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FIELD HEARING ON THE STATE OF THE MUNICIPAL SECURITIES MARKET

DISTRESSED COMMUNITIES

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Selected portions of these remarks are taken from the Chapman and Cutler LLP study *State Laws Dealing with Financial Emergencies of Local Governments (50-State Survey of Rights and Remedies Provided by States to Investors in Financially Distressed Local Government Debt and State Authorization of Municipalities to File Chapter 9 Bankruptcy)* © 2011 All Rights Reserved

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I. INTRODUCTION

A. The Disclosure Issues Presented by Municipal Bankruptcy.

The question of disclosure has always been a matter of importance in the issuance of securities in any market. The better, the clearer, the more accurate the disclosure, the more efficient and effective the market will be. An important reason for requiring adequate disclosure is to level the playing field and insure transparency so that investors are on equal footing with respect to the basics of the transaction. Recently, the municipal market was shaken by isolated predictions of unusually high municipal defaults to come. Individual investors who sold into a down market because of those predictions may have suffered a loss that they would not have experienced had they been more fully informed. Normally, it is the more unsophisticated investors, who have not had the financial experience and information available to them, who have difficulty evaluating these types of warnings and predictions for the future. Ideally, with clearer disclosure the individual investor will be better able to evaluate the securities and events that impact them.

With regard to state and local government debt financing, there are a number of different, relevant provisions concerning what may happen if the municipality faces significant financial distress: whether Chapter 9 bankruptcy is authorized by the state, what rights and remedies the investors may have, what options the municipality will possess and what additional support may be available from the state or others to help avoid a financial meltdown.

In this regard, it would be helpful to disclose or have information generally available to investors (including retail) as to whether the state in which the municipal issuer is located is one that authorizes its municipalities to file for bankruptcy. As will be noted herein, only 13 states specifically authorize a bankruptcy filing, another 11 states have conditional authorization, 3 states have limited authorization, 2 states generally prohibit a filing and the remaining 21 states provide no authorization for a municipal bankruptcy filing at this time. Such disclosure may

allow the investor to determine that the issuance of municipal securities by a local governmental body may not be subject to the threat of a Chapter 9 proceeding unless the state legislature further acts. Therefore, the security may be viewed as a stronger credit or one less likely to present difficulties as far as a threat of a Chapter 9 bankruptcy proceeding. In addition, the Bankruptcy Code and case law support the principle that certain state and local government bond and note issues are exempt from any interference or impairment upon the filing of a Chapter 9 and are protected such that there is the assurance that bonds and notes should continue to be paid from the pledged revenues so collected pursuant to their terms. Disclosure of these characteristics of a new issuance could obviously add to its attractiveness to investors.

Provision for special revenues was added by the Bankruptcy Code Amendments in 1988 to enhance the ability of municipalities to borrow in times of distress with the assurance that the pledge of revenues and taxes would be, as collected, paid to the bondholders. This is to ensure that municipalities, at the time of economic difficulties, will have access to the market without creating fear in the investor that the pledge of revenues could be voided by a Chapter 9 filing. Further, certain state statutes create a pledge, often of taxes, in favor of the municipal bondholders and mandate that pledged tax revenues as collected be paid to the bondholders or the bond trustee without any bankruptcy court impairment or interference. Post-filing, any tax revenues collected that are so pledged as statutory liens or as special revenues and dedicated to the payment of the bondholders should be paid to those bondholders in a Chapter 9. Further, the bankruptcy court in the case of the special revenues and statutory liens cannot, by reason of the bankruptcy, impair post-petition the lien on the revenues so collected. This is unlike the situation in a corporate bankruptcy, where the liens on accounts receivable and inventory created post-petition typically are not available to a pre-petition secured lender of accounts receivable and inventory and where the pre-petition lien terminates on the petition date.

B. Disclosure of Other Rights and Remedies.

It may also be helpful to disclose the rights and remedies available to investors (bondholders and noteholders) upon default, which vary from state to state, based upon state statutes. Disclosure of the ability to refinance or refund, the availability of oversight by a state refinance or oversight authority or financial control board, the availability of intergovernment cooperation, loans and grants, mandamus actions to raise taxes, the right to have a receiver appointed and other provisions may assist the bondholder assess the risk of nonpayment or delay in payment given financial difficulties of the state or local government.

Accordingly, the further articulation of what rights and remedies investors have and what alternatives the state and local government may have should be encouraged. Disclosure of the authorization to file bankruptcy or the fact that any pledge of taxes or revenues is intended as special revenues or is subject to a statutory lien which will not be impaired or adversely affected in bankruptcy would be useful. As previously noted, the rights and remedies of the bondholders, the availability of refinance authorities, oversight authorities, financial control boards, or receivers to assist, the ability to have intergovernment cooperation or help from the state, the possibility to obtain loans and grants and the authority to refund or have taxes raised by mandamus may be important. In fact, disclosure of the availability of these remedies may very well help the municipality or the state articulate the reasons why certain bonds should be viewed by the investing public and assessed in a way that would lower the cost because the risks to the investors have been reduced. Likewise, disclosures of the absence of certain of these elements may increase the risk and therefore the price. However, such disclosures may be significant information for both the retail and institutional investor as would be a clear statement as to what the issuing parties intended and what effect any adverse economic downturn may have on the bond debt.

C. Collective Action Clauses.

In times of economic distress, states and local governments are required to deal with less revenue yet must continue to provide the essential services their governmental mission requires. It is in these times that the lack of sufficient funds may create a situation where the state or local government requires a bridge to better financial times. This is generally done through a combination of budget cuts, increases in taxes, bridge financing and the refinancing, refunding or restructuring of obligations. In doing so, the issuer may want to consider whether, if the existing documents do not adequately deal with the unforeseen circumstances, there should be some changes to the original structure of its specific obligations which, if an appropriate percentage of holders approved, would allow the issuer to refund or refinance the bonds in order to maximize the value to the holders and to effectuate a better structured transaction for the municipality given its new financial reality without impairing the benefit of the bargain.

This presents the question of whether collective action clauses should be included in bond ordinances and resolutions or made a part of the laws authorizing state and local government debt financing. A collective action provision would allow the issuer to change some of the essential terms of an existing debt financing in connection with an exchange, refunding or refinancing after a group of bondholders, possibly approved by the court as being appropriate representatives of all the bondholders, after being fully informed, negotiate and reach a resolution. This resolution would then be approved by a court permitting the restructuring or refunding of the transaction and possibly some of the cash flow in order to maximize the benefits to the municipality or state and its debt holders. Thus, the procedure would be akin to the process under Section 3(a)(10) of the Securities Act of 1933 in which a default under the corporate transaction is resolved by an exchange for new securities found to be fair by a court of competent jurisdiction. Confidentiality provisions for financial information provided to the

bondholder representatives that would restrict the representatives for a determined period and burn off so there is no penalty in acting as a bondholder representative may be desirable. Given state and local governments' continuing desire to make sure that their access to the capital markets is confirmed, it is important that any such court- and bondholder-approved changes, which would be binding on all holders, can be done in a manner that reaffirms the issuer's dedication to maintaining access to the market at a low cost without limiting the ability for future borrowings.¹

As has been noted, state and local governments generally will do whatever necessary to pay their bond debt because of their desire to have access to the bond market at a low, below interest cost. In this way, the state or local government body can insure that it can make its own decisions as to infrastructure improvements, essential governmental services, roads, bridges, schools, sewer systems and water systems on a local basis. This contrasts with the requirement for virtually every other subsovereign in the world, other than in the United States, to petition the central government for some support or approval. This ability of state and local governments to make decisions on the local level has helped create the largest economy with the best infrastructure system in the world. While we need to continue to maintain and to grow and improve that infrastructure, local decisions made by local governmental bodies and states will best be able to bring about the needed results. The question of collective action clauses is one that has been raised in various sovereign debt restructurings, including most recently in the European Union.² Generally, in the U.S., such clauses have been disfavored by the market and

¹ The real issue is whether the proposed modification to the documents denies to the holders the benefit of the bargain or whether the proposed change is designed to maximize value and clarifies technical language to refund, refinance or refund the securities.

² The restructuring models utilized by sovereigns is instructive. See, Patrick Bolton, "Toward a Statutory Approach to Sovereign Debt Restructuring: Lessons from Corporate Bankruptcy Practice Around the World," IMF Staff Papers, 50 (2003); Randall Dodd, "Sovereign Debt Restructuring," The Financier, 9 (2002); John Murray Brown, "Europe Signs up to Irish Rescue," Financial Times (November 21, 2010) available at <http://www.FT.com/cms/s/o/9338047c-f5a0-11df-99d6-00144feab49a.html>.

by institutional holders. However, some additional freedom for the issuer to deal with large groups of retail and institutional holders in a way that can permit the restructuring or modification of payments consistent with the new economic reality may make sense. It is certainly something to explore, assuming the provision can be used in a constructive way in conjunction with refinancings or refundings and not as a means of escaping financial responsibility or denying the benefit of the bargain.

