DEER, Act 400 § 33 (Kings River Conservation District Act). It is possible that an aggrieved bondholder could pursue a writ of mandamus even absent authorizing statutory law.

Selected Examples of the 50 State Survey

California Notes (cont'd)

- xv See, e.g., CAL. EDUC. CODE § 90032 (State University Revenue Bond Act) and CAL. EDUC. CODE § 17184 (California School Finance Authority). The state code may be more expansive than the examples cited here, and the statutory authority for each individual bond issuance should be reviewed before assessing whether other remedies may be available to bondholders.
- xvi See, e.g., CAL. GOV'T CODE §§ 6540-6579.5 (joint exercise of powers: power to issue revenue bonds); CAL. GOV'T CODE §§ 54300-54700 (Revenue Bond Law of 1941). These are examples of revenue bonds. The California state code is more expansive and an attorney should be consulted to examine any specific situation involving a default.
- xvii CAL. GOV'T CODE §§ 53345-53365.7.
- xviii For example, see *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Cal. September 13, 2010) (confirming the postpetition effectiveness of a municipality's pledge of *ad valorem* taxes which qualifies as both a special revenue pledge and a statutory lien). The bond issuance in *Sierra Kings* was subject to a statutory lien pursuant to CAL. HEALTH & SAFETY CODE § 32300. Also, in 1983 the San Jose School District payment of bonds to bondholders was unaffected by a Chapter 9 filing on July 1, 1983 due to CAL. EDUC. CODE § 15250, which provided a tax pledge to bondholders collected by the county or tax collector to pay bondholders first.

Selected Examples of the 50 State Survey

Illinois	
Municipal Bankruptcy Authority	<p>Specific state authority to file a municipal bankruptcy petition only exists with respect to the Illinois Power Agency. With the exception of the Illinois Power Agency, no other municipal entity in Illinois is authorized to file a municipal bankruptcy petition without further legislative authorization.</p> <p>Courts in Illinois have entertained municipal bankruptcy petitions, including <i>In re Village of Brooklyn</i>, Case No. 03-34272 (Bankr. S.D. Ill. Nov. 23, 2004) (confirmation of plan); <i>In re Village of Alorton</i>, Case No. 05-30055 (Bankr. S.D. Ill. Dec. 11, 2006) (confirmation of plan); <i>but see In re Slocum Lake Drainage Dist. of Lake County</i>, 336 B.R. 387 (Bankr. N.D. Ill. 2006) (finding no specific authority and dismissing); <i>In re Washington Park</i>, Case No. 09-31744 (dismissed Dec. 21, 2010, due to lack of authorization). The cases in which plans were confirmed likely were not dismissed because the municipal filings were not challenged.ⁱ</p>
Debt Default Prevention	<p>Debt Limitation</p> <p>Various debt issuance provisions in the Illinois Code contain limitations on how much debt a particular municipal entity may issue. For instance, municipalities with less than 500,000 people may issue debt up to 8.625 percent of the total equalized assessed valuation of taxable property in the municipality. A school district for either kindergarten through eighth grade or ninth grade through twelfth grade may only issue bonds up to 6.9 percent of the taxable property in the district. Should a school district contain kindergarten through twelfth grade, the district may issue bonds up to 13.8 percent of the taxable property in the district. Other debt limitations include (a) 2.875 percent of taxable property in counties with populations less than 500,000 and townships, schools or municipal corporations with populations less than 300,000, or park districts, but this 2.875 percent limit does not apply to schools for acquiring or improving a site; constructing, extending, improving and equipping school buildings; or establishing a working cash fund; and (b) 5.75 percent of the value of taxable property for fire protection districts.ⁱⁱ</p> <p>Financially Distressed City Law</p> <p>Under this provision, a financially distressed city may receive assistance from the Illinois Finance Authority, which may provide financial aid to the city so that it can provide basic municipal services, while permitting the distressed city to meet its obligations with creditors and bondholders.ⁱⁱⁱ</p> <p>Refunding Bonds</p> <p>In certain situations, a municipal entity may issue refunding bonds to refund and refinance outstanding debt.^{iv}</p>

Selected Examples of the 50 State Survey

Illinois (cont'd)	
Mechanisms for Resolution after Default	<p>Financial Planning and Supervision</p> <p>Under the <i>Local Government Financial Planning and Supervision Act</i>, a local government with a population less than 25,000 and suffering a “fiscal emergency” in certain instances may upon two-thirds vote of the members of its governing body petition the Governor for the establishment of a financial planning and supervision commission in order to remove the “fiscal emergency.” A unit of local government may contract out of the provisions of the <i>Local Government Financial Planning and Supervision Act</i>.^v</p> <p>Receivership</p> <p>In certain revenue bond default situations, a receiver may be appointed to take possession and operate the project for which the bonds were issued.^{vi}</p>
Remedies on Default	<p>Appropriate Relief</p> <p>In certain situations, a bondholder may obtain relief from an “appropriate civil action in the appropriate circuit court.”^{vii}</p> <p>Foreclosure</p> <p>In certain situations, bondholders may foreclosure on a mortgage and seize and sell the underlying asset.^{viii}</p> <p>Injunctive Relief</p> <p>In certain situations, bondholders may obtain injunctive relief to enjoin an action with respect to a bond issuance.^{ix}</p> <p>Mandamus</p> <p>In certain situations, bondholders or their trustee may bring a court action to compel the local governing body to perform a ministerial action that it has refused to undertake, such as refusing to collect taxes or fees where the underlying bond authorization requires such a collection.^x</p>

Selected Examples of the 50 State Survey

Illinois (cont'd)	
Other Bondholder Protections	<p>Special Revenue Bonds</p> <p>As provided by § 922(d) of the Bankruptcy Code, payments to bondholders holding special revenue bonds would not be stayed on the filing of a municipal bankruptcy petition and payments to holders could continue. Whether an issuance would qualify as a special revenue bond depends on the provisions of the authorizing statute with respect to the bonds at issue.^{xi}</p> <p>Statutory Liens</p> <p>Were a municipal entity to file a petition under Chapter 9 of the Bankruptcy Code, bondholders holding bonds to which statutory liens have attached would continue to receive payment on those bonds. For a statutory lien to apply, the authorizing law of the bond issue must contain such a lien.^{xii}</p>
Illinois Notes	

- i 20 ILL. COMP. STAT. 3855/1-20(b)(15) (specific authorization for Illinois Power Agency). Pursuant to Illinois law, further, under the *Local Government Financial Planning and Supervision Act*, the financial planning and supervision commission has the power to recommend that the local government file a petition under Chapter 9 and to submit this recommendation to the state legislature. 50 ILL. COMP. STAT. 320/9(b)(4). The Illinois Code, however, does not include any provisions specifically authorizing a public entity, with the exception of the Illinois Power Agency, to file a petition.
- ii 65 ILL. COMP. STAT. 5/8-5-1 (municipalities less than 500,000). Certain exceptions to this provision exist, such as debt incurred for constructing a wastewater facility to comply with the Clean Water Act. This provision, further, does not apply to home rule municipalities. 105 ILL. COMP. STAT. 5/19-1 (school district for either kindergarten through eighth grade or ninth grade through twelfth grade); 105 ILL. COMP. STAT. 5/19-1 (School district containing grades kindergarten through twelfth grade); 50 ILL. COMP. STAT. 405/1 (local governments including counties with populations less than 500,000 and townships, schools or municipal corporations with populations less than 300,000); 50 ILL. COMP. STAT. 405/1.2 (providing exception for working cash fund); 70 ILL. COMP. STAT. 705/12 (fire protection districts); and 70 ILL. COMP. STAT. 1205/6-2 (park districts). These provisions have been provided as examples of statutory debt limitations under the Illinois Code. The state code may be more expansive and an attorney should be consulted to examine any specific situation.

Selected Examples of the 50 State Survey

Illinois Notes (cont'd)

- iii 65 ILL. COMP. STAT. 5/8-12-1 *et seq.* “Financially distressed City” means any municipality which is a home rule unit and which (i) is certified by the Department of Revenue as being in the highest 5 percent of all home rule municipalities in terms of the aggregate of the rate per cent of all taxes levied pursuant to statute or ordinance upon all taxable property of the municipality and as being in the lowest 5 percent of all home rule municipalities in terms of per capita tax yield, and (ii) is designated by joint resolution of the General Assembly as a financially distressed city. 65 ILL. COMP. STAT. 5/8-12-3.
A designation as “financially distressed city” shall last for 10 years until the city submits a balanced budget and proves its responsibility.
- iv *See, e.g.,* 65 ILL. COMP. STAT. 5/8-4-14 (allowing for refunding revenue bonds issued by municipalities with a population less than 500,000) and 65 ILL. COMP. STAT. 1/11-130-12 (allowing for water supply and sewerage system refunding bonds). The state code may be more expansive and the statutory authority for each bond issuance should be reviewed with respect to each proposed refunding bond issuance.
- v 50 ILL. COMP. STAT. 320/1 *et seq.* “Local governments” include counties, cities, villages, incorporated towns, townships, special districts and units of local government that exercise limited governmental powers, but not including school districts. “Fiscal emergency” includes the existence of any one or more of the following conditions: (1) the existence of a continuing default in the payment of principal and interest on any debt obligation for more than 180 days; (2) the failure to make payment of over 20 percent of all payroll to employees of the unit of local government in the amounts and at the times required by law where the failure has continued for more than 30 days after such time for payment, unless two-thirds of such employees agree in writing to such extension; (3) the insolvency of the unit of local government, being a financial condition that the unit is (A) generally not paying its debt as it becomes due unless they are the subject of a bona fide dispute or (B) unable to pay its debts as they become due. 50 ILL. COMP. STAT. 320/3.
In 1980 the Chicago Board of Education was placed under supervision of the state, and in 1989 East St Louis was placed under state supervision.
- vi *See, e.g.,* 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act); 50 ILL. COMP. STAT. 455/6 (Medical Services Facilities Revenue Act); 50 ILL. COMP. STAT. 465/20 (Local Government Housing Finance Act); 65 ILL. COMP. STAT. 5/11-103-15 (airports for municipalities of less than 500,000); 65 ILL. COMP. STAT. 5/11-119.1-6 (Joint Municipal Electric Power Agencies’ bond documents may contain provisions allowing for appointment of receiver); 65 ILL. COMP. STAT. 5/11-119.2-6 (Joint Municipal Natural Gas Agencies’ bond documents may contain provisions allowing for appointment of receiver); and 65 ILL. COMP. STAT. 5/11-130-7 and 5/11-130-12 (water supply and sewerage system bonds). The state code may be more expansive and the statutory authority for each bond issuance should be reviewed before assessing whether a receiver may be appointed.

Selected Examples of the 50 State Survey

Illinois Notes (cont'd)

- vii *See, e.g.*, 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act) and 50 ILL. COMP. STAT. 465/20 (Local Government Housing Finance Act). The state code may be more expansive and the statutory authority for each bond issuance should be reviewed before assessing whether such a remedy is applicable.
- viii *See, e.g.*, 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act); 50 ILL. COMP. STAT. 455/6 (Medical Service Facility Revenue Bond Act); and 50 ILL. COMP. STAT. 465/20 (Local Government Housing Finance Act). The state code may be more expansive and the statutory authority for each bond issuance should be reviewed before assessing whether bondholders may pursue a foreclosure action.
- ix *See, e.g.*, 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing the availability of injunctive relief under the particular statute.
- x *See, e.g.*, 70 ILL. COMP. STAT. 200/2-51 (Civic Center Code); 65 ILL. COMP. STAT. 5/11-48.3-11 (municipal zoo authorities); 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act); 50 ILL. COMP. STAT. 455/6 (Medical Service Facility Revenue Bond Act); 50 ILL. COMP. STAT. 465/20 (Local Government Housing Finance Act); and 65 ILL. COMP. STAT. 5/11-103-15 (airports for municipalities of less than 500,000). It is possible that an aggrieved bondholder could pursue a writ of mandamus even absent authorizing statutory law.
- xi *See, e.g.*, 65 ILL. COMP. STAT. 5/8.4.1-11 (revenue bonds issued by municipalities paid by revenues from operation of utility system or revenue-producing enterprise) and 65 ILL. COMP. STAT. 5/11-130-7 (water supply and sewage system bonds). These are examples of special revenue bonds. The state code may be more expansive and an attorney should be consulted to examine any specific situation involving a default.
- xii *See, e.g.*, 105 ILL. COMP. STAT. 5/1E-110 (creating statutory lien for Downstate School Finance Authority); 50 ILL. COMP. STAT. 445/6 (Industrial Building Revenue Bond Act, providing that a mortgage or deed of trust attaches without filing); 30 ILL. COMP. STAT. 350/13 (certain qualified governmental units under the Local Government Debt Reform Act) and 65 ILL. COMP. STAT. 5/11-103-15 (airports for municipalities of less than 500,000, establishing statutory mortgage lien). These are examples of statutory liens. The state code may be more expansive and an attorney should be consulted to examine any specific situation involving a default.