D. The Unique Challenges of Municipal Disclosure.

The health and vitality of the municipal bond market is of importance to all Americans. As noted by Linda Chatman Thomsen, the Director of the SEC's Enforcement Division, in announcing sanctions against the City of San Diego for fraudulent municipal bond offerings, "American investors trust municipal bonds as they do few other investments. With over \$2.2 trillion in municipal securities outstanding – two-thirds of which are held by individual investors – municipal bonds are a vitally important segment of our nation's securities market." Nevertheless, as we know, the municipal securities market is characterized by the absence of any formal administrative framework for required content of new issue disclosure. "Issuers and investment bankers have each come to acknowledge their disclosure responsibilities but are still grappling with how to carry them out in a market which relies largely on voluntary guidelines and reflects little economic consequence to exemplary versus inadequate disclosure practices." American Bar Association, Section of Urban, State and Local Government Law, *Disclosure Roles of Counsel in State and Local Government Securities Offerings*, 2nd Ed (1994) at 1. As a consequence, "in the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by the demands of market participants and anti-fraud strictures." SEC Release Nos. 33-7049 and 34-33741, available March 9, 1994, at 6 (the "1994 Interpretative Release").

The adequacy of disclosure provided in municipal security offering materials is tested under federal securities laws against an objective standard: an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable investor. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

1994 Interpretive Release, p. 10-11. Municipal practitioners recognize that the SEC has developed a body of case law, litigation releases, orders and investigative reports that assists in highlighting areas in which the SEC has found disclosure to be deficient. Thus, the SEC's action with respect to Orange County and its failure to disclose information with respect to the investment strategy of the investment pools; with respect to Maricopa County, Arizona, and the failure of the county to disclose that it had developed a deficit in its general fund and that the proceeds of the bonds would be used to finance an operating deficit; and the failure of the City of Miami to disclose that ever-growing deficits were masked by transfers from other funds and the use of bond proceeds have highlighted some of the more dramatic failures to disclose material information.

Developing standards for the disclosure of information which, while not necessarily determinative of an investment decision, is conducive to a thriving municipal bond market, becomes more difficult. In the absence of specifically described disclosure requirements, industry groups such as the National Federation of Municipal Analysts, the Government Finance Officers Association, the Securities Industry Financial Markets Association and others have, from time to time, issued recommended guidelines to help establish market standards for the content and timing of disclosure. Furthermore, the market itself has frequently mandated certain disclosures. For example, in order to facilitate the sale and liquidity of their bonds, healthcare, housing and student loan issuers often have agreed to provide quarterly financial statements. Indeed, one of the recommendations of the SEC White Paper in 2007 (Securities and Exchange Commission, Staff Report on the Disclosure and Accounting Practices in the Municipal Securities Market (July 26, 2007)) was that issuers of municipal securities establish policies and procedures for disclosure appropriate for the particular issuer.

It is respectfully suggested that, in order to facilitate the sale, liquidity and acceptance of municipal bonds generally, consideration of additional disclosure should be considered with respect to state laws dealing with financial emergencies of local government. While basic disclosure sets a floor, there may be additional disclosure that may or may not be viewed as required, but may be extremely helpful to the investor and the issuing governmental body. Particularly in this time of financial distress for many municipalities, disclosure with respect to the ability of the issuer to be a debtor under Chapter 9 of the Bankruptcy Code governing municipalities, other debt resolution mechanisms applicable to the issuer and the anticipated treatment of the securities in question in a Chapter 9 proceeding may be valuable to be disclosed. Specifically, if the structure of the transaction includes special revenues pledged to bondholders which, under the Bankruptcy Code, survive the filing of a Chapter 9 petition or if such structure is based upon a statutory lien that is similarly protected, it may make a difference to investors and impact pricing. This disclosure can only enhance the marketability of the securities. Whether and the extent to which it should be required as opposed to encouraged is a matter for future discussion.

E. The Chapman and Cutler Study.³

Chapman and Cutler LLP is about to release its 50 state survey of rights and remedies provided by states to investors in financially distressed local government debt and state authorization of municipalities to file Chapter 9 bankruptcy. We sought to provide a compilation of various state laws and constitutional provisions relating to rights, remedies, refinancing, refunding and restructuring mechanisms provided by the 50 states, the District of Columbia and Puerto Rico. This compilation reveals the individual creativity of various states to develop for themselves, given their unique situation and issues, methods of addressing state and local

³ The author acknowledges the invaluable assistance of his colleagues at the firm, especially Laura Appleby and Ann Acker, in making this study a reality.

government financial distress. It is not intended to be exhaustive, given the dynamics of our legislative process, and these rights, remedies and restructuring mechanisms are still evolving and changing. It is our hope that this presentation will be beneficial not only to the bond investors, but also to the states and local governments in considering what should be disclosed and whether or not they should revisit some of these issues so that they have the most effective rights, remedies and mechanisms to address any financial distress they may suffer in the future. Moreover, an analysis of options available will assist issuers in developing standards for disclosure. It also is intended to help bondholders, rating agencies, institutional investors and funds assess more effectively the issues relating to state and local government debt financing and steps that can be taken to arm the market with information necessary to analyze the strength of a particular security. It is meant to aid the discussion of further disclosure and provide additional information for that discussion.

In these times of severe economic difficulties, obviously information relating to whether municipalities will be able to pay the principal and interest owed on long-term obligations must be provided. However, the current lack of clarity as to the rights of bondholders and remedies available in the event of a municipal default limits the exploration of various alternatives. While investors may express great concern that a municipality will unilaterally file a municipal bankruptcy petition under Chapter 9 of the U.S. Bankruptcy Code without any attempts to work with investors in restructuring debt, in reality the states have enacted a plethora of laws to help rehabilitate municipalities before they reach such an untenable position. As a last resort, should such restructurings fail, and only in certain states, a municipality could pursue a municipal restructuring under the U.S. Bankruptcy Code. Rarely have municipalities filed for Chapter 9.⁴

⁴ See the charts regarding municipal bankruptcy attached as Appendix A. Since 1937 only 624 filings have occurred, and since 1980 only 253 Chapter 9 petitions have been filed as of June 30, 2011. For the most part, these 253 Chapter 9 petitions were filed by small special tax districts and few, if any, municipalities of any size. States, to date, cannot file for Chapter 9 protection. *See Jim Spiotto Speaks Before House Judiciary*

The adequate disclosure of such facts can only benefit all municipal issuers. For instance, states have enacted statutory provisions waiving sovereign rights in connection with financings to assure bondholders that if they purchase the revenue bonds of municipalities within these states, the pledge of revenue to the bondholders cannot be diverted or terminated.⁵ These statutory provisions were not only for the bondholders but also for the citizens of the state so that by providing assurance to bond investors of adequate remedies, all municipalities could make use of municipal bond financing when necessary.

It is true that currently municipalities both large and small are facing severe economic hardship. Ironically, during times of financial crisis, a municipality needs the support of the municipal bond market. As was recognized by one scholar in examining municipal defaults during the Great Depression:

It must also be remembered that drastic enforcement of claims for debt service may be to the detriment of bondholders in the long run. A city that suffers a breakdown in governmental services is apt to become less attractive to prospective residents and new industries. Progress is retarded, and the growth that would eventually have restored the city to a sound financial basis

Subcommittee on State Bankruptcy Proposal and Testimony of James E. Spiotto, Hearing on the Role of Public Employee Pensions in Contributing to State's Insolvency and the Possibility of a State Bankruptcy Chapter before the House Judiciary Committee's Subcommittee on Courts, Commercial and Administrative Law, available at <http://judiciary.house.gov/hearings/pdf/Spiotto02142011.pdf> (Feb. 14, 2011). See Appendix B.

⁵ As will be discussed, *infra*, most states have statutory provisions authorizing the pledge of revenues for the payment of certain bond indebtedness and disallow the revenues so pledged from being diverted or used for purposes other than first making the required payment on bond indebtedness. See, e.g., CAL. EDUC. CODE § 1525.

With respect to the states, some speculate that the U.S. Supreme Court is moving closer to establishing greater limitations on the federal government's ability to interfere with the internal governance of the states – states' rights. See *Virginia Office for Prot. & Advocacy v. Stewart*, 131 S.Ct. 1632 (2011) (Roberts, J. dissenting; Kennedy, J. concurring).

becomes stunted. The bondholder's best interests lie in a going concern.⁶

The well-developed truth is that there is a symbiotic relationship between bondholders being paid and state and local governments being able to maintain infrastructure and offer services. Failure to pay bondholders equates either to increased borrowing costs or to denial of access to the capital market, which generates less substantive and affordable services. In addition to the support of the municipal bond market, a troubled municipality may need the support of its state's laws to help guide it through severe economic hardship.

F. The Purpose of this Presentation.⁷

These materials will first provide a general overview of the municipal bond climate and examine those mechanisms that states have enacted to remedy financial distress and an evolving default situation. In virtually all states, some form of a limitation on debt, tax or a combination of both have been enacted to limit the amount of debt that a municipality may hold at any one time. In addition, all states recognize refunding bond provisions, which may aid municipalities in simply "refunding" or "refinancing" a default away. At some point, however, issuing refunding bonds may no longer be the effective answer to a municipality's financial situation.

In addition to these mechanisms that may help protect a municipality from entering a default situation (financial oversight, financial control boards, intergovernmental cooperation, local government cooperation and others), certain states have enacted debt resolution provisions to help aid troubled municipalities in developing a plan for paying their debts. The next section will discuss those provisions. In addition to these debt resolution provisions, many states contain provisions explicitly setting forth remedies for bondholders in a default situation. While many of

⁶ A.M. Hillhouse, MUNICIPAL BONDS: A CENTURY OF EXPERIENCE at 362 (1936).

⁷ The author acknowledges the invaluable assistance of his colleagues at the firm, especially Laura Appleby and Ann Acker, in making this study a reality.

these remedies are available for holders of revenue bonds and not general obligation debt, the availability of such remedies may be important to any municipal investor and will be addressed herein. Examples of such remedies include actions for mandamus, suits to force the payment of debt, suits for declaratory relief, suits to appoint a receiver and suits for injunctive relief. Although not within the scope of these materials, bondholders may also seek relief under the federal securities laws with respect to actions based in securities fraud and may bring state law fraud and negligent misrepresentation claims.⁸

Next, the effect of Chapter 9 of the U.S. Bankruptcy Code on the payment to bondholders will be reviewed. Filing under Chapter 9 of the U.S. Bankruptcy Code can be an alternative from municipalities from which the market does not shrink, provided that the principles and practical realities of municipal financing are not disturbed. These materials will analyze the viability of Chapter 9 as the last resort for municipalities.⁹ While state authorization is required and not all states authorize their municipalities to file a municipal bankruptcy petition, municipal bankruptcy could be a powerful tool for municipalities on the brink of disaster to restructure their debt. Along with a general overview of the municipal bankruptcy provisions of the U.S. Bankruptcy Code, these materials will pay particular attention to provisions allowing for the continued payment of two types of bond issuances – special revenue bonds and bonds to which a statutory lien applies – even after a municipal bankruptcy filing has occurred.

⁸ For a more detailed discussion of such claims and available remedies, see James E. Spiotto, *Municipal Insolvency: Bankruptcy, Receivership, Workouts and Alternative Remedies*, in STATE & LOCAL GOVERNMENT DEBT FINANCING, ch. 13 (M. David Gelfand, ed. 2004).

⁹ See Exhibit B. Of the states, 13 states allow their municipalities to file Chapter 9 petitions; 11 states place conditions on the filing by municipalities; 3 states include limitations; and 2 states prohibit such a filing, although one prohibiting state provides an exception to its prohibition. The remaining 21 states are either unclear or do not have specific authorization. Without specific authorization from the state, a municipality may not file a petition under the U.S. Bankruptcy Code. The District of Columbia and Puerto Rico are not authorized to make use of Chapter 9 and are not “municipalities” as defined in the U.S. Bankruptcy Code.

As will be clear from these pages, while certain general themes are evident across state lines, the laws of the states addressing issues of municipal insolvency are a tangled web of provisions that even internally in a state cross constitutional and statutory provisions. The disclosure of the provisions applicable to a particular debt offering will bring a better understanding to the municipal marketplace of the rights and remedies available to bondholders in the unlikely event that a municipality defaults on a debt issuance. As a result, investors will be better able to evaluate the strength of the debt.

II. THE IMPORTANCE OF DEALING EFFECTIVELY WITH MUNICIPAL FINANCIAL DISTRESS

The United States contains the most extensive and sophisticated public works system in the world including 4,042,778 miles of roadways, 603,259 bridges, 1,100 local bus systems, 19,750 airports (of which 5,178 are for public use), 25,320 miles of inland and intercoastal waterways, almost 84,000 dams, more than 2 million miles of pipe in water supply systems and over 15,000 wastewater treatment plants provided mostly by municipalities and political subdivisions of a state.¹⁰ Not only our local but also our national welfare and economic growth depend upon the efficient operation of municipal facilities, most of which are financed by bonds purchased by the municipal bond market.

In fact, our ability to supply jobs and encourage business growth in metropolitan areas will require construction of new public work systems and the continued maintenance and operation of our present public works and infrastructure. Significant increases in infrastructure spending at both the federal and local levels are not only necessary, but inevitable.¹¹ There will

¹⁰ National Transportation Statistics, Table 1-1. Available at http://www.bts.gov/publications/national_transportation_statistics/pdf/entire.pdf; National Inventory of Dams, available at: <http://geo.usace.army.mil/pgis/f?p=397:5:1081121975602189::no> (dams); 2006 Community Water System Survey Report, available at <http://water.epa.gov/aboutow/ogwdw/upload/cwssreportvolume12006.pdf>.

¹¹ During economic downturns, the increased issuance of state and local bonds is followed by increases in employment and GDP growth. For charts presenting this correlation, see James E. Spiotto, *Historical and*

be an increasing demand on the municipal bond market to finance these infrastructure improvements over the next 20 years. According to the American Society of Civil Engineers, over the next five years it is estimated that \$2.2 trillion in debt financing will be needed to bring our infrastructure to acceptable levels.¹² Obviously, access to the market will be enhanced by workable state laws with respect to municipalities and a workable federal statute governing municipal debt adjustment and the establishment of disclosure standards regarding municipal bankruptcy and other remedies.

A knowledge of these state and federal provisions is particularly important given a number of issues that have emerged with respect to municipal finances, including mass underfunding of pension obligations that, if not addressed now, will one day come to haunt both municipalities and likely the states in which they are located. Given the possibility of an increase in municipal bond defaults¹³ and the percentage of municipalities having budget deficits that we have already seen, it is increasingly apparent that effective and efficient debt resolution mechanisms are needed and, if created, should be disclosed. As we hope will be seen from these materials, many state legislatures understand this need and have responded with laws aiming to

Legal Strength of State and Local Government Debt Financing, 8-9 (Nov. 2010), available at http://www.chapman.com/events/20101116/SpiottoWebinar_111610.pdf.

¹² See American Society of Civil Engineers, *2009 Report Card for American's Infrastructure*, available at <http://www.infrastructurereportcard.org/>.

¹³ Even with the increasing number of municipal defaults in recent years, the default rate for rated municipal bonds is significantly lower than rated corporate bonds. According to Moody's, between 1970-2009, there were 54 rated municipal bond defaults compared to 1,707 rated corporate defaults. Seventy-eight percent (78%) of the rated municipal defaults were in the healthcare and housing project finance sectors. The median recovery rate for rated municipal issuers was .85¢ on a \$1.00. In 2009, corporate defaulted rated bonds and loan recoveries ranged from 54% first lien bank loans, 37.5% senior secured bonds, 37.78% senior unsecured bonds, 22.4% senior subordinated bonds and 34.3% for all bonds. According to S&P, between 1986-2008, there were 39 rated municipal defaults compared to 1,604 rated corporate defaults. Recent statistics on municipal defaults show a downward trend in the second half of 2010 and first quarter of 2011. According to Bloomberg in January to June of 2011, there were only 24 municipal default totaling \$746 million compared to 60 defaults totaling \$2.29 Billion for the first half of 2010 and 144 defaults totaling \$4.8 Billion for the first half of 2009. See Appendix C on U.S. Municipal Bond Defaults 2010 and 2011 (Q1). (See also Bloomberg, *Municipal Market*, July 15, 2011 p.1.)

protect both taxpayers and bondholders from the devastating effect a municipal default could have. Hopefully, a consensus will develop in the market as to appropriate disclosures of these laws and their expected consequences.

III. STATE INTENDED PROTECTIONS OF BONDHOLDERS

At the front lines of protecting the municipal marketplace are debt limitations imposed by state constitutions and statutory law to restrict the amount of debt that a municipality may issue at any one time. In addition to debt limitation provisions, all states contain provisions in their statutory law for the issuance of refunding bonds. The disclosure or recognition of such debt limitations should not be informative. This next section will discuss measures taken by the various states.

A. Debt Limitations

One of the most important protections for bondholders are the limitations that the various states have imposed on the amount of debt a municipality may issue and hold at any one time. In fact, all states with the exception of Alaska, Florida, and Tennessee impose some sort of limit on the amount of debt a municipality may have outstanding at any one time.¹⁴ Municipalities in 28 states are restricted by limits imposed by their respective constitution. The other 21 states that impose debt limitations on their municipalities do so via statutory provisions.

These municipal debt limits range from a percentage of a valuation of assessed property in the local unit of government to a set monetary amount.¹⁵ In addition, states handle debt for

¹⁴ Even Alaska and Florida have some indirect control on debt. Alaska has a limitation on taxes and a municipality may not levy ad valorem taxes for any purpose in excess of 3 percent assessed value of the property in the municipality. *See* Alaska Stat. § 29.47.090 Compare Alaska Stat. 29.45.100. Florida has a limitation on ad valorem taxes to finance or refund capital projects only if approved by the voters. *See* Fla. Const. art VII, § 12.