Selected Examples of the 50 State Survey

Michigan	
Municipal Bankruptcy Authority	<p>Under Michigan law, a local government or school district may file a petition under Chapter 9 of the Bankruptcy Code if an emergency manager who has been appointed by the governor believes the local government has no other alternative and makes a recommendation to the governor and treasurer that the local government or school district should be authorized to file a Chapter 9 petition. In the recommendation, the emergency manager must include either, a determination that no feasible financial plan can be adopted that can satisfactorily rectify the financial emergency of the local government in a timely fashion; or a determination that the emergency manager's plan has been in place for at least 180 days, but cannot be implemented as written or as it might be amended in a manner that can satisfactorily rectify the financial emergency in a timely manner. If the local government is a school district, the emergency manager must also give written notice to the superintendent of public instruction. If the governor approves the emergency manager's recommendation, he or she must notify the emergency manager and treasurer in writing. Unless an entity is specifically authorized, it may not file a municipal bankruptcy petition.</p> <p>Between 1980 and December 31, 2011, two municipal entities in Michigan have filed petitions under Chapter 9 of the Bankruptcy Code — a hospital in 1992 and the Village of Merrill in 1987.ⁱ</p>
Debt Default Prevention	<p>Annual Audit Reporting</p> <p>Each municipality must file an annual audit report. The report must meet certain criteria for the municipality to issue municipal securities without further approval of the state. If the municipality does not meet the requirements to issue bonds without state supervision, it must obtain, for each municipal security, the prior written approval of the state.ⁱⁱ</p> <p>Debt Limitation</p> <p>The Michigan Constitution contains debt limits for cities, villages and counties. A county may not issue debt totaling more than 10 percent of its assessed valuation. The Michigan legislature may limit debt issued by cities and villages.ⁱⁱⁱ</p>

Selected Examples of the 50 State Survey

Michigan (cont'd)	
Debt Default Prevention <i>continued</i>	<p>Local Government and School District Fiscal Accountability Act</p> <p>Should a local government request assistance or the treasurer inform the governor that he or she has conducted a preliminary review of a local government financial situation and has determined that certain conditions indicating a serious financial problem exist, the governor must appoint a review team to undertake a local financial management review. The local government may work with the state to develop a plan for resolving the stress and enter into a consent agreement. The consent agreement may include a continuing operations agreement developed by the local government or a recovery plan developed and imposed by the state. Unless the state determines otherwise, the local government is exempt from collective bargaining requirements.^{iv}</p> <p>Refunding Bonds</p> <p>In certain situations, a municipal entity may issue refunding bonds to refund and refinance outstanding debt.^v</p>
Mechanisms for Resolution after Default	<p>Emergency Financial Management</p> <p>If a municipality fails to pay an installment of principal and interest on an outstanding municipal bond on or before its due date, the state treasurer or superintendent for public instruction can investigate the municipality's fiscal affairs, consult with the governing body of the municipality and negotiate with the municipality's creditors to develop a plan for financing, adjusting or compromising the outstanding, overdue bond.^{vi}</p> <p>Municipal Receivership</p> <p>If a local government is in such deep financial distress that it is in a financial emergency and a consent agreement under the Local Government and School District Fiscal Accountability Act cannot be reached or is breached, the governor may place the local government into receivership and appoint an emergency manager. The emergency manager has broad powers to operate and restructure the municipality. If an emergency manager is appointed, the chief officer of the municipality's powers are suspended; the emergency manager is granted the ability to modify, terminate or renegotiate contracts, including collective bargaining agreements; the municipality is exempt from collective bargaining requirements for the earlier of five years or the end of the receivership; and the emergency manager may enter into agreements to consolidate services with other local governments and may file a municipal bankruptcy petition on behalf of the municipality.^{vii}</p>

Selected Examples of the 50 State Survey

Michigan (cont'd)	
Mechanisms for Resolution after Default <i>continued</i>	Receivership In certain default situations, Michigan law allows for the appointment of a receiver with respect to revenue bonds. ^{viii}
Remedies on Default	Mandamus In certain situations, bondholders or their trustee may bring a court action to compel the local governing body to perform a ministerial action that it has refused to undertake, such as refusing to collect taxes or fees where the underlying bond authorization requires such a collection. ^{ix}
Other Bondholder Protections	Special Revenue Bonds As provided by § 922(d) of the Bankruptcy Code, payments to bondholders holding special revenue bonds would not be stayed on the filing of a municipal bankruptcy petition and payments to holders could continue. Whether an issuance would qualify as a special revenue bond depends on the provisions of the authorizing statute with respect to the bonds at issue. ^x Statutory Liens Were a municipal entity to file a petition under Chapter 9 of the Bankruptcy Code, bondholders holding bonds to which statutory liens have attached would continue to receive payment on those bonds. For a statutory lien to apply, the authorizing law of the bond issue must contain such a lien. ^{xi} Further, on February 7, 2012, the Michigan Governor signed into law a provision establishing a statutory lien on particular aid payments made by the state to certain financially troubled school districts that use those payments to secure bond issuances. ^{xii}
Michigan Notes	

- i MICH. COMP. LAWS § 141.1523 (2011). In November, 2010, Michigan rejected a request for permission to file a municipal bankruptcy petition filed by the municipality of Hamtramck.

Selected Examples of the 50 State Survey

Michigan Notes (cont'd)

- ii MICH. COMP. LAWS § 141.2303 (2011). To qualify to issue municipal securities without further approval of the state, the municipality must (a) not be operating under the provisions of the Local Government and School District Financial Accountability Act; (b) have not issued securities in the immediately preceding 5 fiscal years or current fiscal year that were authorized under the Emergency Municipal Loan Act, other than certain loans authorized under that act; (c) have not been required by the terms of a court order or judgment to levy a tax in the previous fiscal year, unless it is determined that the court order did not have an adverse impact on the municipality; (d) have filed its audit report within 6 months from the end of its fiscal year; (e) have certified the debt retirement fund balance for any municipal security that is funded from an unlimited tax levy does not exceed 150 percent of the amount required for principal and interest payments due for the security in the next fiscal year; (f) not be exceeding its statutory or constitutional debt limits; (g) have no outstanding security not authorized by statute; (h) not be in violation of any provisions in the covenants for an outstanding security; (i) not have been delinquent more than one time in the preceding year in transferring employment taxes or pension, retirement or benefit plan contributions; (j) certify that its delinquent property taxes do not exceed 18 percent of the amount levied; (k) not have submitted a qualifying statement or application for any other municipal securities that was materially false or incorrect; (l) certify that it is not in default on the payment of any debt, with the exception of industrial development revenue bonds; (m) not have ended the immediately preceding fiscal year with a deficit in any fund, unless it has a plan to correct the deficit condition; (n) not have been found by a court to be in violation of any finance or tax-related state or federal statutes; (o) not have been in violation of its audit reporting requirements; and (p) have not issued a refunding security in the preceding fiscal year to avoid a potential default on an outstanding security.
If the state does not grant the municipality a “qualified status” based on its audit, the municipality must obtain, for each municipal security, the prior written approval of the state to issue a municipal security.
- iii MICH. CONST. art. VII, § 11 (counties); MICH. CONST. art. VII, § 21 (cities and villages). Pursuant to MICH. COMP. LAWS § 78.26, a village governed by the Home Rule Village Act may not incur indebtedness exceeding 10 percent of the assessed valuation of the real and personal property within the village subject to taxation.

Selected Examples of the 50 State Survey

Michigan Notes (cont'd)

- iv MICH. COMP. LAWS § § 141.1501 to 141.1514(a) (2011). As to whether a municipality is in severe financial stress, there are a number of triggering events, including a written request by the governing body or chief administrative officer, or a major creditor with an undisputed claim remaining unpaid for at least six months and exceeding \$10,000 or 1 percent of the annual general fund budget of the local government; petition of 5 percent of voters voting in the last gubernatorial election; failure to timely deposit its minimum obligation payment to the local government pension fund; notification either that employees have not been paid or that payment is seven or more days late; notice of a bond payment default or violation of a bond covenant; resolution from the state senate or house of representatives; a violation of the municipal finance act, the emergency municipal loan act, or the uniform budgeting and accounting act; failure to provide an adequate annual financial report or audit to the state treasurer; failure to distribute tax revenue, as required by law that has been collected for another taxing jurisdiction; a breach of obligations under a deficit elimination plan or agreement entered into pursuant to a deficit elimination plan; a court order of an additional tax levy without prior approval of the governing body; the municipal government has ended its fiscal year in a deficit; a school district ended its most recently completed fiscal year with a deficit in one or more funds and the district had not submitted a deficit elimination plan to the state financial authority within 30 days after the deadline to submit its annual financial statement; a local government has been assigned a long-term debt rating within or below the BBB category or its equivalent; or under the sole discretion of the state treasurer or the superintendent of public instruction, other facts and circumstances exist indicative of financial stress. MICH. COMP. LAWS § 141.1512 (2011).
- v *See, e.g.* MICH. COMP. LAWS § 141.2603(1) (allowing any outstanding security that has been assumed in part by another municipality to be refunded by the municipalities as to their respective liabilities) and MICH. COMP. LAWS § 141.2609 (allowing refunding securities under the Drain Code of 1956). Municipalities may issue refunding bonds to refund all or any portion of funded indebtedness, but their issuance must be necessary such as to avoid a default. MICH. CIVIL JUR., *Municipal and Public Bonds* § 51 (2010).
- vi MICH. COMP. LAWS § 141.2802. This provision applies to any county, township, city, village, school district, intermediate school district, community college district, metropolitan district, port district, drainage district or district library or another government authority or agency that has the power to issue a security. MICH. COMP. LAWS § 141.2802. The plan to be established under the provision must be found to be fair and equitable and reasonably within the ability of the municipality to meet. Once the plan is deemed fair and equitable, the department must advise the governing body to take necessary steps to implement the plan. If the governing body does not do so, the department may implement the plan on behalf of the municipality.

Selected Examples of the 50 State Survey

Michigan Notes (cont'd)

- vii MICH. COMP. LAWS § § 141.1515 to 141.1531 (2011). An emergency manager may initiate court proceedings in Ingham County, the county in which the Michigan state capital city is located, in the name of the local government to enforce compliance with any emergency manager order or any constitutional or legislative mandate, or to restrain violations of any constitutional or legislative power of his or her orders.
- Under a similar previous law in Michigan, the state had taken over certain municipalities suffering severe financial emergencies. In *Flint City Council v. State of Michigan*, 655 N.W.2d 604 (Mich. Ct. App. 2002), the state treasurer reported to the governor that the City of Flint had a serious financial problem. The governor appointed a financial review team to assess Flint's financial situation and found a substantial general fund deficit. The review team also determined that Flint city officials demonstrated an inability "to accurately monitor revenue and expenditures throughout a given fiscal years and to amend city budgets accordingly." As such, the review team recommended that the governor appoint an emergency financial manager. The city appealed and the court found the governor's decision was supported.
- The state has taken over the Detroit Public Schools; City of Pontiac; City of Escorse; Village of Three Oaks; City of Hamtramck; City of Highland Park; and City of Flint. See Eric Scorsone, *Local Government Financial Emergencies and Municipal Bankruptcy*, Michigan Senate Fiscal Agency Issue Paper, available at <http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf> (last visited July 14, 2011).
- Most recently, on November 29, 2011, the state placed the City of Flint under the control of an emergency manager. Also currently operating under emergency managers appointed by the state are the City of Benton Harbor, City of Ecorse, and the City of Pontiac, and the Detroit Public Schools. See *Governor Names Flint Native as City's Emergency Financial Manager*, Detroit Free Press (Nov. 30, 2011), available at <http://www.freep.com/article/20111130/NEWS06/111300370/Governor-names-Flint-native-city-s-emergency-financial-manager>.
- viii See, e.g., MICH. COMP. LAWS § 141.110 (allowing for appointment of receiver with respect to revenue bonds). Under § 141.110, a receiver may be appointed to administer and operate any public improvement as long as its revenues are pledged to pay the principal and interest on the bonds at issue. The receiver may fix and charge rates and collect revenues sufficient for the payment of any bonds or obligations outstanding, but must act under the direction of the court.
- For instance, in *Farmington Township v. Warrenville State Bank*, 185 F.2d 260 (6th Cir. 1950), bondholders asked the court to appoint a receiver. The court appointed a receiver and found that the receiver was allowed to continue to charge a specified amount each year for water hydrant rentals to help the township repay its debt.

Selected Examples of the 50 State Survey

Michigan Notes (cont'd)

- ix *See, e.g.*, MICH. COMP. LAWS § 41.347 (provides that bondholders representing in aggregate not less than 20 percent of entire outstanding bond issue by township water supply and sewage disposal services and facilities may protect and enforce the statutory lien and compel performance of duties by officials of borrower); and MICH. COMP. LAWS § 331.8e(2) (provides that bondholders representing in aggregate not less than 20 percent of entire outstanding bond issue by hospital authority may protect and enforce the statutory lien and compel performance of duties by officials of borrower, including fixing sufficient rates to pay bonds). It is possible that an aggrieved bondholder could pursue a writ of mandamus even absent authorizing statutory law.
- x *See, e.g.*, MICH. COMP. LAWS § 41.343 (revenue bonds for water supply and sewage disposal projects); MICH. COMP. LAWS § § 125.667(5) and 125.709(2) (revenue bonds for housing facilities); and MICH. COMP. LAWS § § 141.107(4) (Revenue Bond Act). These are examples of special revenue bonds. The state code may be more expansive and an attorney should be consulted to examine any specific situation involving a default.
- xi *See, e.g.*, MICH. COMP. LAWS § 41.346 (establishing statutory lien on net revenues of water supply and sewage disposal project); MICH. COMP. LAWS § § 125.667(5) and 125.709(2) (statutory liens for bonds issued by housing facilities); MICH. COMP. LAWS § 125.1666(2) (Downtown Development Authority bonds providing for statutory lien on tax increment revenues); MICH. COMP. LAWS § 141.108 (establishing statutory lien on net revenues under Revenue Bond Act); MICH. COMP. LAWS § 331.8e (establishing statutory lien on all net revenues on bonds issued by hospital authorities); and MICH. COMP. LAWS § 333.26220a(5) (disposal site revenues subject to statutory lien under Low-Level Radioactive Waste Authority). These are examples of statutory liens. The state code may be more expansive and an attorney should be consulted to examine any specific situation involving a default.
- xii 2012 MICH. PUB. ACTS 2 (signed into law Feb. 7, 2012). Under the provision, among other things, if an emergency manager has been appointed pursuant to the Local Government and School District Fiscal Accountability Act, or the district has approved a deficit elimination plan, the portion of state school aid paid or to be paid on behalf of the district to the Michigan finance authority, or to a trustee designated by the authority, for the sole purpose of paying the principal of and interest on a bond, is subject to a statutory lien, paramount to all other liens, for the sole purpose of paying principal and interest on the obligation.