¹⁵ *Compare* Alabama – ALA. CONST. ART. XII, § 225 and Am. 342 (debt may not exceed a particular percentage of valuation) *with* Washington D.C. – D.C. CODE § 47-102 (setting debt limit at 1878 levels).

certain “essential” services differently. For instance, in Arizona, while the constitutional debt limit with voter consent is 15 percent of the taxable property in the local unit of government, if bonds are issued for supplying a town or city with water, artificial light or sewers or for purchasing and developing land for open space preserves, parks, playgrounds and recreational facilities, public safety, law enforcement, fire and emergency services facilities or streets and transportation facilities, the debt limit increases to 20 percent.¹⁶ In Kansas, bonds issued by cities with respect to sewer systems, to acquire or enlarge a municipality utility, and certain street improvement bonds are not counted towards the issuing city’s bond indebtedness calculation.¹⁷ Revenue bonds issued in Kansas are also not included in this calculation.¹⁸ In Arkansas, industrial development bonds do not count towards the state’s debt limit.¹⁹

In Idaho, two-thirds of voters must approve bond issuances in which a local government would incur debt exceeding the income and revenue the local government would receive in a year. Should voters approve a bond issuance, the state constitution requires that the local government collect an annual tax sufficient to pay the bond interest as it comes due and to establish a sinking fund for payment of the principal within 30 years.²⁰ A few states, such as Louisiana, have set debt limits based on the type of project rather than a blanket limit into which all debt issued by a particular local government falls.²¹ In Puerto Rico, the Puerto Rican constitution directs the Puerto Rican legislature to fix municipal debt limits, but the limits may

¹⁶ ARIZ. CONST. art. IX, § 8.

¹⁷ KAN. STAT. § 10-309.

¹⁸ *Id.* at § 10-311.

¹⁹ ARK. CONST. Am. 62.

²⁰ IDAHO CONST. art. VIII, § 3.

²¹ LA. CONST. art. VI, § 34; LA. REV. STAT. § 39:562.

not be less than 5 percent or more than 10 percent of the aggregate tax valuation of the property within the municipality.²² In other states, such as Rhode Island, a debt limit has been set for cities and towns, but the debt measurement is net of any tax anticipation bonds and the amount in any sinking fund.²³

There have been recent attempts in some states to tighten local debt limits. For instance, in November 2010, Colorado voters considered a state constitutional amendment that would have greatly limited the ability of local governments to borrow funds. This amendment, which was overwhelmingly defeated by 73 percent of voters, would have prohibited local government borrowing after 2010, unless the voters approved the borrowing. Specifically, the amendment would have required voter approval for all borrowing, limited local government borrowing to bonded debt, and established a debt limit for local governments to 10 percent of the assessed value of the real property therein. The length of borrowing would also have been reduced from the typical term of 20 to 30 years to a constitutional limit of 10 years. Currently, Colorado imposes a debt limit on school districts of 20 percent of the last valuation on taxable property or 6 percent of the most recent determination of actual value of the property.²⁴ Rhode Island has a pending legislative proposal that payment of bond debt will have first priority of revenues of a municipality in order to assure the municipal market of the dedication to payment.²⁵

Although states attempt to limit the amount of debt that their municipalities may incur, local governments sometimes take certain actions to avoid these debt limitations. For instance, revenue bonds financed by particular rents, tolls or charges generated from a project are exempt

²² P.R. CONST. art. VI, § 2.

²³ R.I. GEN. LAWS § 45-12-2.

²⁴ COLO. REV. STAT. § 22-42-104.

²⁵ S. 0614, Jan. Sess. 2011 (Rhode Island 2011) (approved by Rhode Island State Senate May 26, 2011).

from debt limitation calculations in many states. Similarly, many local governments issue tax increment financing (“TIF”), which is generally not counted in the debt limitation valuation. In fact, the Supreme Court of Iowa has held that a TIF district’s issuance of bonds does not count towards a city’s constitutional debt limit because the bonds are not a legally enforceable obligation to the city.²⁶ In other situations, a local government may attempt to use “nonappropriation” financing, in which a local government agrees to make rental payments on a facility built by either a private company or a public entity. The payment of the rent is contingent on the local governing board appropriating money for the rental payment. Courts have had a mixed reaction as to whether so-called “nonappropriation” funding should be counted in a local government’s debt limit.²⁷ In California, there are three major exceptions to the state constitution’s debt limit, including the “Offner-Dean” lease exception allowing for certain long-term lease obligations, if meeting certain criteria, to be exempt from the State’s debt limit; the “Special Fund Doctrine,” which is a judicially created debt limit exception applicable to long-term indebtedness financed through a special fund, such as enterprise revenues; and the “Obligation Imposed by Law” exception applicable to involuntary indebtedness such as a money judgment.²⁸ Also in California, municipalities sometimes issue “certificates of participation,” a strategy generally exempt from state constitutional debt limits where local governments market lease obligations through the retail securities market by means of certificates of participation that

²⁶ *Fults v. City of Coralville*, 666 N.W.2d 548 (Iowa 2003).

²⁷ Compare *Shulz v. State*, 639 N.E.2d 1140 (N.Y. 1994) (upholding “nonappropriation” financing as exempt from debt limit) with *Brown v. City of Stuttgart*, 847 S.W.2d 710 (Ark. 1993) (rejecting notion that “nonappropriation” financing is exempt from debt limit).

²⁸ For a more detailed discussion of California debt limitations and the issuance of public bonds in California in general, see California Debt and Investment Advisory Commission, *California Debt Issuance Primer* (2005), available at <http://www.treasurer.ca.gov/cdiac/debtpubs/primer.pdf>.

pay tax-exempt interest and are liquid.²⁹ These are just a few examples of strategies that a municipality might utilize to circumvent a constitutionally or statutorily imposed debt limit. For specific questions an attorney familiar with the laws and process of a particular state should be consulted.

B. Refunding Bonds

Perhaps the most common way that municipalities restructure their debt is through the issuance of refunding bonds. Refunding bonds, as the name implies, are bonds that are issued to redeem the principal of outstanding bonds. Every state provides some sort of refunding bond provision for its municipalities. By issuing refunding bonds, a municipality may be able to refinance its debt at a rate more favorable to itself or to let its debt mature at a time when the municipality believes it will be more flush with money. Refunding bonds also may help a municipality to push off its debt troubles for another day. Generally, the issuance of refunding bonds does not constitute indebtedness for the purposes of debt limitations imposed by almost all of the states. This is because the purpose of refunding bonds is to refinance already existing bonds.

Refunding bonds generally may be issued any time before the final maturity of the debt to be refinanced. Although municipalities generally have flexibilities in refunding their current obligations, many states impose provisions limiting the use of refunding bonds in an attempt to protect the financial solvency of a particular municipality. For instance, in Pennsylvania refunding bonds may only be issued to (1) reduce total debt service over the life of the bond issuance; (2) reduce annual debt service; (3) eliminate unduly burdensome or restrictive covenants or restrictions; (4) refund any maturity or maturities to a later date; (4) substitute

²⁹ For a general overview of lease financing and certificates of participation in California, see California Debt Advisory Commission, *Guidelines for Leases and Certificates of Participation* (1993), available at <http://www.treasurer.ca.gov/cdiac/reports/Guidelines93-8.pdf>.

bonds for notes or bond anticipation notes or to substitute notes for bonds; or (5) adjust lease rentals.³⁰ Pennsylvania law further limits municipalities in their issuance of refunding bonds by disallowing local governments from extending the term of the outstanding debt through refunding to a maturity date that could not have been included in the original issue, unless “in the case of an emergency refunding of stated maturity date to avoid a default occasioned by an unforeseen shortage in total revenues”³¹ This provision, however, would only apply if the municipality in question were to first petition the state government and the petition receive state approval.³² Other states have similar provisions.

C. Conclusion

By setting debt limits and taxing limits and allowing for the issuance of refunding bonds, the states have attempted to curb the number of municipal financial crises and defaults. Disclosure of such statutory precautions is obviously something to be considered. In addition to these provisions, and as will be discussed next, some states have gone a step further to help beleaguered municipalities resolve their financial issues at the initial signs of a problem.

IV. DEBT RESOLUTION MECHANISMS

A. Introduction

In addition to debt limitations and allowing for the issuance of refunding bonds, seventeen states have implemented municipal debt supervision or restructuring mechanisms to aid municipalities. If municipal debt is being issued in a state with such a mechanism, disclosure of the mechanism should be encouraged. These programs, many of which are identified in the

³⁰ 53 PA. STATS. §§ 8241-8251.

³¹ *Id.* at § 8243.

³² *Id.*

chart immediately following this paragraph, range from the California Debt and Investment Advisory Commission and the Florida Local Government Financial Technical Assistance Program, which provide guidance for and keep records of the issuance of municipal bonds in those states, to the layered approach of Rhode Island to aid municipalities depending on the municipality’s level of financial instability. States with these provisions have effectively used these mechanisms to control the restructuring of their municipalities. For instance, as will be discussed, the State of Michigan, under its municipal restructuring mechanism, recently denied a request by one of its municipalities to file a petition under Chapter 9 of the U.S. Bankruptcy Code, likely concluding that its state’s restructuring mechanism was more effective in handling the municipality’s crisis. States that contain provisions allowing for state intervention into a municipality’s finances include:

	STATE	SUPERVISION PROVISION
1.	California	Debt and Investment Advisory Commission
2.	District of Columbia	Financial Responsibility and Management Assistance Authority
3.	Florida	Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program
4.	Idaho	Debt Readjustment Plans
5.	Illinois	Financially Distressed City Law and Financial Planning and Supervision
6.	Indiana	Distressed Political Subdivision Protections
7.	Kentucky	County Restructuring Provisions
8.	Massachusetts	<i>Ad hoc</i> State Intervention
9.	Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act
10.	Nevada	Local Government Financial Assistance and Audit Enforcement Act
11.	New Jersey	Local Government Supervision Act and Municipal Rehabilitation

	STATE	SUPERVISION PROVISION
		and Economic Recovery Act of 2002 and Special Municipal Aid Act
12.	New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board
13.	North Carolina	Local Government Finance Act
14.	Ohio	Fiscal Watch; Fiscal Emergency; and the Financial Planning and Supervision Commission
15.	Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act
16.	Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission
17.	Texas	Municipal Receivership

The idea of state remedial measures to aid troubled municipalities is not a recent phenomenon. The earliest instances in the United States of remedial mechanisms occurred in January 1879 in Memphis, Tennessee, and Mobile, Alabama.³³ In Memphis, the city was placed into a temporary administrative receivership when the Tennessee legislature disincorporated the city and placed it into the “Taxing District of Shelby County.” The governor was authorized to appoint two individuals to compromise the existing indebtedness of the former city. In Mobile, the Alabama legislature repealed the city’s charter and the governor appointed a three-member commission vested with the assets of the former city and authorized to compromise the existing indebtedness.³⁴

B. States Recognizing Municipal Receivers – Rhode Island and Texas

Similar situations occur even today. For instance, in Rhode Island, the city of Central Falls petitioned a state court and was placed into judicial receivership for its financial woes in

³³ Hillhouse, A.M., MUNICIPAL BONDS: A CENTURY OF EXPERIENCE at 324-25 (1936).

³⁴ This is not unusual and follows historical precedent going back to the fifth century B.C. and the Greek town of Atarneus, where a Greek banker took over administration due to a defaulted loan.

May 2010. The city of 18,000 was \$3 million in debt. In response to the city's filing for judicial receivership, in June 2010 the Rhode Island legislature passed and the governor signed into law a process of progressive state intervention for municipalities in financial distress. The new law created a three-step process for distressed governments, in what was possibly an attempt by Rhode Island to prevent *ad hoc* efforts by municipalities to restructure with tactics that could be unfriendly to the municipal markets.³⁵ The law applied retroactively to prevent the Central Falls judicial receivership from continuing.

After the legislation became law, Central Falls was placed into municipal receivership when a state commission found that the municipality had insufficient power to restore fiscal responsibility. The city council of Central Falls attempted to challenge the new state law, but a state court judge in October 2010 upheld the constitutionality of the state-appointed receiver. Shortly thereafter, in November 2010, the receiver exercised his significant power to disband the Central Falls City Council and replace it with a three-member advisory council. The receiver publicly stated that he fired the council because "several members of the City Council have chosen to continually obstruct our efforts to return fiscal stability to the City."³⁶ Recently the Rhode Island passed legislation to give the municipal debt holders a guarantee of first rights to property taxes and general revenues in the event of bankruptcy. This was in an apparent effort to demonstrate the creditworthiness and improve the availability of Rhode Island's municipal debt that is vital to ensuring financing for essential infrastructure improvement and recoveries.³⁷

³⁵ See *Assembly and Governor OK Measure to Prevent Municipal Receivership* (6/17/2010) (Press Release), available at <http://www.rilin.state.ri.us/news/pr1.asp?prid=6591>.

³⁶ Romy Varghese, *Receiver Replaces Elected Council of Rhode Island City*, WALL STREET JOURNAL, available at <http://online.wsj.com/article/BT-CO-20101111-715808.html> (last visited November 12, 2010).

³⁷ S. 0614, Jan. Sess. 2011 (Rhode Island 2011) (approved by Rhode Island State Senate May 26, 2011) and signed by the Governor in July 2011.

In addition to the recent Rhode Island law and a law in Texas allowing for a judicially appointed municipal receiver, other states have chosen to allow for a financial control board, emergency managers, coordinators, overseers or a financial commission to aid troubled municipalities. As background, the concept of a financial control board first made its appearance with the creation of a financial commission to oversee Manchester, New Hampshire, in 1921.³⁸ Although the Manchester financial commission was appointed by the governor, the mayor and alderman of Manchester fixed the commission's compensation. The commission was allowed to control and regulate appropriations, expenditures and bond issuances but could not control the collection of taxes.

C. Financial Control Boards

Today, the laws of Florida, Illinois, Indiana, Michigan, Nevada, New Jersey, New York, North Carolina, Pennsylvania and Rhode Island include a variation on a provision allowing for the appointment of a financial control board or commission, emergency managers, coordinators or overseers over a troubled unit of local government. The intent of many of these provisions is to identify early signs of financial distress for a city or municipality so that the state may intervene before the city or municipality reaches the level of a municipal crisis. Importantly, such provisions are not just a web of buried state laws never to be used but, rather, are applied where situations call for intervention.

1. The New York Experience

Perhaps the most well-known appointment of a financial commission was the implementation of the New York City Financial Control Board in 1975. In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that New

³⁸ Hillhouse, A.M., MUNICIPAL BONDS: A CENTURY OF EXPERIENCE at 326 (1936).

York had, for more than ten years, been using questionable accounting and borrowing practices to eliminate its annual budget deficits.³⁹ Banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could only be resolved by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York nearly defaulted on the payment of its notes in October 1975, and it was predicted that a default was likely in December absent federal aid.⁴⁰ In response, the State Municipal Assistance Corporation issued a series of securities on behalf of the city and a financial control board was appointed.

The New York City Financial Control Board was given the power and responsibility to review and provide oversight with respect to the financial management of New York City's government. Among other things, the act establishing the board required the city to prepare and submit a "rolling" four-year financial plan to the Financial Control Board prior to the beginning of each city fiscal year. The Financial Control Board, today, although essentially dormant since the mid-1980s, can be reactivated if certain conditions are triggered, including the inability of the city to meet its debt service payments.⁴¹

In addition to the New York City Financial Control Board, the New York legislature may implement Emergency Financial Control Boards for any municipality outside of New York City.

³⁹ For a detailed study of the New York City fiscal crisis see Shalala & Bellamy, *A State Saves a City: The New York Case*, 1976 DUKE L.J. 1119 (1976); United States Congress, House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (95th Cong. 1st Sess., August 1977).

⁴⁰ NEW YORK TIMES, October 19, 1975, Section 4 at 1.

⁴¹ See THE BOND BUYER, Nov. 30, 1990, pp. 1, 45.

For instance, this provision was used in November 1975 to take control of the City of Yonkers (the board was terminated on December 31, 1978) and most recently with regard to Nassau County in January 2011.⁴²

2. The Pennsylvania Experience

Similar to the New York experience, Pennsylvania has implemented a series of provisions to aid ailing cities. Pennsylvania law contains the Financially Distressed Municipalities Act, which applies to any county, borough, incorporated town, township or home-rule municipality.⁴³ Under these provisions, if the state Department of Community Affairs determines that a municipality is financially distressed based on certain triggering events, the department may appoint a coordinator to guide the municipality in getting its financial affairs in order. 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, the Borough of Wilkinsburg in 1988, and most recently Harrisburg in October 2010.

In addition to the Financially Distressed Municipalities Act, Pennsylvania law contains the Intergovernmental Cooperation Authority Act, which was created in 1991 to deal with insolvency issues faced by Philadelphia. The Act created a five-member authority with authorization to enter into intergovernmental cooperation agreements with cities, and these agreements were preconditions to the issuance of any obligations by the authority. Among other things, the authority could issue bonds and the city and the authority were required to work together to develop a five-year recovery financial plan.

⁴² David M. Halbfinger, *New York State Seizes Finances of Nassau County*, N.Y. TIMES, Jan. 26, 2011, at A1.

⁴³ 53 PA. STAT. §§ 11701.101 - 11701.501.

3. The Michigan Experience

Likewise, the State of Michigan, under its former Local Government Fiscal Responsibility Act, has taken over the Detroit Public Schools; the City of Pontiac; the City of Escorse; the Village of Three Oaks; the City of Hamtramck; the City of Highland Park; and the City of Flint.⁴⁴ These provisions have recently been replaced by the Local Government and School District Fiscal Accountability Act.⁴⁵ Under this Act, if a school district or municipality is in a perilous financial situation, the Michigan governor may declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager is appointed, the emergency power has broad powers to operate and restructure the municipality including the ability to reject, modify or renegotiate contractual obligations.⁴⁶ As a last resort, this emergency manager may file a Chapter 9 municipal bankruptcy petition on behalf of the municipality.⁴⁷ Showing the seriousness with which Michigan and states with similar provisions take the filing by their municipalities of a municipal bankruptcy petition, in November 2010 the Emergency Financial Assistance Loan Board for the City of Hamtramck rejected a request by Hamtramck to file a municipal bankruptcy petition. This request was denied by the state that same month.