Selected Examples of the 50 State Survey

Pennsylvania	
Municipal Bankruptcy Authority	<p>Any municipality, parking authority, public transportation authority, political subdivision, city of the first class or city of the second class may file if meeting one of the following conditions: recommendation of designated plan coordinator; interruption in ability to provide health and safety services; creditor rejection of plan of adjustment; municipal distress solvable via Chapter 9; or failure to follow or adopt recommendations of a designated plan coordinator. "City of the First Class" includes Philadelphia and "City of the Second Class" includes Pittsburgh. Parking authorities in Philadelphia and metropolitan transportation authorities may not file if they have outstanding bonds. Unless a municipality is specifically identified, it is not authorized to file a petition.</p> <p>In addition, on August 1, 2011, the Pennsylvania governor signed into law a provision that would prevent any "City of the Third Class" that has been identified as "financially distressed" under the Municipalities Financial Recovery Act, which includes Harrisburg, Pennsylvania, from filing a petition under Chapter 9 of the Bankruptcy Code. The provision expires on July 1, 2012. Should a city file a petition, all state funding to that city would be suspended. Despite this prohibition, on October 11, 2011, the City of Harrisburg filed such a petition, which subsequently has been dismissed by the court.</p> <p>Between 1980 and December 31, 2011, five municipal entities in Pennsylvania have filed municipal bankruptcy petitions.ⁱ</p>
Debt Default Prevention	<p>Debt Limitation</p> <p>The General Assembly has the authority to prescribe debt limits. Philadelphia's debt may not exceed 13-1/2 percent of the average annual assessed value of taxable property therein, during the 10 years immediately preceding the year of the increase.ⁱⁱ</p> <p>Rehabilitation of Distressed Municipalities</p> <p><i>Financially Distressed Municipalities Act.</i> If the State Department of Community Affairs determines a municipality is financially distressed, the department may appoint a coordinator to help the municipality prepare a plan to put its finances in order. The coordinator may hold public meetings and negotiate with creditors and other parties in preparing the plan. If the creditors reject the plan, a triggering event occurs, allowing the municipality to file a municipality bankruptcy petition.ⁱⁱⁱ</p>

Selected Examples of the 50 State Survey

Pennsylvania (cont'd)	
Debt Default Prevention <i>continued</i>	<p>Philadelphia Rehabilitation and Oversight <i>Intergovernmental Cooperation Authority Act.</i> This act was created to enable capital market access by cities of the first class (Philadelphia) for deficit elimination and seasonal borrowings to avoid default on existing obligations and chronic cash shortages. The authority may issue bonds and other obligations, but only at the request of the city being assisted. Further, the city assisted and the authority must develop, implement and periodically revise a five-year recovery financial plan. The authority also has the power over the city budget.^{iv}</p> <p>Refunding Bonds In certain situations, a municipal entity may issue refunding bonds to refund and refinance outstanding debt.^v</p>
Mechanisms for Resolution after Default	<p>Receivership In certain default situations, Pennsylvania law allows for the appointment of a receiver with respect to revenue bonds.^{vi}</p> <p>Trustee Appointment If a local unit of government defaults on the payment of principal or interest on a bond issuance and the default continues for 30 days, or if the local government unit fails to comply with any provision in a bond or note; or if allowed by the authorizing resolution, and holders of 25 percent in aggregate principal amount of bonds outstanding so choose, a trustee may be appointed to represent bondholders.^{vii}</p>
Remedies on Default	<p>Accounting In certain default situations, bondholders may bring a proceeding to require the authority in question to account as if it were a trustee of an express trust.^{viii}</p> <p>Mandamus In certain situations, bondholders or their trustee may bring a court action to compel the local governing body to perform a ministerial action that it has refused to undertake, such as refusing to collect taxes or fees where the underlying bond authorization requires such a collection.^{ix}</p>

Selected Examples of the 50 State Survey

Pennsylvania (cont'd)	
Other Bondholder Protections	<p>Special Revenue Bonds</p> <p>As provided by § 922(d) of the Bankruptcy Code, payments to bondholders holding special revenue bonds would not be stayed on the filing of a municipal bankruptcy petition and payments to holders could continue. Whether an issuance would qualify as a special revenue bond depends on the provisions of the authorizing statute with respect to the bonds at issue.^x</p> <p>Statutory Liens</p> <p>Were a municipal entity to file a petition under Chapter 9 of the Bankruptcy Code, bondholders holding bonds to which statutory liens have attached would continue to receive payment on those bonds. For a statutory lien to apply, the authorizing law of the bond issue must contain such a lien.</p>
Pennsylvania Notes	

- i 53 PA. STAT. ANN. § § 5510.11, 5571, 11701.261, 12720.211, 28211; 74 PA. CONS. STAT. ANN. § 1773. Pursuant to § 5510.11, a parking authority in a city of the first class is not authorized to file a federal bankruptcy petition if such authority has outstanding any bonds issued pursuant to the chapter. Pursuant to § 5571, a political subdivision may file a federal bankruptcy petition only after its petition has been submitted to and approved by the State Department of Internal Affairs. Pursuant to § 11701.261, a municipality, following a vote by a majority of the municipality's governing body, may file a petition pursuant to the federal bankruptcy laws if one of the following conditions is present: (i) after recommendation by the plan coordinator pursuant to § 241(6) of the statute; (ii) imminent jeopardy of an action by a creditor, claimant or supplier of goods or services which is likely to substantially interrupt or restrict the continued ability of the municipality to provide health or safety services to its clients; (iii) one or more creditors of the municipality have rejected the proposed or adopted plan, and efforts to negotiate a resolution of their claims have been unsuccessful for a 10 day period; (iv) a condition substantially affecting the municipality's financial distress is potentially solvable only by utilizing a remedy exclusively available to the municipality through the Federal Municipal Debt Readjustment Act; or (v) a majority of members of the current or immediately preceding governing body of a municipality determined to be financially distressed has failed to adopt a plan or to carry out the recommendations of the coordinator pursuant to the statute. Pursuant to § 12720.211, a city of the first class is not authorized to file a federal bankruptcy petition unless (a) it has no outstanding bonds issued pursuant to the Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class and (b) it has received approval from the governor for the filing of a federal bankruptcy petition.

Selected Examples of the 50 State Survey

Pennsylvania Notes (cont'd)

Pursuant to § 28211, a city of the second class is not authorized to file a federal bankruptcy petition unless (a) it has no bonds outstanding under the Pennsylvania Intergovernmental Cooperation Authority for Cities of the Second Class and (b) it has received approval from the governor for the filing of a federal bankruptcy petition. Pursuant to § 1773, a public transportation authority is not authorized to file a federal bankruptcy petition if such authority has outstanding any bonds issued pursuant to the chapter. *See also* 53 PA. STAT. ANN. § 101 (classification of cities).

With respect to the commonwealth's prohibition on Cities of the Third Class filing municipal bankruptcy petitions until July 1, 2012, see PA. ACT no. 26 (printer's no. 1452, signed into law by governor on June 30, 2011).

Of the five entities filing municipal bankruptcy petitions, three were cities or towns (specifically Harrisburg, a borough and a township) and two were special municipal districts.

- ii PA. CONST. art. IX, § 10; PA. CONST. art. IX, § 12 (Philadelphia debt).
- iii 53 PA. STAT. ANN. §§ 11701.101 to 11701.501. These provisions apply to any county, borough, incorporated town, township and home-rule municipality. Triggering events include the municipality maintaining a deficit over a three-year period, with a deficit of 1 percent or more in each of the previous fiscal years; expenditures exceeding revenues over a three-year period; defaulting on bond payments; missing payroll for 30 days; missing required payments to judgment creditors; failing to forward employee withholding taxes; accumulating a deficit in two successive years of 5 percent or more of its revenues; failing to make certain budgeted payments; attempting to negotiate and adjust a claim in excess of 30 percent against a fund or budget and failing in the negotiation; filing a municipal bankruptcy petition; or experiencing a decrease in a quantified level of municipal service from the preceding fiscal year, resulting in it reaching its legal limit in levying real estate taxes for general purposes. *See* 53 PA. STAT. ANN. §§ 11701.201.

There have been 26 filings under these provisions since 1987 and six rescissions of such filings. Examples of municipalities that were determined to be financially distressed include Pittsburgh in 2003 and the Borough of Wilkinsburg in 1988. *See Borough of Wilkinsburg v. Department of Community and Economic Development*, 728 A.2d 389 (Pa. Commw. Ct. 1999). Other cities include Farrell (1987); Aliquippa (1987); Clairton (1988); Borough of Braddock (1988); Borough of Franklin (1988); Borough of Rankin (1989); Duquesne (1991); Scranton (1992); Johnstown (1992); Borough of Millbourne (1993); Chester (1995); Borough of Greenville (1995); Borough of West Hazleton (2003); Township of Plymouth (2004); Nanticoke (2006); New Castle (2007); Westfall Township (2009); Reading (2009) and Harrisburg (2010). Distress determinations have been rescinded for certain cities including Wilkinsburg, Shenandoah, Ambridge, East Pittsburgh, North Braddock and Homestead. Pennsylvania Department of Community and Economic Affairs Distress Determinations, available at <http://www.newpa.com/get-local-gov-support/technical-assistance/request-assistance/act-47/index.aspx> (last visited July 15, 2011).

Selected Examples of the 50 State Survey

Pennsylvania Notes (cont'd)

Several cases have explored the interplay between Act 47 and collective bargaining agreements; *see, e.g., Wilkesburg Police Officers Ass'n v. Commonwealth*, 564 A.2d 1015 (Pa. Commw. Ct. 1989) (rejecting union argument that Act 47, by limiting prospective bargaining agreements, violates the constitution's requirement that municipalities engage in collective bargaining); *City of Farrell v. Fraternal Order of Police Lodge No. 34*, 645 A.2d 1294 (Pa. 1994) (upholding arbitrator's decision to increase union salaries despite challenge from the city, noting that the approved plan did not freeze or place limits on increases of police salaries, though it did prohibit increases in the cost of fringe benefits); *Pittsburgh Fire Fighters, Local No. 1 v. Yablonsky*, 867 A.2d 666 (Pa. Commw. Ct. 2005) (holding that § 252 of Act 47 applies to both arbitration settlements and arbitration determinations); *City of Scranton v. Fire Fighters Local Union No. 60*, 29 A.3d 773 (Pa. 2011) (finding that Act 47 does not impinge on arbitration awards under Pennsylvania's Policemen and Firemen Collective Bargaining Act with respect to employee bonuses, salary increases and health benefits).

At least one commentator has noted that an issue in applying Act 47 (the financially distressed municipalities provisions) is how to deal with collective bargaining after a financial distress declaration has been made. As it stands, the provisions prohibit financially distressed municipalities from entering into collective bargaining agreements conflicting with the plan. Unions argue that this is an impermissible restraint. *See* A.C. Schroeder, *The Interplay Between the Municipalities Financial Recovery Act and the Policemen and Firemen Collective Bargaining Act: an Analysis of City of Scranton v. Fire Fighters Local Union No. 60*, 19 WIDENER L.J. 541 (2010).

- iv 53 PA. STAT. ANN. § 12720.101 *et seq.* These provisions were created in 1991 to deal with issues faced by the City of Philadelphia. Philadelphia continues to be under the guidance of the Pennsylvania Intergovernmental Cooperation Authority.
- v *See, e.g.,* 53 PA. STAT. ANN. §§ 8241-8251 (municipal refunding bonds generally). The state code may be more expansive with respect for refunding bond provisions related to various types of bond issuances, and an attorney should be consulted to examine any specific situation involving a default.
- vi *See, e.g.,* 53 PA. STAT. ANN. § 15733 (revenue bonds issued by cities of the first class to construct sewer systems) and 53 PA. STAT. ANN. § 8264 (receiver for revenue projects). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether such a receiver may be appointed.

Selected Examples of the 50 State Survey

Pennsylvania Notes (cont'd)

- vii 53 PA. STAT. ANN. § 8263. On written request by bondholders holding 25 percent or more principal amount of bonds outstanding and on being furnished with indemnity, a trustee may: bring a writ of mandamus or other proceeding in equity to enforce the rights of bondholders to impose and collect rents, rates, tolls and charges adequate to carry out the agreement or carry out any other agreement with the bondholders; bring suit on the bonds; require an accounting from the local government; in the case of general obligation bonds and guaranteed revenue bonds, petition the court to levy, after a hearing and notice to real estate owners, the amount due before or after the exercise of any right to accelerate the bonds or notes, plus the estimated cost of collection; to seek an injunction; or after 30 days' prior written notice to the local government, and subject to the bond ordinance or relevant indenture, declare the unpaid principal and interest immediately due and payable.
- viii *See, e.g.*, 53 PA. STAT. ANN. § 12720.305 (Pennsylvania Intergovernmental Cooperation Authority for Cities of the First Class) and 53 PA. STAT. ANN. § 25687 (waterworks bonds). The state code may be more expansive and the statutory authority for each individual bond issuance should be reviewed before assessing whether a bondholder may bring an action for an accounting.
- ix *See, e.g.*, 53 PA. STAT. ANN. § 15733 (revenue bonds issued by cities of the first class to construct sewer systems); 53 PA. STAT. ANN. § 15920 (revenue bonds issued by cities of the first class); 53 PA. STAT. ANN. § 12720.305 (Pennsylvania Intergovernmental Cooperation Authority for Cities of the First Class); and 53 PA. STAT. ANN. § 25687 (waterworks bonds). It is possible that an aggrieved bondholder could pursue a writ of mandamus even absent authorizing statutory law.
- x *See, e.g.*, 53 PA. STAT. ANN. § 15907 (revenue bonds issued by cities of the first class shall contain a pledge and grant of security interest in project revenues). This is an example of a special revenue bond. The state code may be more expansive and an attorney should be consulted to examine any specific situation involving a default.