4. The Massachusetts *Ad Hoc* Experience

Similar to the laws of states establishing specific authority for financial control boards or similar commissions, Massachusetts has typically employed a system of implementing

⁴⁴ Former MICH. COMP. LAWS. § 141.2802 (this provision has been replaced by the Local Government and School District Fiscal Accountability Act). *See also* 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 8, 2011).

⁴⁵ MICH. COMP. LAWS §§ 141.1501-141.1531 (2011).

⁴⁶ MICH. COMP. LAWS. § 141.1519 (2011).

⁴⁷ MICH. COMP. LAWS. § 141.1523.

legislation on an *ad hoc* basis to create a financial control board or overseers for municipalities in severe financial distress. For instance, in the 1990s the City of Chelsea was placed into a state receivership. The receiver cut city payroll by 25 percent and cut non-pecuniary employment benefits. In one year, the receiver was able to cut city expenses by 10 percent of the city's budget (by \$5 million).⁴⁸ In March 2010 the Governor signed into law provisions allowing the City of Lawrence to borrow \$35 million from the market and establishing a fiscal overseer for the municipality.⁴⁹ In a July report the financial overseer reported that Lawrence's fiscal emergency was the result of years of mismanagement and fiscal challenges. The fiscal overseer has aided the city in producing a balanced budget.⁵⁰ In another instance, in 2004 Massachusetts made a \$52 million state loan to the City of Springfield and established a Financial Control Board to oversee the city.⁵¹

D. Conclusion

As indicated by the case studies discussed above, the states have divergent techniques for addressing the financial woes of their municipalities. As always, because each state contains unique laws for addressing municipal issues, for any specific questions, details or issues, further analysis and consultation with professional advisors may be advisable. In addition, should a

⁴⁸ See Omer Kimhi, *Reviving Cities: The Legal Remedies to Municipal Insolvency* (N.Y.U. School of Law 2007) at 131, 205.

⁴⁹ See chapter 58 of Acts of 2010.

⁵⁰ *Letter from Robert G. Nunes, Fiscal Overseer to Secretary Jay Gonzalez of the Office for Administration and Finance; the Massachusetts Senate Committee on Ways and Means and the Massachusetts House Committee on Ways and Means*, dated July 22, 2010.

⁵¹ See chapter 169 of Acts of 2004. The Springfield Financial Control Board ended five years of direct management on June 30, 2009. According to the Commonwealth of Massachusetts, Springfield emerged from a \$41 million deficit in fiscal year 2005 to a reserve fund balance of nearly \$40 million at the close of fiscal year 2009. See http://www.mass.gov/?pageID=mg2utilities&L=1&sid=massgov2&U=sfcb_for_redirect (last visited July 8, 2011).

state's guidance to a troubled municipality fail, a number of provisions, as will be overviewed next, exist establishing investors' rights and setting forth remedies in the event of default.

V. BONDHOLDER RIGHTS AND REMEDIES

In addition to the more general provisions of the states addressing municipal restructuring issues, the states have implemented a series of patchwork provisions, allowing bondholders to protect their rights and granting certain remedies in the event of a default. The disclosure of the state's treatment of bondholders in the event of default is helpful to an investment decision.

As background, state laws generally allow for the issuance of bonds within two broad categories – general obligation and revenue bonds. General obligation bonds are those bonds to which the state or local government has pledged its full faith and credit.⁵² Revenue bonds are those bonds issued by state and local governments that are paid solely based upon the revenues to be collected by the municipal body in connection with the financed improvement. State revenue bond laws are generally project specific. An example of a revenue bond would be bonds payable solely from and secured as to payment of principal and interest by a pledge of the net revenues – fees – of a water or sewer system. As a further example, in Arkansas separate laws provide authorization for the issuance of numerous types of revenue bonds including, but not limited to, parking meters; suburban improvement district bonds; property owners' improvement district bonds; municipal property improvement district bonds; water distribution district bonds; drainage and levee improvement district bonds; public corporations for municipal facility bonds; public utility bonds; and bridge improvement district bonds.⁵³ In general, each of these provisions contains different mechanisms in protecting bondholder rights.

⁵² General obligation bonds may have revenue or tax pledges reserved for their payment. These pledges, such as on the unlimited ad valorem tax pledge to general obligation bonds of health care districts in California, provide bankruptcy-remote revenue sources.

⁵³ For a more detailed list of revenue bond issuance provisions, see the author.

When a municipality defaults on a bond issuance, bondholders may institute a lawsuit requesting that the municipality take certain actions, immediately pay all amounts due and owing to bondholders, or otherwise cure the default.⁵⁴ Such actions may be in the form of a suit for money judgment, mandamus, specific performance or other equitable relief, such as requesting the issuance of an injunction. Where bondholders are owed principal or interest by a municipal body that has not been paid, they may bring a suit for payment of that debt and the municipal body, absent filing a petition under Chapter 9 of the U.S. Bankruptcy Code, cannot take any action to obtain a moratorium of such a suit.⁵⁵ In light of these principles the next few sections will provide an overview of the general rights and available remedies.

⁵⁴ For a more detailed discussion of such remedies, see James E. Spiotto, *Municipal Insolvency: Bankruptcy, Receivership, Workouts and Alternative Remedies*, in STATE & LOCAL GOVERNMENT DEBT FINANCING, ch. 13 (M. David Gelfand, ed. 2004).

⁵⁵ See *id.* at § 13:45 (discussing institution of lawsuit); see also *Flushing Nat'l Bank v. Mun. Assistance Corp.*, 40 N.Y.2d 731 (1976). In *Flushing National Bank*, a moratorium was issued by the City of New York against payment and institution of lawsuits by noteholders. The highest court in New York found that the moratorium violated the contractual obligation of the municipality and the constitutional rights of the noteholders to full faith and credit. The court held that the noteholders, whose principal and interest were due, had a right to bring suit and demand payment, and the municipality did not have the right to enjoin or stop such payment.

A. Mandamus

The applicable law of all states likely would permit a bondholder to petition a court for a writ of mandamus to enforce the rights granted to the bondholders in a bond issuance. A writ of mandamus is a tool that bondholders, or their trustee, could use to compel the local governing board to perform some ministerial action that is required by law to levy taxes to pay past-due debt. Specifically, if the law requires the local board to take such an action and the board refuses, the court may order the board to act, regardless of whether the board was reasonable in not acting. For instance, if a local governing board refuses to collect taxes or fees or levy sufficient taxes to pay the current payment of debt as it comes due, and the underlying bond authorization statute requires the collection of taxes or fees, a bondholder could petition for a writ of mandamus to compel such action. The remedy is “extraordinary” and one court has provided:

It is not to be used to establish rights but to enforce rights that have already been established. The writ can be used to compel a tribunal to act but cannot control its discretion. If there is a plain, speedy, and adequate remedy at law, mandamus does not lie. When such a remedy is available through certiorari or appeal, mandamus should not be ordered. The other available remedy, however, “must be competent to afford relief on the very subject matter in question, and be equally convenient, beneficial and effectual.”⁵⁶

The Seventh Circuit Court of Appeals, in *Connett v. City of Jerseyville*, 125 F.2d 121 (7th Cir. 1941), held that where a mortgage or a statute requires a city to adopt rates for a waterworks

⁵⁶ *Hewitt v. Ryan*, 356 N.W.2d 230, 233 (Iowa 1984) (internal citations omitted).

sufficient to pay the indebtedness of the waterworks, a court may compel the city to adopt the schedule. The Seventh Circuit found, however, that although a court had the power to compel the city to adopt the statutory schedule, it had no power to fix the rates for the waterworks. Thus, if a local government is provided discretion in its act, mandamus would be a difficult remedy to assert unless the local board's acts were arbitrary or capricious.⁵⁷

In the event a local board refuses to take some action required by law, such as collecting taxes on fees to pay for a bond issuance, if a consensual restructuring fails, pursuing a writ of mandamus may be an alternative.⁵⁸ Because whether to pursue such an action would involve myriad concerns, an attorney should be consulted before considering such an option.

B. Receivership

In addition to allowing bondholders or their representative to file a petition with a court for a writ of mandamus to force a local government to take a required action, many bond issuances allow for the appointment of a receiver to oversee the particular project in question, and if appropriate, raise rates or taxes sufficient to pay debt issued to finance the public improvement. A modern example of such an action occurred recently in Jefferson County, Alabama. In September 2010 an Alabama state court appointed a receiver to operate and administer the county's sewer system. The county had \$3.2 billion in sewer debt that it was unable to pay, related largely to a failed interest-rate swap transaction. The receiver was given the power to operate and administer the sewer system, including, as allowed by the bond indenture, the ability to raise rates.