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

© 2012 Chapman and Cutler LLP

Presentation to the California Debt and Investment Advisory Commission

Unfunded Pension Obligations: Is Chapter 9 the Ultimate Remedy? Is There a Better Resolution Mechanism?

October, 2012

James E. Spiotto
Chapman and Cutler LLP

© Copyright 2012 by James E. Spiotto. All rights reserved.

Chapman and Cutler LLP

Attorneys at Law • Focused on Finance®

3279045

Table of Contents

I.	The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBS	5
II.	Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?.	14
III.	What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?	28
IV.	A Solution Is Required to Avoid the Inevitable Meltdown	39
V.	The Use of a Public Pension Funding Authority to Solve the Severe Pension Underfunding Problem	42
VI.	Can the Underfunding of Pensions for State or Local Governments Be Addressed in a Court Proceedings?	56
VII.	General Analysis of Chapter 9.	62
VIII.	The Role of Special Revenues in Chapter 9	75
IX.	Recent Court Test of Special Revenues/Statutory Lien Protections	77
X.	How Is Municipal Bond Debt Treated in a Chapter 9 Proceeding?	80
XI.	Other Issues in Chapter 9	82
XII.	Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings	83
XIII.	Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings	88
XIV.	Conclusion.	95

State and Local Debt

Financial Challenges — Past, Present & Future

▪ 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 major repeating theme is that such Sovereigns have incurred obligations that are unaffordable and unrealistic. Pension benefits have doomed the financial futures of many Sovereigns
- The Sovereign crisis must be addressed to avoid damaging the Financial Market and to support the perception that Sovereigns (including state and local governments in the U.S.A.) have the ability to manage their financial affairs and thereby avoid unfriendly credit markets going forward and inability to fund the governmental services their citizen expect
- 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 (state and local) to follow

State and Local Debt

Financial Challenges — Past, Present & Future

- This presentation will study the pension underfunding problem and the alternatives available to state and local government short of a financial meltdown and propose a Public Pension Funding Authority as the preferred means of addressing the Pension underfunding crisis through a Sovereign Debt Resolution Mechanism
- Past history has shown not enough capacity for voluntary change and too many emotional and political overtones to the pension underfunding problem. What is required is a clear recognition of the dire alternative of Chapter 9 bankruptcy and what can be done by the state and local government before suffering the stigma of financial meltdown or the filing for municipal debt adjustments in a Chapter 9 — therefore, the critical need for the Public Pension Funding Authority is apparent

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- A. State and local government workers are approximately 12% of the nation's workforce — 16 million employees
- B. While available cash to pay for employee benefits was decreasing, local and state governments sought to meet demand for services by adding more workers faster than other sectors
 - 1. Since 1970, state and local employees have increased by over 60% and have increased more than any other percentage of overall government employees (federal, state and local) from 77.8% to 85.6% (between 1970 and 2000)

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

2. Extraordinary Personnel Growth and Future Pension Crisis* (Mortgaging Your Grandchildren)

	NUMBER OF STATE EMPLOYEES	NUMBER OF LOCAL EMPLOYEE S	PERCENTAGE OF STATE OF ALL GOVERNMENT EMPLOYEES	PERCENTAGE OF LOCAL OF ALL GOVERNMENT EMPLOYEES
1970	2,755,000	7,392,000	21.1	56.7
1997	4,732,608	12,000,608	24.2	61.4
Percent Increase from 1970	71.8%	62.3%	14.7%	8.3%

Pension obligations for municipal workers do not have priority in bankruptcy and no protection for deferred compensation

- Demand for Funding Now
- In 1995-1996 Orange County Cut Thousands to Balance Budget

* State and local government employees have grown between 1946 – 2008 by 12.7 million employees, faster than the rate of growth in population. In 1946, there were 2.3 state and local government employees per 100 citizens. In 2008, that number was 6.5. Are we less effective? (Grandfather State and Local Government Spending Report by Michael Hodges)

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- C. Meanwhile, demographics and actuarial assumptions have changed and there has been increased attention focused on the ability of state and local governments to pay the accrued costs of benefits for the expanding number of government employees
- D. In the United States, the unfunded pension liability of state and local governments is believed to exceed \$1 trillion with OPEBs ranging from \$300 billion or more. Some economists have suggested that, given a realistic rate of return for investments as compared to the “unrealistic” rate of return on investments projected by State and Local Pension Fund, the real amount of underfunding is closer to \$3 trillion. The cost of unfunded health benefits promised to retirees could push the number even higher
- E. At the same time, the debt of state and local governments has almost doubled in the last ten years from \$1.197 trillion in 2000 to \$2.8 trillion in the fourth quarter of 2010. Citicorp contends the market for state and local government debt in the U.S.A. is actually \$3.7 trillion with individual holders being \$1.8 trillion (rather than \$1 trillion) or 50% of the market

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

Wilshire Consulting has released its 2011 Report on State Retirement Systems: Funding Levels and Asset Allocation. The study includes 126 state retirement systems and concludes the following:

- Wilshire Consulting estimates that the ratio of pension assets to liabilities, or *funding ratio*, for all 126 state pension plans was 69% in 2010, down sharply from an estimated 85% in 2008 but up from 65% in 2009
- For the 125 state retirement systems that reported actuarial data for 2010, pension assets and liabilities were \$2.01 billion and \$3.11 billion, respectively
- Of the 107 state retirement systems that reported actuarial data for 2008, 89% are *underfunded*. The average underfunded plan has a ratio of assets to liabilities equal to 74%

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

Illinois New Pension Legislation

While the reforms contained in the legislation do not solve the Illinois or local government pension crises, leaving untouched the benefits of current employees, the legislation creates reduced pension benefits for new employees hired after January 1, 2011, including the following modifications:

- Raises the retirement age to 67 with ten years of service for full retirement. Some retirement plans currently allow full retirement at age 55 or even lower
- Raises the early retirement age to 62 with ten years of service for a reduced benefit
- Limits the maximum pensionable salary to the 2010 Social Security wage base of \$106,800. Previously there was no limit to the salary from which a worker could draw a pension for any of the pension plans included in the reforms
- Eliminates “double-dipping” by suspending the pension of any retiree who goes to work for a government that participates in another pension system until that employment ends

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

The Illinois Bill falls far short of the reforms many have called for, including:

- The legislation does **NOT** reform Chicago or downstate police and firefighters' pension funds, which are some of the worst funded in Illinois but that was addressed in late legislation
- The legislation allows Chicago Public Schools to take a partial pension holiday totaling more than a billion dollars over the next three years
- The reforms do not include increases to either employer or employee contributions to the pension funds
- The General Assembly and judge retirement funds are exempted from many of the provisions of the reform bill that apply to every other pension fund
- In 2010, Minnesota, South Dakota and Colorado have passed legislation to adjust (i) retirement age, and (ii) pension benefits (lowering or eliminating increases in pension benefits or increasing employer/employee contributions) to realistic and affordable levels and those pieces of legislation are being challenged in the courts as to impairing pension and retirement rights. The lower courts in Minnesota and Colorado in 2011 have upheld legislation supporting pension benefit cuts

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

This is not a new problem. Historically, pension systems on the state and local level have been at various times underfunded for most of the last 50 years

The average funding ratio has grown and declined over time

PERIOD	FUNDING % OF TOTAL PENSION LIABILITIES
Mid-1970s	50%
1990	80%
2000	100%
2003	77%

- Historically, extraordinary personnel growth plus political pressure contributed to the rise of pension liabilities
- The up market for investments in the late 1990s and between 2003-2007 has helped investor return and narrowed the underfunding gap and the recent market uptick since mid-2009 has also helped
- However, there are implicit obstacles to solving pension liabilities
- There is political pressure to increase pension benefits when current salaries are limited by restricted revenues

* Source: Standard & Poor's, Research: Managing State Pension Liabilities: A Growing Credit Concern, Jan. 2005

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- State and local legislatures listen and respond to employee unions and increase benefits without providing corresponding sources of funding
- The ever increasing demand for infrastructure improvements and expanded public safety services have more than strained state and local budgets (estimated \$2.5 trillion of infrastructure improvement required with the next five years)
- Pension obligation bonds (“POB”) have masked the real systemic problem that needs to be addressed and have been a “Band-Aid” and short term fix for significant budget loopholes and the consistent current underfunding of pension obligations
- Defined benefit plans (“DB”) (as compared to defined contribution plans (“DC”)) are for the most part doomed to failure – benefits promised cannot easily be provided, especially given the revenue restraints that state and cities face
- The transition to a DC plan is less volatile, more predictable and, if funded currently, far safer
- The transition to DC plan from a DB plan is costly and complicated

I. The Pension and OPEBs Crisis – The Hard Facts and Possible Solutions – The Current State of the Underfunding of Pensions and OPEBs

- Expectations of government employees and unions are high and not easily changed and efforts to increase employees' contributions are not well received
- Many state constitutions protect pension benefits from being changed retroactively and some prospectively
- In the absence of state constitutional provisions, certain states have adopted legislation prohibiting diminishing or impairing public employee pension rights
- A long-term fix is needed to transition DB plans (that don't work) to DC plans and to substitute increases in benefits to meet political needs with zero tolerance for underfunding as a current budget matter or with increasing benefits that have no funding source – approximately 90% of public employee pension plans are defined benefit plans while less than 15% of private pension plans are defined benefit plans

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- State Constitutional, Statutory Provisions and Case Law – Non-Impairment vs. Required to Save the Pension Plan
- Pension a Gratuity or Vested Right
- Labor Contracts and Pension Plan Flexibility
- Impairment When Change Is Necessary

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- A. 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

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

B. 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 plan 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 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)
7. Caps on cost of living increases or changes in percentages used for increases that cut the benefits were upheld in order to maintain the viability of the pension program (Minnesota and Colorado)

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

C. 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
- dismissal of public employee

even though such may indirectly affect the pension benefits received

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- D. The key issue appears to be how can you fund affordable pensions. While states may prohibit impairment of vested rights to a pension, they generally provide no basis to assure annual funding of annual required contribution (ARC) or the source or mechanism of funding. Given the separation of powers, courts have been reluctant or have outright refused to interfere with the legislative or executive powers of state and local governments and order additional or new funding sources for underfunded pensions. The lack of tying pension benefits to dedicated sources of the payment and the absence of limiting pension and OPEB benefits to affordable dedicated sources of funding of the state and local government pension have contributed to the current pension underfunding crisis

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- E. Pension obligations can, in very extreme circumstances, be “discharged” where necessary to serve an important public purpose:
- If the state and local government 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

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- 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 nonconsenting 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)

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

F. The Public Pension Authority Solution?

In states that do not authorize a municipality to file under Chapter 9 of the Federal Bankruptcy Code, federal law has not preempted the determination of insolvency and federal law has left it to the individual states to choose how to proceed:

- Under those circumstances, the federal government could create a Special Commission court or authority, or a state can choose to:
 - Establish fact-finding and determining boards, commissions or authorities (“Public Pension Funding Authority”) that can determine the critical facts necessary for funding or restructuring unfunded pensions based on the circumstances such as:
 1. The ability and willingness to increase taxes and to fund pensions can be determined by the Public Pension Funding Authority with recommendations to local government home rule legislative boards (city council, etc.) or by referenda of the local electorate

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

2. The elected officials, workers and electorate can make an informed decision based on facts determined by the Public Pension Funding Authority as to the ability of the local government body to pay based upon the relationship between (a) the necessity and amount of tax dollars available to pay for essential governmental services and (b) funds available to pay wages and pension benefits. There would be independent, objective and professional determination by the Public Pension Funding Authority whether the wages and pension benefits are reasonable and sustainable by the local government
3. Issues of affordability of wages or pension benefits (in light of the costs of essential governmental services) can be determined by the authority and those determinations can be binding on the state, local government and workers in future labor negotiations or resolutions
4. The adverse effect to younger workers by not addressing the issue now can be avoided

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

5. Either (a) increase in pension funding (if necessary through tax increases, increased contributions by employees or employer or state intercepts) so that the actuarially required payment is made annually by the government body or (b) adjustment of pension benefits and employee contributions so that which can be reasonably paid is paid and the actuarially required payment is made annually
6. State pension authorities can establish minimum level of pension funding required (“Target Percentage”) and can require mandatory participation in Public Pension Funding Authority review and determine if below Target Percentage has been triggered and inability of the governmental body to sustain over time providing essential governmental services and fully-funded pension benefits and wages (“Governmental Functions Emergency” or “GFE”)
7. While government workers and government bodies may voluntarily seek the aid of the pension authority, upon the determination of a GFE, the Public Pension Funding Authority should have the jurisdiction to make any and all determinations related to pensions and obtaining appropriate pension funding at a level that is sustainable while assuring that the local government will have funds available to provide essential governmental services