⁵⁷ See, e.g., *Reed v. Gaylord*, 216 N.W.2d 327, 331 (Iowa 1974).

⁵⁸ For further discussion as to the pursuit of a writ of mandamus against a municipality with respect to a bond issuance, see W. Michael Garner, *Procedural Aspects of Municipal Finance Litigation*, in *STATE & LOCAL GOVERNMENT DEBT FINANCING*, § 14:59 (M. David Gelfand, ed. 2004).

As background, in the early 1990s, Jefferson County's sewer system was found to have violated the Clean Water Act ("CWA") by illegally discharging pollution. As a result, in December 1996 a U.S. district court in Alabama entered a consent decree requiring the county to meet the requirements of the CWA. To make these changes, the county issued approximately \$3.6 billion in warrants from 1997 to 2003 and entered into an interest-rate swap arrangement. Because of the failed interest-rate swap, the county was unable to meet its obligations and had refused to increase or change its rates. The trustee, Bank of New York Mellon Corp., had first filed a petition to appoint a receiver in federal court, which was dismissed, and then refiled in the state court.

As mentioned, the underlying bond indenture in the Jefferson County situation allowed for the appointment of a receiver and for that receiver to have control over sewer rates in the county. Similarly, authorizing provisions for revenue bond financing in 44 states, including Puerto Rico, allow for the appointment of a receiver in the event of a default. These provisions are generally tied to specific revenue bond issuances. For instance, Maryland law contains certain provisions allowing for the appointment of a receiver should a municipality default on sewage facility bonds.⁵⁹ Under Maryland law, should a local unit of government default on bonds for sewage facilities, a receiver may enter, take possession of the facility to operate and maintain it, and set facility rates, fees or charges. In addition, the receiver may collect, receive and apply all revenue of the facility. Such receivership provisions are generally tailored by a state's laws to address the type of bond that is being issued.

Such provisions are generally bond specific. Thus, to establish the rights and remedies, including the ability to appoint a receiver with respect to a particular bond issuance, specific

⁵⁹ MD. CODE, ENVIR. § 9-807.

review and analysis may be required to determine the particular legal authorization and thoroughly review the authorizing language in the bond indenture.

C. Accounting

In addition to the provisions discussed above, some states, depending on the type of bond, may allow for bondholders to seek an accounting. Specifically, at least 23 states, including the District of Columbia and Puerto Rico, allow for bondholders or a representative trustee to bring an action for an accounting to require the local government to account for how a bond fund has been spent as a trustee would be required to take such action.⁶⁰ If a municipality has diverted or has threatened to divert funds collected and reserved for a specific bond issuance, a bondholder or trustee, depending on the specific indenture, may bring an equitable action for an accounting and recovery of any amount diverted. Along with this, the bondholder could seek an injunction to enjoin any diversion. A bondholder considering this option must act quickly, however, because the equitable doctrine of laches could apply, causing the bondholder to lose its right to bring such an action if a court finds the bondholder waited too long after learning of a diversion of funds to bring the action.⁶¹ Because a bondholder may lose his rights if he doesn't take action in a reasonable time, it is imperative that a bondholder remain vigilant and consult legal representation should he suspect a misapplication of funds.

⁶⁰ A court may require in a default situation the issuer of the bond debt to account for the use of the proceeds of the debt issue or the taxes collected for payment of the debt.

⁶¹ See, e.g., *Elbert, Ltd. v. City of San Diego*, 254 P.2d 98 (Cal. App. Dist. 1953).

D. Foreclosure Action

Much like in a civil context where a mortgagee holds a mortgage on a mortgagor's home and may bring a foreclosure action if obligations are not paid, some states allow bondholders or their representative to pursue a foreclosure action against a certain project generally in the conduit finance context against property owned or financed by a private concern.⁶² For instance, in California, state law has established an industrial development authority for each public agency. Each agency may issue industrial development revenue bonds to help private business purchase property for certain uses, such as industrial uses, energy development, research and development activities, commercial uses, processing or manufacturing recycled or reused products, business activities, residential real property for families, airports, sewage and solid waste disposal activities, water furnishing activities, or any other activity qualifying as exempt under § 501 of the Internal Revenue Code.⁶³ The authorities may issue bonds for a project payable solely as special obligations out of the revenues or other sources specified in the bond proceedings.⁶⁴ In the event of default, the bond indenture may include, among other remedies, enforcement by foreclosure or sale.⁶⁵ Generally, foreclosure is not permitted for essential governmental property as it would be against public policy.

E. Other Relief

In addition to the forms of relief discussed previously, a wide variety of provisions exist in the states to allow bondholders to protect their interests. For instance, at least 15 states

⁶² Foreclosure is generally allowed in conduit financing. There, collateral owned or financed by the private concern is involved.

⁶³ CAL. GOV. CODE §§ 91502-91503.

⁶⁴ *Id.* at § 91535.

⁶⁵ *Id.* at § 91537. Other allowed remedies include mandamus, appointment of a receiver, injunction, specific performance, equitable relief, or any one or more of such remedies or any other remedy.

specifically allow for injunctive relief in the event of a default.⁶⁶ One such example is Kentucky, where certain bondholders may petition a court for injunctive relief to enjoin any unlawful act or any act taken violating bondholders' rights.⁶⁷ Other states allow bondholders to pursue any action necessary, including contractual remedies, to enforce and protect their rights. The attached charts provide a more general analysis of the types of relief available in each state.

F. Conclusion

Originally municipal and state debt obligations were viewed as moral obligations and, in the early 1800s, few if any statutes or constitutional provisions permitted a legal basis for such obligations. The repudiation of debt by 13 states after the Civil War brought about statutory and constitutional provision debt limits and other statutory provisions and remedies to provide assurance to the market that state and municipal debt was a safe and protected investment. Since the late 1800s the states have implemented a wide array of provisions to protect the rights of bondholders and allow for certain remedies in the event of a default. As will be discussed next, however, if a municipality is truly in trouble and is located in a state authorizing its municipalities to file a municipal bankruptcy petition, bondholders may have further protection depending on the type of bonds they hold. This is because the bankruptcy filing would not cut off payments of principal and interest to special revenue bondholders, although in most cases the municipality would be required to pay the operations costs of the particular project before paying bondholders. In addition, those holding bonds secured by a statutory lien are guaranteed payment of collected taxes since a bankruptcy court cannot invalidate or interfere with the rights

⁶⁶ This is in addition to the general availability of injunctive relief under the civil procedure code for most states to prevent irreparable harm when there is no adequate remedy at law. This issue is a difference as to public policy and irreparable harm with respect to municipal debt and, thus, a specific state statute may provide more expansive relief.

⁶⁷ See KY. REV. STAT. § 96.184(5)(b).

granted by state law to debt holders. Adequate disclosure of the likely treatment of the security being sold in the event of a bankruptcy would clearly be of assistance to the investing public.

VI. MUNICIPAL BANKRUPTCY

Historically, Chapter 9 has been used generally by small tax districts and small municipalities while major issuers of municipal debt have refrained from proceeding with a Chapter 9 filing. As set forth in Exhibit A, since 1937, when Chapter 9 was instituted, there have been 624 Chapter 9 filings as of June 30, 2011. Since 1980 there have been 253 filings as of June 30, 2011. Of those who have filed since 1980, only three municipal debt issuers of any significance, namely: (1)-Orange County in 1994, in which the public debt was refinanced and paid, (2)-the City of Bridgeport, Connecticut, in 1991, which ultimately was dismissed, and (3)-the City of Vallejo in 2008, which is exiting bankruptcy in July 2011. About a third of 253 Chapter 9 filings since 1980 have been dismissed, rather than being completed, by confirming a Plan of Debt Adjustment. While corporate issuers utilizing Chapter 11 have filed in recent years over 1,000 Chapter 11 filings per year, the Chapter 9 filings, even during the current economic downturn, have been small: 5 in 2007, 4 in 2008, 10 in 2009, 6 in 2010 and 4 as of June, 2011. Chapter 9 has been viewed by major municipal issuers as clearly the last resort and an alternative to be avoided at virtually all costs. It is no accident that New York City in 1975, Cleveland in 1978, Philadelphia in 1991 and other significant issuers of municipal debt, when faced with a financial crisis, chose other viable alternatives rather than filing Chapter 9. Chapter 9 provides no additional revenues or tax sources to solve the problem, and it affects all creditor relationships and not just the few that are the problem. Chapter 9 tips over those desired creditor relationships that are not the problem and are working just fine. Further, the stigma and complexity and travail of Chapter 9 is more than what many local governments can tolerate.