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

8. The Public Pension Funding Authority will provide transparency and independent fact determination and can recommend increased pension funding or state intercept of taxes otherwise available to the local governmental body to be used for funding pension payments so that they are the actuarially-required payment or, if necessary, determine there must be a restructuring in order to avoid a breakdown of essential governmental services and a GFE. In recommending a restructuring, the pension authority can determine what is affordable and sustainable and recommend changes to the local governmental body and workers or it can be empowered to require such restructuring, if necessary, through a pre-packaged plan in Chapter 9 filing
9. The Public Pension Funding Authority answers the unanswerable problem of failing to connect pension benefits to an affordable dedicated source of the annual payment of the ARC while assuming the funding of essential governmental services without pension payment holidays or other smoke and mirror gimmicks that have to date significantly contributed to the pension underfunding crisis

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

G. Other Actions Can Also Help Resolve the Crisis. The Labor Contract or Agreement Should Permit Reductions and Changes that are Economically Required

1. The failure to have properly worded pension plan or labor contract can be fatal to voluntary changes. It should permit modification and reduction at least prospectively. See *Sprague v. General Motors Corp.*, 92 F.3d 1425 (7th Cir. 1996); *In re Dorskocil Cos.*, 130 B.R. 870 (Bankr. D. Kan. 1991)
2. It is almost impossible to get every employee to agree to change and, absent a Collective Bargaining Agreement, consent of each affected employee is unlikely, especially if the state statute prohibits unilateral reduction or elimination of pension benefits
3. Even with a union, voluntary change is resisted because of the precedent

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

- H. Outside of a Bankruptcy Court Order (and possibly the use of Pension Authority), changes of pension obligations (unilateral reductions) are practically and politically unlikely but may provide the best results
1. Most State Court Judges are elected by those affected, either directly or indirectly
 2. This is a local rather than federal matter
 3. Most pension plans are subject to State Constitutional or statutory provisions that will not permit the change
 4. Pension benefit reduction is obviously unpopular and causes “morale” issues
 5. But “Necessity knows no laws.” Change may be mandated by the Reality of the Situation – If the Pension System will fail, Pensioners receive less, the purpose of the legislation will be frustrated and less is truly more, especially if less is assured

II. Can Pension Benefits and OPEBs Be Rolled Back, Reduced or Changed?

6. There is precedent to “discharge” pension obligations where the governmental body’s survival mandates such action so that essential government services can continue to be provided. See *Faitoute Iron & Steel Co. v. City of Ashbury Park*, 316 U.S. 511-513 and *U.S Trust v. New Jersey*, 431 U.S. 1, 25-28
7. What is needed is a mechanism like the Public Pension Funding Authority that is independent, neutral and determines the essential facts so the debate of unwillingness or inability can be transcended to a mechanism to provide increased funding or adjustment to what can be afforded for full funding of affordable benefits
8. Bankruptcy is not only rare but is accompanied by a stigma that effects all creditor relations of the government and has far reaching negative consequences. Intermediary step that provides the benefits of a neutral, independent determination of fact issues and a mechanism for full-funding of affordable benefit is not only desired but necessary. Otherwise, the ultimate harsh result will be far worse to all

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

A. First determine whether the problem is

- “Unwillingness to Pay” or “Inability to Pay” problem
- Unwillingness to Pay can be solved

B. If there is determined to be an unwillingness to pay and there is an ability to pay then there can be a recommendation of an increase in annual pension contributions or increase in taxes to fund them

- Referendum or legislative action on providing the funds necessary to fund pension obligation

C. While both lead to the same result, the Inability to Pay may require more drastic action

D. Voluntarily consenting to rollback of benefits from employees sufficient to solve the problem

- Not likely and uncertain results
- If the employees know the worst case, voluntary consent may be possible

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

- E. Encourage voluntary and consensual resolution to the extent possible (as difficult as this may be)
- F. Provide the reality backdrop of a Public Pension Authority which can encourage voluntary consensual resolution and, if needed, provide the harsh reality of what can be afforded and paid or the dire consequences of future enforcement of reality including Pre-Package Chapter 9 with even harsher results for all
- G. What a Pension Authority can help determine:
 - What is it: “Unwillingness to Pay” or “Inability to Pay”
 - Consensual Rollback of Benefits - When less is more
 - Mandated Changes - Actuarially Required When Pension Plan Rescue Is Necessary
 - Whether Voluntary Steps Can Be Taken as Some States are Doing or Hope to do
 - 14 Steps to a Brighter Future (See III.I. below)

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

H. Failure to Address the issue now will lead to potentially larger problems later

- Defined Contribution vs. Defined Benefit Plans
- New Employees vs. Vested Employees
- Mis-use of Contribution Holidays
- Lack of Dedicated Sources of Funding
- No Requirements to make Annual Required Contribution (“ARC”)
- The reality of Pensions that are too big to be paid
- Need for Significant Increase in Employer and/or Employee Contribution

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

I. The beginnings of movement toward a Public Pension Authority Model:

There are some actions that state or local governments can take to attempt to solve pension problem as part of or prior to use of a public pension funding authority and outside of a Chapter 9 or court proceeding (states such as Arizona, California, Illinois, New York, Oregon and West Virginia have considered or taken some of these actions)

1. Review actuarial assumptions to make sure they are realistic and work. Too conservative assumptions can indicate problems that don't really exist and too liberal assumptions may miss a real problem
2. Review investment policy and returns so that poor investment policies are identified and changed before it is too late. Arbitrary rules of valuation or investment can contribute to underfunding. Market volatility can provide false comfort as compared to realistic valuation of assets with adjustment for market cycle. Be careful to avoid if possible losses not reflected in valuations and report accurately any deferral of gains

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

3. Increase sponsor and/or employee contribution to the plan – easier said than done
4. Prohibit an increase in benefits without an identified revenue or funding source
 - Ban special legislation to benefit special employee groups
 - Require legislature to pass budgets that fully fund current pension obligations and pay a fair portion to cover the unfunded pension obligations
 - Eliminate automatic increases in pension benefits and end-of-career mega increases in salary
 - Create new and more independent advisors and retirement boards

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

5. Move from a DB Plan to DC Plan or provide for Adjustable DC Plan benefits if market volatility or investment result will not actuarially justify the higher payout provided employee increased contributions to maintain higher benefit level with fixed employer contribution based on affordability

Start immediately with new hires and work on developing plan transition to defined contribution for current employees

Transition can be accomplished as part of Big Fix - phase out of defined benefit plans and phase in defined contribution plans:

- Issue POB for cash to cure underfunding and transition cost (transition costs from DB to DC plus underfunding dealt with by savings created, by increased contributions, cap on benefits, change from DB to DC, possible arbitrage on taxable bond proceeds and pension obligations as well as additional funding through bond proceeds)
- Use “cure” as motivation for voluntary agreed termination of DB Plan and creation of DC Plan
- If no agreed termination of DB plan, then phase out with new employees

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

6. Eliminate any automatic increases tied to indexes that cause costs or benefits to rise higher and faster than investment return (either a cap on increases in benefits or elimination of any automatic increase not specifically passed with recognized funding source)
7. No new pension benefits without specific dedicated funding
8. Refrain from POB or “Savings Plan” which provides temporary budget solutions but is not a long term fix. Any voluntary rollback of benefits or increase in employee contributions should not equate to effective lowering of contributions by the state or local government
9. Cap specific pension benefits for each employee category for state and local governments so that legislative or executive branches cannot grant end of career or politically motivated and selective increases which are unfair and costly

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

10. Beware of cash out programs or eliminate early retirement programs or money purchase options which may have untested assumptions and most likely cost more than anticipated
11. Change retirement age and years in service to reduce costs
12. Restrict alternative pension benefit to actual “high risk” jobs - public safety (police and fire) with lower age and service requirements
13. Consolidation of Pension Programs and duplication of function
14. Provide “Supervising Adult” designated state official for audit, review, reporting, transparency and accountability — such as the Public Pension Funding Authority

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

- J. The voluntary action (14 steps) may not be possible and changes in benefits may not be voluntarily capable of being agreed to between workers and government without additional persuasive mechanism such as the Public Pension Funding Authority
- There are limits to the ability to fund given the realities of tax increases and statutory and constitutional limits and caps. There are limits to intercepts of state tax revenues from funds necessary for essential governmental services to fund pension underfunding. The debate as to increased funding versus restructuring benefits based on the ability to pay and the ability to fund pension benefits as well as essential governmental services requires an objective decider of facts. A Public Pension Funding Authority's objective and expert determination of reasonableness and sustainability of pension benefits in comparison to the funding necessary to pay for essential governmental services can be what is needed to objectively put into focus what can be afforded

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

- Delay in reaching a resolution only means increased underfunding lessening the options and decreasing the prospect of funding pension funds
- From the workers perspective, delay in resolving pension underfunding may mean less in the end for pension benefits. The negative effects of a GFE or a Chapter 9 will be less benefits and a financial stigma that will restrict future ability to fund
- Both government representatives and workers and their unions must recognize that delay means less for the workers and a higher price being paid by the municipality especially if all else fails and a GFE occurs or Chapter 9 filing is necessary

III. What Can State or Local Governments Do to Solve a Pension or OPEB Problem (Without Resorting to a Court Proceeding)?

**CONTINUATION OF THE STATUS QUO
WILL NOT LEAD TO A
HAPPY ENDING**

IV. 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 government 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
- The Demand to Invalidate Unjustified Pension Obligation. Taxpayers and other creditors including the holders of the state or local government's 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).)

IV. A Solution Is Required to Avoid the Inevitable Meltdown

- The Only Way Out Is Change. 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 government. 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

IV. A Solution Is Required to Avoid the Inevitable Meltdown

- Ultimately, in order to provide a capacity for growth and change in those situations where voluntary and consensual resolution has not worked, it will be necessary to make use of a Public Pension Funding Authority that will determine objectively the ability to pay from available tax sources, engage government representatives and taxpayers as well as workers and unions with objective determination of what is affordable and sustainable and the consequences of failure to each
- This may be voluntary or mandatory to avoid or solve a Governmental Functions Emergency (where the government cannot afford essential governmental services and pension funding or where the Target Percentage of minimum funding has not been reached)

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

- A. The voluntary steps that governments and workers can take to reach a consensual resolution are always the best. But sometimes past promises, emotions, politics or the inability to see the objective facts will prevent or impair the ability to resolve the problem
- B. The use of Chapter 9 – Municipal Debt Adjustment, or for States repudiation of Debt or slow pay or no pay are not desired solutions and have significant financial consequences to the governmental body and its future financial survival

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

- C. State receiverships, commissions and boards of adjustment have been used in times of past financial distress to make necessary determinations of inability to pay, to approve plans of adjusted payments and prevent a governmental function meltdown and the serious consequences of impaired governmental services. These quasi-judicial state authorities have addressed financial distress to permit funding or financing of governmental debt when it was financially sound and affordable, provide bridge financing in time of financial illiquidity or determine what level of debt was affordable and provide a means of implementing such plan

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

- D. 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?

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

- What cost-cutting measures are required to achieve affordable benefits?
- What past employment benefits are affordable and what ones, if any, are not?
- What adjustments to past employment benefits are mandated to avoid a governmental functions meltdown or GFE?
- What is the minimum acceptable funding percentage for funding pension benefit (“Target Percentage”)?

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

- E. 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 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?

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

- 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 governmental functions emergency or meltdown?
- Recommend tax increases to fund additional pensions contributions and require the local home rule unit's legislative body (city council et al.) to consider a tax increase or have non-home rule governments 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
- Determine whether an intercept of state tax revenue should be implemented to pay required benefits

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

- Determine whether arbitration (voluntary or involuntary) should be engaged in
- Determine whether contributions are necessary from both public employees and employers
- Determine what cost-cutting measure or adjustment of pension benefits is necessary to achieve affordable benefits and allow the continued funding of the cost of essential governmental services

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

- F. The last two decades have seen in corporate Chapter 11 Bankruptcy corporate pension benefits adjusted to meet demonstrated affordable levels. There have been significant reductions in benefits to allow the reorganized company to survive. Popular solutions from the corporate world include:
- Change retirement plans for new hires to reduce defined benefit plans, cash balance plans or defined contributions and variations whereby the employer's contribution is fixed and the employee benefit can vary based on the benefit desired by the employee
 - Transfer OPEB obligations from employers to trust administered by employees funded with one-time employer contributions (and if desired by employees, ongoing employee contributions)
 - Freeze the plan and have a new going forward plan for all employees
 - Have representation of public employers and employees negotiate affordable cost reduction to existing plans
 - The Public Pension Funding Authority can consider these and other creative resolutions and whether given the interests of all, they can be utilized to resolve the pension underfunding problem

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

- G. The Public Pension Funding Authority would be created by state legislature (statute) or constitutional amendment as the case may require. Also, a Public Pension Funding Authority could be created on the federal level provided it does not interfere with Tenth Amendment rights of the states. Given the quasi-judicial function independent experts with experience in public pension, debt restructuring and related area should be selected by the highest court of the state or the Constitutional Officers of the state. The state should fully fund the Public Pension Funding Authority as needed. A designated State Constitutional Officer or the Supreme Court of the state shall be responsible for overseeing the Authority and its statutory mission as well as providing staff support. This State Constitutional Officer should be the supervising adult on the topic and responsible for obtaining funding and staffing of the Authority

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

- H. Governmental bodies would be able to obtain voluntary jurisdiction over their issue by filing a petition before the Public Pension Funding Authority. The Public Pension Authority would establish guideline criteria that would be the trigger for its mandatory jurisdiction: the determination by the Public Pension Funding Authority that either a government (A) had funding below the Target Percentage of minimum acceptable funding for pension benefits or (B) has suffered a Governmental Functions Emergency whereby the annual payment of the ARC for pension as determined by the Authority would lead to the inability to fund the costs of essential governmental services. Either of these determinations would be an automatic trigger for mandating the supervision by the Public Pension Funding Authority for that government

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

The possible triggers for the mandatory jurisdiction over the pension of a governmental unit, in the Authority's discretion, could include:

1. Governmental unit failed to fund its pension benefits to the minimum acceptable level established by the Authority, or
2. Funding of the ARC for its pension benefits annually would prevent or impair the government's ability to provide essential governmental authority and such condition is likely to continue, or
3. Failure to fund the ARC for its past employment obligations has no justifiable basis in the determination of the Authority, or
4. Governmental unit has a Governmental Functions Emergency and is not providing essential governmental services to its citizen and has underfunded past employment obligations, all at a level determined by the Authority to be material

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

- I. The Public Pension Funding Authority would have the powers necessary to resolve the underfunding of past employment benefits including:
 - 1. Recommend tax increase or requiring a referenda on tax increases
 - 2. Intercept state taxes in order to pay ARC and other past employment benefits
 - 3. Recommend reductions in pension or OPEB benefits to prevent governmental functions emergency or meltdown
 - 4. Approve the local government budget
 - 5. Require mandatory arbitration which could include (i) making findings and determinations as to the level of employee benefits and whether they are sustainable and affordable by the government recommending benefit level for employees and retirees at such affordable levels and approving settlements of adjusted benefits or other relief appropriate given the circumstances or (ii) adjudicating necessary modifications to employee contracts and approving arbitration decisions

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

6. Suspend tax limitations or caps and mandate tax increase votes or referenda to provide adequate funding of past employment obligations
7. Increase pension contributions by employer and employees so that the ARC is paid annually and all past employment benefits are adequately funded
8. Provide ability to issue bonds to cover a portion of pension or OPEB but only if tied to the enactment of significant pension/OPEB reforms that are determined to be a complete resolution of the problem
9. Transfer the local pension plan to an established statewide plan structured to ensure adequate funding and state intercept of tax authority
10. Authorize the local government to file for municipal debt adjustment (Chapter 9 of Federal Bankruptcy Code) using the determinations of the Authority as the basis for a pre-packaged plan of debt adjustment

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

- J. The Public Pension Funding Authority is the last resort before Chapter 9 bankruptcy in order to avoid a governmental functions meltdown. The stigma of Chapter 9 and its harsh consequences can be avoided by use of the Authority. The political or shortsighted views of local government in refusing or failing to fund the ARC when it has the ability to do so and the unrealistic or parochial view of government, workers or their representatives can be clarified in the sunlight of the Authority. A neutral, independent and expert authority will determine the salient facts and the local government and the government workers and their representative will either see the light or suffer the consequence of the determination of the Authority which can be enforced by state courts or Chapter 9 proceeding

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

- States Cannot Go Bankrupt but Can Repudiate Indebtedness as Sovereign
- Local Governments Need State Authorization to File a Chapter 9 Bankruptcy Proceeding (Which may already be given)
- Chapter 9 Cases Deal with Adjustment of Debt not Debt Payment
- Pension and OPEB Obligations Have No Priority and Will Be Paid After Secured Creditors
 - Statutory Liens and Revenue Bonds and Priority Creditors Are to Be Paid First
- Courts Have Allowed Alteration of Pension Benefits
 - To Rescue Failing Plan
 - To Change Unworkable Legislation
 - To Balance Rights and Interest

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

- A. Absent the use of the Pension Funding Authority the recourse to freefall Chapter 9 or state courts is uncertain and probably unsatisfactory. As noted earlier, pension plans and provisions for employee benefits should be written to permit modification, especially in the case of dire necessity or hardship to the governmental body. Absent that provision permitting modification, there may be difficulty in obtaining Court relief except for impossibility and, in addition, state constitutional provisions may prohibit any reduction in earned benefits
1. To Rescue Failing Plans. If the Pension Plan is to fail or is actuarially unsound, Courts have allowed change to provide a better outcome than uncontrolled collapse
 2. To Change Unworkable Legislation. Pension Plan base upon legislation (State or local) which does not work can and should be changed and courts have recognized the need and ability for such a change

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

3. To Balance Rights and Interests. Some Courts have attempted to balance the interest and benefits in authorizing change to Pension Plans
4. These Principles in Practice. Even states that find that their relevant contracts clauses prevent an impairment of pension rights, typically hold that adverse conditions which could lead to the failure of the pension plan and thus the purpose of the legislation itself, justify amendments to the plan. Accordingly, in Colorado, a pension plan can be changed so long as any adverse modification is balanced by a corresponding change of a beneficial nature, a change that is actuarially necessary, or a change that strengthens or improves the pension plan. *McInerney v. Public Employees' Ret. Ass'n*, 976 P2d 348, 352 (Colo. App. 1999) Similarly, in Massachusetts, modifications to a state retirement scheme can be permitted so long as such modifications are reasonable and bear some material relationship to the theory of a pension system and its successful operation. *Madden v. Contributory Retirement Appeal Board*, 729 NE2d 1095 (Mass. 2000)

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

5. Other Examples. The courts of Vermont have found that, even if a party's contract rights have been impaired, the contract clause is only violated where the impairment is not reasonable and necessary to achieve an important public purpose. Accordingly, an ordinance requiring greater contributions by employees along with increased benefits was not an impermissible impairment. *Burlington Fire Fighters' Ass'n v. City of Burlington*, 543 A.2d 686 (Vt. 1988) West Virginia has also adopted a balancing test holding that, where a substantial impairment has been shown and a legitimate public purpose for the impairment is demonstrated, a court must determine whether the adjustment of the rights and responsibilities of the contracting parties is based upon reasonable conditions and is of a character appropriate to the public purpose justifying the legislation adopted. *State ex rel. West Virginia Regional Jail & Correctional Facility Auth. v. West Virginia Inv. Mgmt. Bd.*, 508 SE2d 130 (W.Va. 1998)

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

- B. States as sovereign cannot file for bankruptcy under Federal Bankruptcy Code. States can repudiate indebtedness but examples of repudiation are rare. Retired employees could go to Court to enforce pension payments as a contract obligation recognized by State Constitutional provisions
 - 1. Any repudiation by the state of pension liabilities would be politically inappropriate and adversely affect credit assessment
 - 2. During the Depression (1930's), the inability of state and local governments to have sufficient funds to pay employees resulted in payment by script while others (bondholders) got paid in cash

VI. Can the Underfunding of Pensions for State or Local Governments Be Addressed in Court Proceedings?

3. Local governmental bodies may be authorized by state law to file for a Chapter 9 proceeding for municipal debt adjustment or, if a quasi municipal entity such as a municipal hospital or other quasi corporate entity or a conduit financing by a corporation, Chapter 11 may be available to reduce the related pension obligations
4. States as a sovereign may make use of Sovereign Debt Restructuring Mechanism (“SDRM”) such as:
 - Composition of Creditors
 - Receivership
 - Arbitration
 - Sovereign Debt Tribunal – with independence, expertise, neutrality, predictability to attempt to reach volition of the parties

VII. General Analysis of Chapter 9

- 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. Twelve States have Statutory Provisions in which the State specifically authorizes filing (AZ, AR, CA, ID, MN, MO, MT, NE, OK, SC, TX, WA), another twelve States authorize a filing conditioned on a further act of the State, an Elected Official or State entity (AL, 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.

VII. General Analysis of Chapter 9

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

12 States that specifically authorize municipal bankruptcies:

Ala. Code 1975 § 11-81-3 (For Bonds Not Warrants)
Ariz. Rev. Stat. Ann. § 35-603
Ark. Code Ann. § 14-74-103
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.

12 States that conditionally authorize municipal bankruptcies:

Cal. Gov't Code § 53760
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

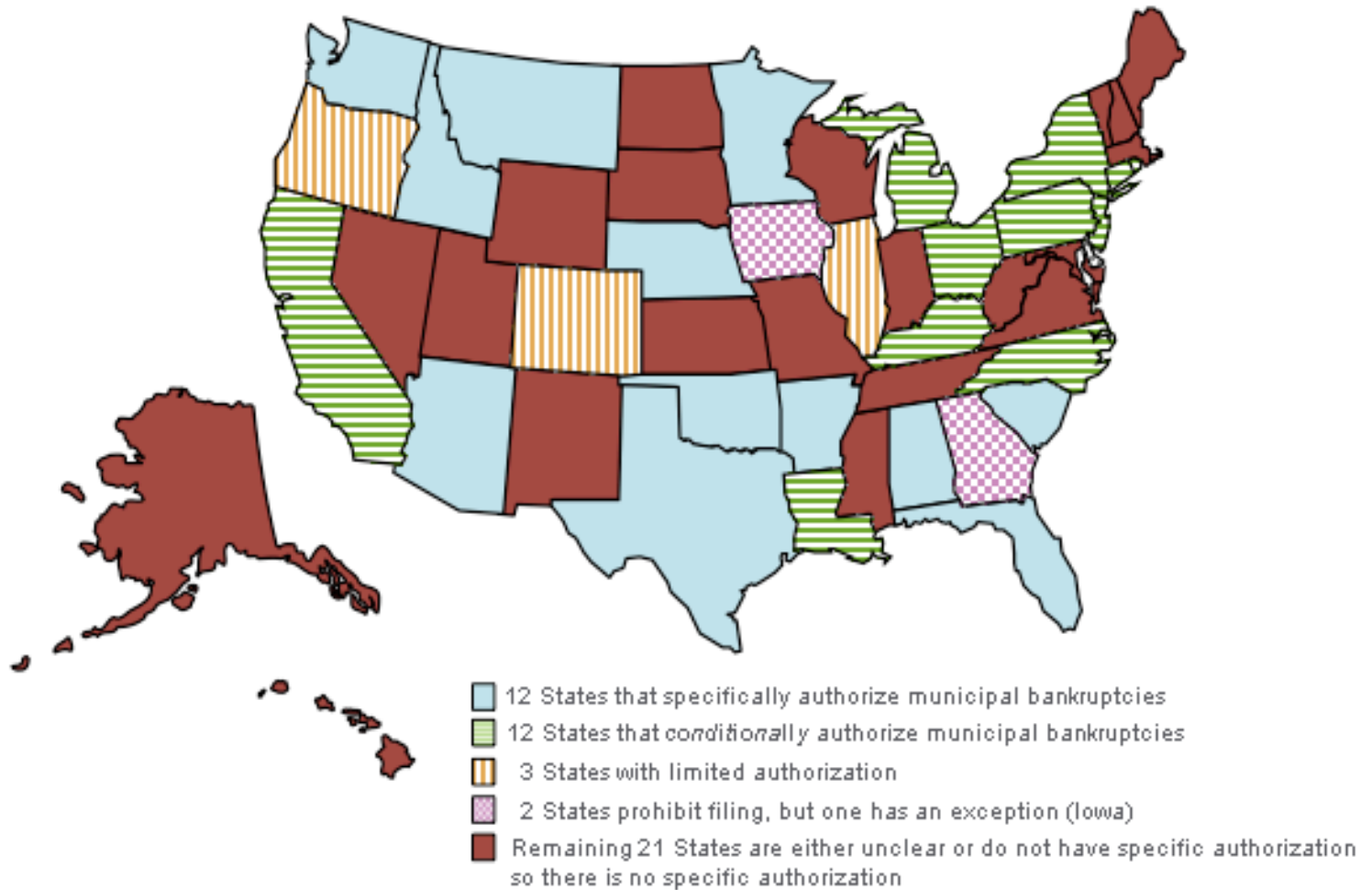
3 States with limited authorization

- 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))

2 States prohibit filing but one has an Exception

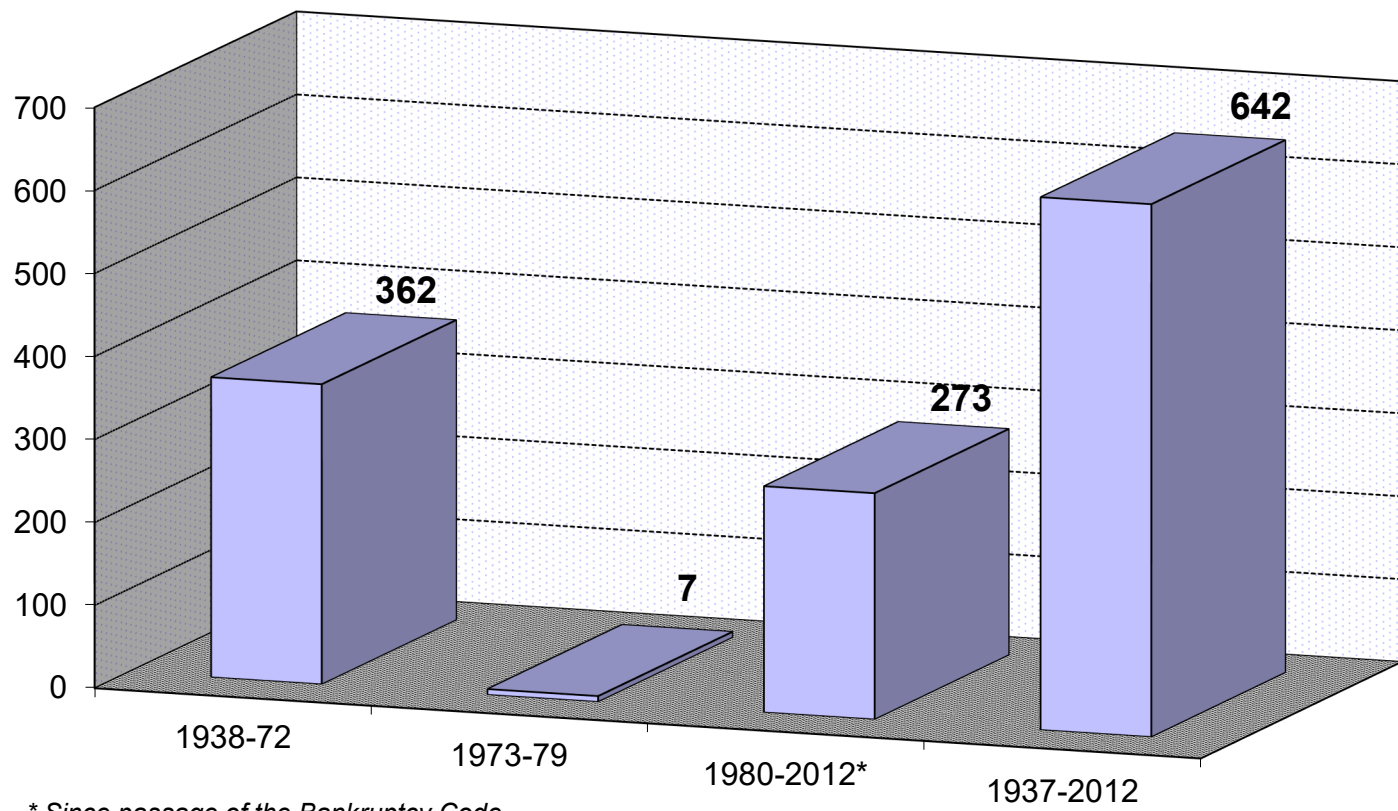
- Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)
- Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

VII. General Analysis of Chapter 9



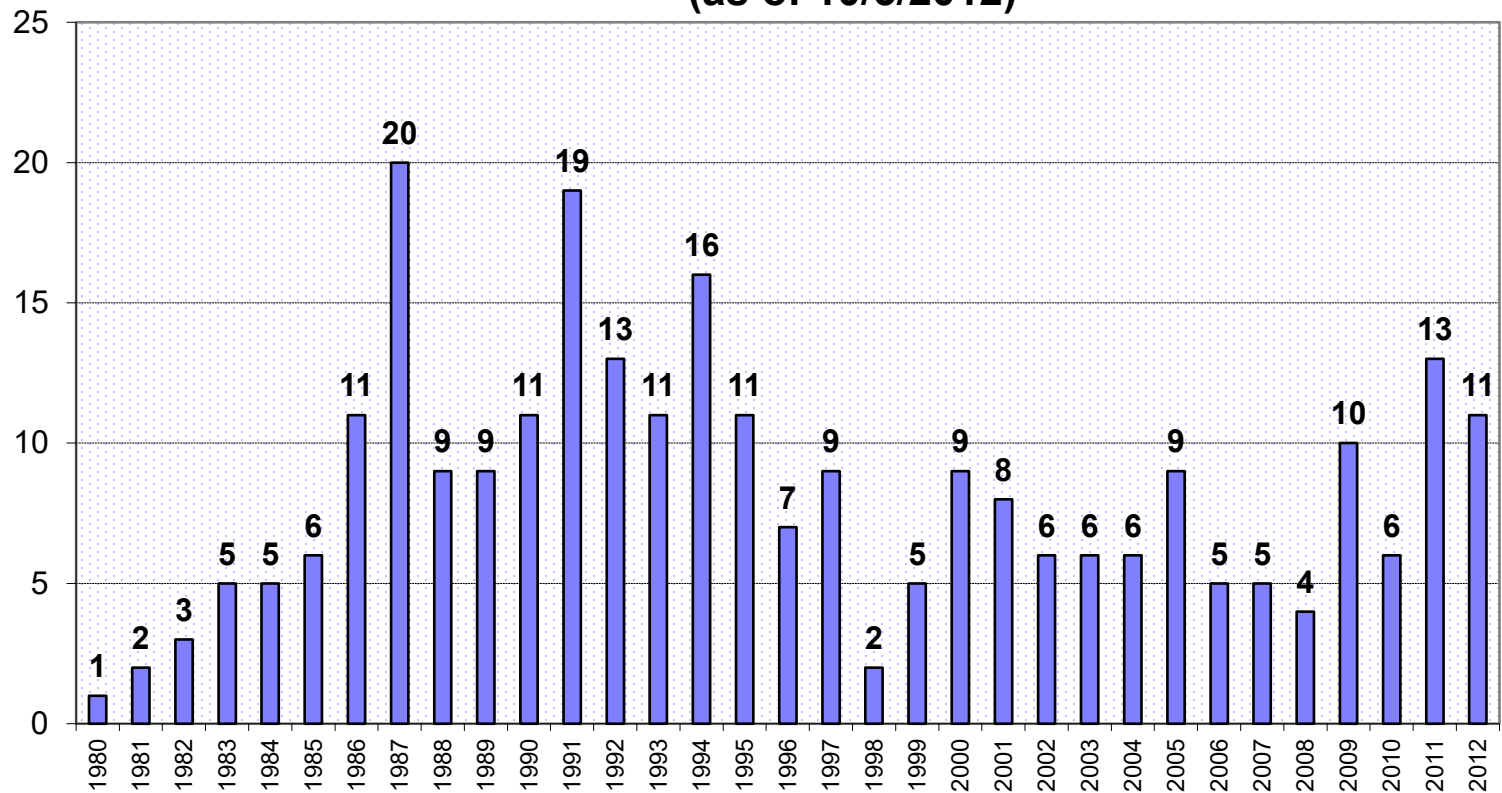
VII. General Analysis of Chapter 9

FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2012 (as of 10/5/2012)



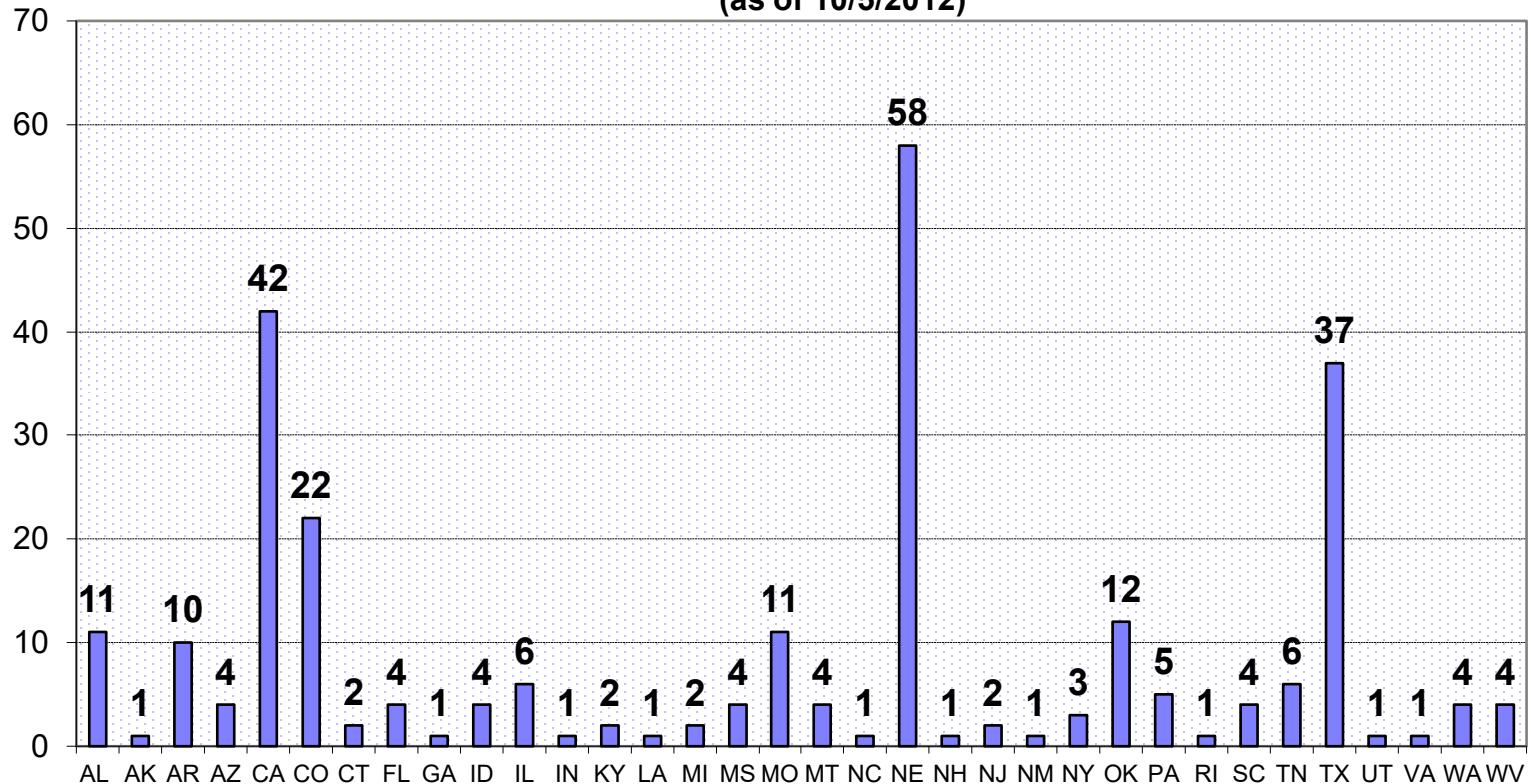
VII. General Analysis of Chapter 9

CHAPTER 9 FILINGS BY YEAR • 1980-2012
(as of 10/5/2012)



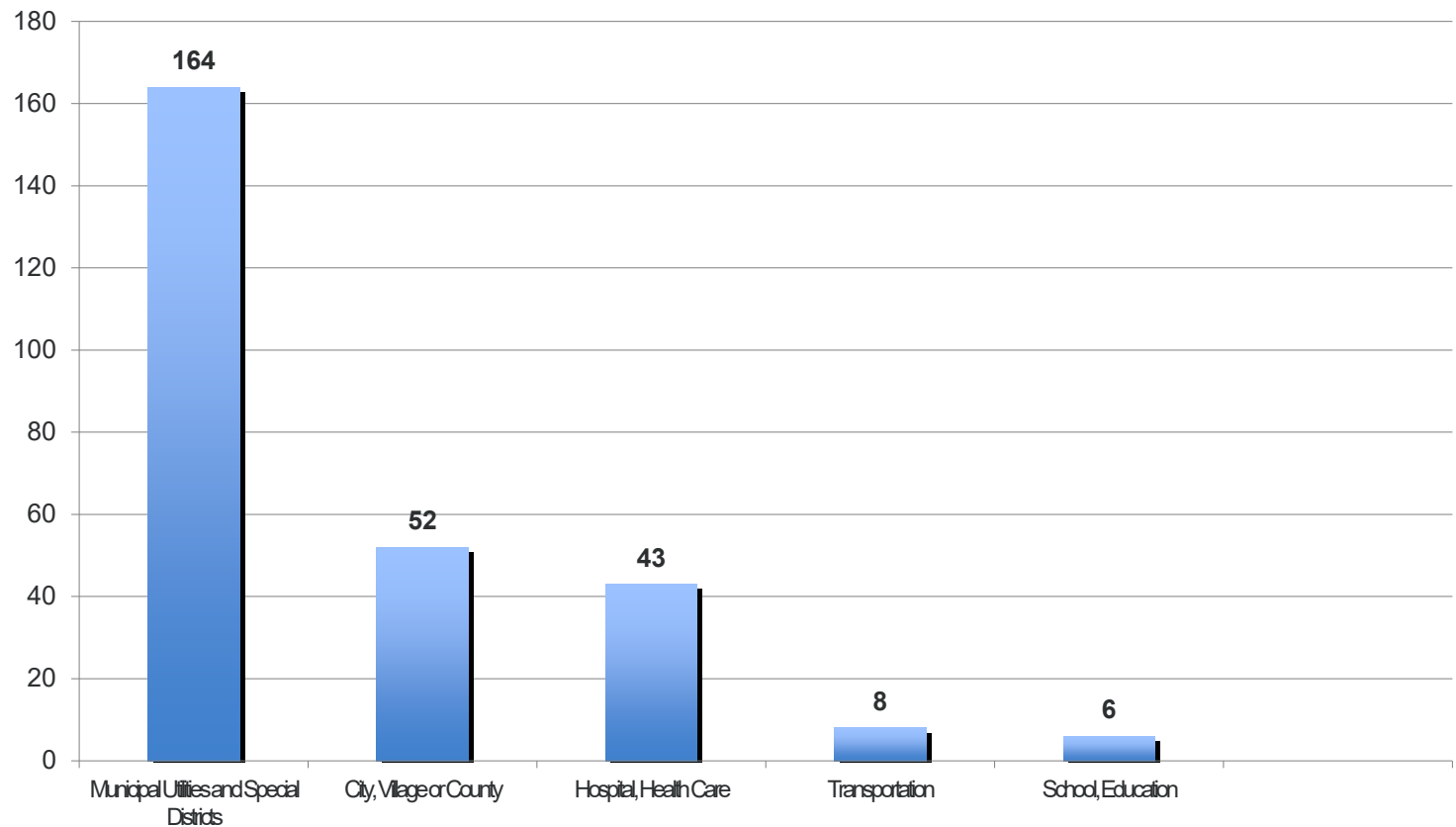
VII. General Analysis of Chapter 9

CHAPTER 9 FILINGS BY STATE • 1980-2012
(as of 10/5/2012)



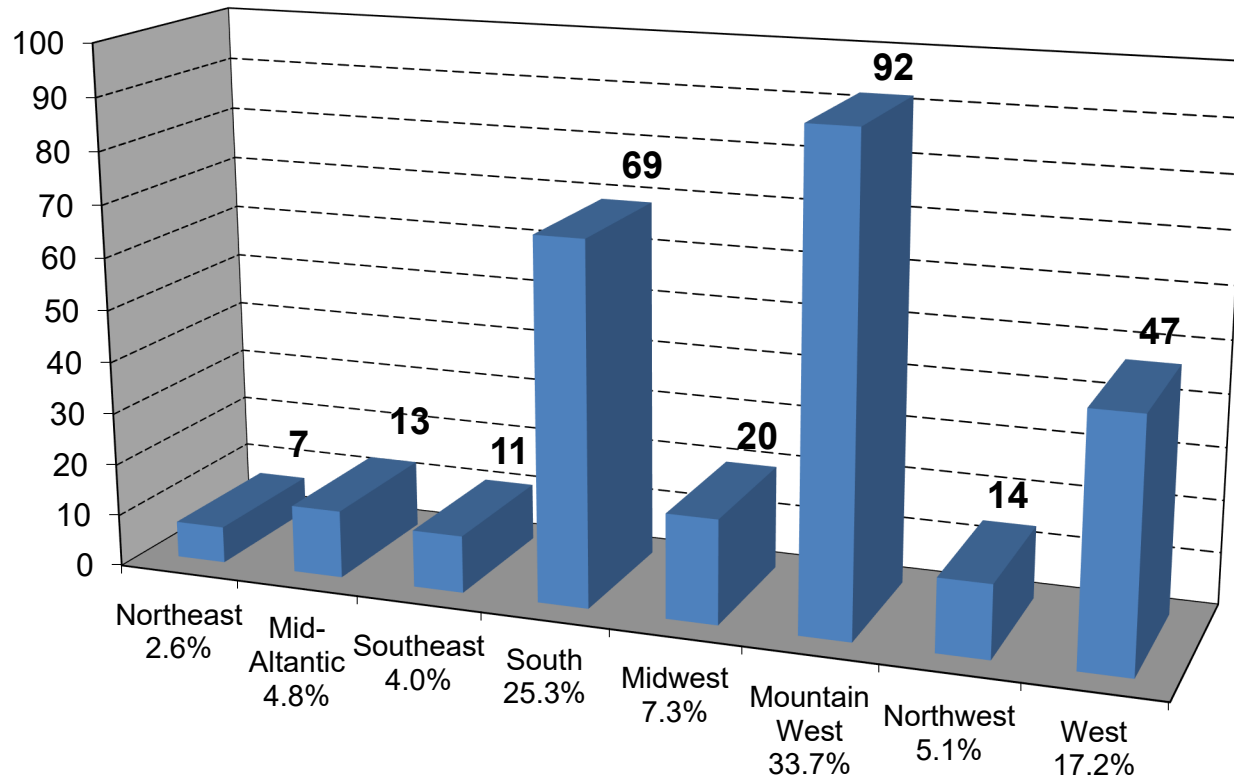
VII. General Analysis of Chapter 9

CHAPTER 9 FILINGS BY TYPE • 1980-2012 (as of 10/5/2012)



VII. General Analysis of Chapter 9

CHAPTER 9 FILINGS BY REGION • 1980-2012
(as of 10/5/2012)



VII. General Analysis of Chapter 9

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

Summary of Chapter 9 Priorities

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
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.)

b Chapter 9 incorporates Section 364(d) of the Bankruptcy Code which permits a debtor to obtain postpetition 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 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.

VII. General Analysis of Chapter 9

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
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.

VII. General Analysis of Chapter 9

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
<p>6. Unsecured Debt includes:</p> <p>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.</p> <p>B. General Obligation Bonds.</p> <p>C. Trade.</p> <p>D. Obligations for accrued but unpaid prepetition wages and pensions and other employee benefits.</p> <p>E. Unsecured portion of secured indebtedness.</p> <p>F. Subordinated Unsecured Claims.</p>	<p>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.</p> <p>Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services.^e</p> <p>These do not enjoy any priority, unlike in a Chapter 11.^f</p> <p>Any debt subordinated by statute 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 <i>pro rata</i> distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.</p>

^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 collective bargaining agreements (making the standard less restrictive, *i.e.*, “impairs ability to rehabilitate”), or Section 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.

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.

VIII. The Role of Special Revenues in Chapter 9

- 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 prepetition
- 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

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.

IX. Recent Court Test of Special Revenues/Statutory Lien Protections

- The 1988 municipal bankruptcy amendment recognizing the postpetition 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 Tenth Amendment to the U.S. Constitution reserving power to the states, the *Orange County* bankruptcy produced a decision recognizing that liens created by 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

IX. Recent Court Test of Special Revenues/Statutory Lien Protections

- However, recently the Bankruptcy Court in the Eastern District of California has 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

IX. Recent Court Test of Special Revenues/Statutory Lien Protections

- 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, 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

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

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

TYPE OF BONDS/NOTES	BANKRUPTCY EFFECTS
General Obligation Bonds	<p>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.</p> <p>Prepetition, 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.</p>
General Obligation Bonds plus Pledged Revenues	<p>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 postpetition 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.</p>
Special Revenue Bonds	<p>A pledge on special revenue bonds will survive a bankruptcy filing.</p> <p>Prepetition, 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.</p>
Revenues subject to Statutory Lien	<p>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 postpetition.</p>

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.

XI. Other Issues in Chapter 9

Labor Issues

- 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

Non-Bonded Debt or Contracts

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

Priming of Bonded Debt by

- Necessary operating expenses

Priming of Unsecured Debt by

- Administrative claims

Duration of Chapter 9

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

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

No Priority for Pension and OPEB Obligations

Behind Secured Creditors – Statutory Lien, Revenue Bonds and Priority Claims

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

- A. A Chapter 9 proceeding deals with municipal debt adjustment and is and should be the absolute last resort for a municipality
 - 1. There have been only approximately 642 Chapter 9 proceedings since 1937 (362 between 1937-1972, 7 between 1973-1979, 273 between 1980-2012). The cases between 1937 and 1972 involved only \$217 million of debt of which \$140 million plus was repaid. Since 1937, 170 of the 642 cases were dismissed or closed without a plan of adjustment being confirmed
 - 2. Generally, only small special purpose tax districts or smaller municipalities file as a last resort but there are exceptions, e.g., Orange County 1994, Bridgeport 1991, etc.
 - 3. It should be a very dire situation that would be a predicate for a municipality's filing of a Chapter 9 to deal with pension obligations

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

- B. Unlike a Chapter 7 or 11 proceeding for corporations, in a Chapter 9 there are:
1. No priority for wages, pensions or insurance benefits over general unsecured claims. In Chapter 7 or 11, under § 507(a)(4) and (5), \$11,725 per employee priority for amounts earned but not made within 180 days of the filing of bankruptcy
 2. No provision for special standard and hearing before there can be a modification of labor contract. There is no requirement for a determination after hearing that modification or rejection is so necessary to reorganization that without such modification a reorganization would not be possible. In a Chapter 9, a labor contract can be modified or rejected based upon business judgment that, balancing the hardship of rejection or reduction in benefits, is outweighed by likelihood of “liquidation.” For municipality, liquidation is unlikely even though continued municipal operation may be threatened

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

3. No requirement on the municipality to supply sufficient information sharing with employees or unions in order to reject or modify pension or OPEB. Section 1113 and 1114 of Bankruptcy Code are not part of Chapter 9 authorization
4. Accordingly, in Chapter 9, pension benefits and OPEBs receive no special treatment (unlike corporations in Chapter 11) and will be treated and adjusted just like other unsecured obligations
5. Special revenue bonds, interest payments on bonds (prepetition) and statutory liens in favor of bonds and notes shall all be paid prior to unsecured claims including pension benefits and OPEBs without any priority

XII. Treatment of Pension and OPEB Liabilities in Chapter 9 Proceedings

6. Workers and unions might make a constitutional challenge to a Bankruptcy Court's authority to adjust pension benefits asserting that adjustment of pension benefits or OPEBs obligations is unconstitutional. While Sections 903 and 904 of the Bankruptcy Code reserve state power to control municipalities and the Bankruptcy Court has no authority over political or governmental powers of a municipality or its property, revenues or the use and the enjoyment thereof, the Bankruptcy Court in a Chapter 9 has the power to approve a Plan of Debt Adjustment that deals with all contractual obligations. Accordingly, state constitutional provisions regarding pensions are contractual obligations that cannot unilaterally be eliminated or diminished by the municipality. However, this would not appear to prohibit the Bankruptcy Court from approving a Plan of Debt Adjustment in a Chapter 9 if it is specifically authorized by the state or the state/local government, through receivership or oversight authority, may "discharge" that portion of the funded pension liabilities that cannot be paid and still have funds to provide essential governmental services. See *Ashbury Park* case and the *U.S. Trust* case

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

- A. \$11,725* per Employee Priority Claim Ahead of Unsecured Creditors for Wage, Pension and Health Care Claims Accrued and Unpaid 180 Days Prior to Filing (To be adjusted periodically pursuant to Section 104)
- B. Procedures for Information Sharing and Required Court Hearings to Terminate Union Contracts and Pension and Retirees Benefits
 - To modify as necessary for a Plan of Reorganization or balance of the equities and assure that all creditors are treated fairly and equally (§ § 1113 and 1114 of Bankruptcy Code)

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

- C. There are special priorities and provisions governing labor agreements, pensions and OPEBs and the modification of such
 - 1. Section 1113 of the Bankruptcy Code deals with the standard for rejection and requires a Court hearing after sharing of all relevant information by the corporation with the unions or employees. The Labor Agreements could not be modified without a Court determination after hearing that reorganization is not possible without modification of the labor contract

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

2. Section 1114 of the Bankruptcy Code provides for a retiree committee and representatives to be appointed to represent the interests of retirees for medical and health care benefits and any modification of existing contracts and benefits can only be done after appointment of the committee and representatives. Modification of medical and health care benefits is permitted when there is a failure of negotiations to obtain a resolution and a Court hearing and determination by the Court that the modification is fair and equitable and the reorganization of the Debtor is not possible without such modification
3. Priority for pension and health care benefits payment not made within 180 days of filing bankruptcy under Section 507(a)(4) and (5) which provides up to \$11,725 per employee priority for wages, sick leave, pension and health care payments earned but not paid during 180 days prior to filing

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

D. Process for Terminating Pension Plan

1. Corporate pension plans are employer-sponsored pension plan statutorily vested under ERISA. Municipal and state pension plans are not covered by ERISA but private corporations and “non-municipal” public companies such as private hospitals, could be covered by ERISA
2. ERISA provides for 3 types of terminations
 - voluntary standard - plan fully funded
 - voluntary distress - plan underfunded
 - involuntary termination - PBGC implemented
3. Any voluntary termination must satisfy certain notice, disclosure and other procedures under ERISA and Bankruptcy Court approval of contract modification

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

4. If union is involved under Section 1113 of the Bankruptcy Code, the termination must have the consent of the union
5. Alternatives to termination of pension plan
 - IRS funding waiver (generally limited to 2 years)
 - Plan “freezing” benefits and contribution
 - Restoration of funding
6. The debtor employer must proceed with 3 concurrent processes
 - Initiate distress termination proceedings in Bankruptcy Court
 - Proceed with negotiations and PBGC administrative process
 - Administrative filings, disclosures and backup material
 - Formal and informal negotiations with PBGC
 - 60 to 90 day notice to all affected parties of proposed termination
 - Administrative review by PBGC upon requisite findings by Court
 - Section 1113 proposal, disclosure, negotiations and rejection/modification process, as noted above

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

E. Overview of PBGC Claim in Bankruptcy

1. PBGC has two major and somewhat overlapping claims against bankruptcy sponsors of pension plans, namely:
 - “Plan Asset I Plan” (it amounts to the difference between the value of pension plan assets at the time of termination and the value of the pension plan vested obligations to its participants)
 - “Unpaid Funding Contributions” claims which may be a subset of the prior claim
 - In addition, the PBGC sometimes files “premium claims”
 - (PBGC’s premium payment regulation requires payments by plan sponsors for the plan year in which termination of an underfunded plan is initiated and for each year thereafter until the plan is terminated and the “insufficiency” claim arising on termination of a pension)

XIII. Treatment of Pension and OPEB Liabilities in Chapter 11 Proceedings

2. ERISA Lien – Section 4068 of ERISA creates a lien in favor of PBGC upon all property of any employer who does not pay an obligation arising from unfunded benefit liabilities to the PBGC under ERISA Section 4062-64
 - Lien cannot exceed 30% of collective net worth of the employer
 - Tax priority if lien not perfected prior to bankruptcy filing up to 30% of the net worth of Debtor
 - PBGC has asserted that if pension plan is terminated prepetition (and the PBGC's lien is not perfected), PBGC asserts an eighth priority under § 507(a)(8) of the Bankruptcy Code. Also, PBGC has asserted administrative claim ahead of general unsecured debt payment to the extent the employer's termination liability in excess of 30% net worth increased after filing bankruptcy petition and before pension plan termination. Courts have generally not recognized these PBGC asserted claims as priority or administrative claims and treated them as general unsecured claims

XIV. Conclusion

- The definition of insanity is doing the same thing over and over again and expecting a different result
- The pension underfunding crisis has reached a level of insanity – it is now time for a change, adult supervision and hard determination of what is affordable and what is not
- The use of Public Pension Funding Authorities can provide a determination of the critical issues and a voluntary and, if necessary, mandatory mechanism of resolving pension underfunding as a permanent fix to pay annually affordable actuarially required contributions (payments) that do not compromise the ability to provide essential governmental services

This document has been prepared by Chapman and Cutler LLP attorneys for informational purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. Accordingly, readers should consult with, and seek the advice of, their own counsel with respect to any individual situation that involves the material contained in this document, the application of such material to their specific circumstances, or any questions relating to their own affairs that may be raised by such material.

© 2012 Chapman and Cutler LLP