The last resort for troubled municipalities in certain states is the filing of a petition under Chapter 9 of the U.S. Bankruptcy Code. Chapter 9 is a vehicle not for elimination of debt but rather for debt adjustment. Specifically, a Chapter 9 proceeding is a mechanism for a debtor municipality, through a court-supervised proceeding, to attempt to settle disputes with its creditors. Since a municipal unit cannot liquidate its assets to satisfy creditors and continue to function as a municipality, the primary purpose of Chapter 9 of the U.S. Bankruptcy Code is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims. Indeed, one of the stated purposes of the U.S. Bankruptcy Code was to provide a “workable procedure so that a municipality of any size that has encountered financial difficulties may work with its creditors to adjust its debts.”⁶⁸

A. Initiation of Chapter 9 Proceeding and Effect on Bondholder Rights and Remedies

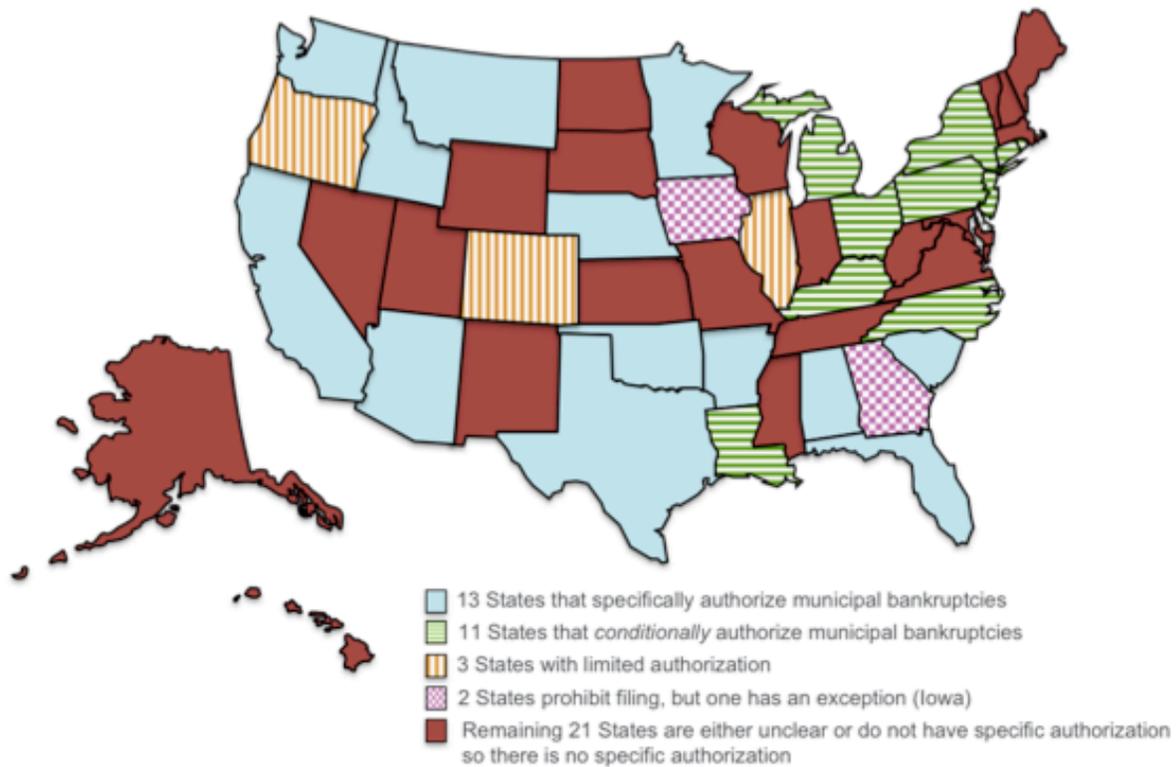
Only a municipality may initiate an action and be a debtor under Chapter 9 of the U.S. Bankruptcy Code.⁶⁹ Moreover, in order for a municipality to proceed under Chapter 9, state law must have specifically authorized the entity to be a debtor under Chapter 9.⁷⁰ In addition to the requirement that a municipality be a subdivision of an agency or a subdivision or instrumentality of the state, it must be specifically authorized to file a Chapter 9 proceeding by the state. The states have adopted different approaches to this requirement as described in Exhibit B. Thirteen states have statutory provisions specifically authorizing the filing by an in-state municipality of a Chapter 9 petition. Another 11 states authorize a filing conditioned on a further act of the state, an elected official or a state entity. Three states grant limited authorization and two states

⁶⁸ H.R. Rep. No. 137, 93rd Cong. 1st Sess. 237248.

⁶⁹ 11 U.S.C. § 109(c).

⁷⁰ 11 U.S.C. § 109(c)(2).

prohibit filing, but one of them has an exception to the prohibition. The remaining 21 states are either unclear or do not have specific authorization with respect to filing. The District of Columbia and Puerto Rico are not permitted to file.⁷¹



Further, a municipality must be insolvent or unable to meet its debts as they mature and must desire to effect a plan to adjust its debts, although the determination of insolvency is not as easy as it seems.⁷² In addition, it must be demonstrated that one of the following has occurred:

- (1) The municipality has obtained the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under Chapter 9;

⁷¹ The term “State” is defined in the U.S. Bankruptcy Code as including “the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor” under Chapter 9. 11 U.S.C.A. § 101(52). See Appendix B for a listing of States and applicable statutory authority to file a Chapter 9.

⁷² 11 U.S.C. §§ 109(c)(3) and (4).

- (2) The municipality has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under Chapter 9;
- (3) The municipality is unable to negotiate with creditors because such negotiations are impractical; or
- (4) The municipality reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under § 547 of the U.S. Bankruptcy Code.⁷³

With regard to an unincorporated tax or special assessment district which does not have its own officials, an action is commenced under Chapter 9 by filing a petition by such district's governing authority or board or body that has the authority to levy taxes or assessments to meet the obligations of each district.⁷⁴

The fact that a municipality has filed a petition does not necessarily ensure that its debts will be adjusted in that proceeding. Section 921(c) of the U.S. Bankruptcy Code's municipal provisions provides that, after objection to the petition, the court, after notice and a hearing, may dismiss the petition if it can be shown to the bankruptcy court that a petition was not filed in good faith or not in accord with the requirements of Chapter 9.⁷⁵

⁷³ 11 U.S.C. §§ 109(c)(5) (A)(B).

⁷⁴ 11 U.S.C. § 921(a).

⁷⁵ For further discussion and detail with respect to Chapter 9 of the U.S. Bankruptcy Code, see James E. Spiotto, *Primer on Municipal Debt Adjustment, Chapter 9: The Last Resort for Financially Distressed Municipalities* (on file with Chapman and Cutler LLP) and James E. Spiotto, *Chapter 9: The Last Resort for Financially Distressed Municipalities*, in *THE HANDBOOK OF MUNICIPAL BONDS* 145-80 (Sylvan G. Feldstein & Frank J. Fabozzi, eds., 2008).

B. Municipal Operations and Bondholders Protections

While in a Chapter 9 proceeding, the municipality will still have to function as a municipality. Depending upon the statutory mission of the municipality, there are certain necessary and basic municipal services that must be provided, such as police, fire and, under certain instances, sewer, water and electrical services. Defining what these necessary municipal services are is a question of state law and may by itself be a complex issue. A bankruptcy court and creditors will not be able to successfully interfere with such service. Section 904 of the U.S. Bankruptcy Code recognizes this reality. Accordingly, certain revenues and activities of the municipal body that may be the cause of the “insolvency” may not be able to be restrained, curtailed or modified without a compelling reason. Even municipal debt secured by “special revenues,” which pledge is preserved by reason of § 928 of the U.S. Bankruptcy Code, is subject to the payment of necessary operating expenses.

C. “Special Revenues” Pledged to Bondholders

Many municipal bonds are revenue bonds secured by a pledge of revenues derived from a specific project or a special tax levy. In fact, all states recognize some form of a revenue bond. As background, in a corporate bankruptcy context, § 552 of the U.S. Bankruptcy Code provides that property acquired by the estate or the debtor after commencement of a case is not subject to any lien resulting from a security agreement entered into by the debtor before the commencement of the case. Thus, in a corporate bankruptcy, if a revenue pledge were to exist, such as a lien on inventory or accounts receivable, the pledge likely would not survive the filing of a bankruptcy petition (namely any property or revenue created post-petition, such as inventory manufactured or accounts receivable received from sales of inventory after the filing of the case). In a municipal bankruptcy, however, this is not the case. Specifically, § 928 of the U.S. Bankruptcy Code provides that in the case of “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 § 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, subject to the payment of operating expenses, holders of special revenue bonds would continue to receive payment on those bonds, regardless of the bankruptcy filing.⁷⁶

Particular attention should be directed to the definition of "special revenues," the pledge of which survives bankruptcy.⁷⁷ "Special revenues" are defined as:

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

⁷⁶ *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

⁷⁷ 11 U.S.C. § 902(2).

Examples of the “special revenues” mentioned in clause (A) include receipts derived from or received in connection with the ownership, financing, operation or disposition of a municipal water, electric or transportation system. An excise tax on hotel and motel rooms or the sale of alcoholic beverages would be a special excise tax under clause (B). “Special excise taxes” are taxes specifically identified and pledged in the bond financing documents and are not generally available to all creditors under state law. General state sales, general income or general property taxes would not be special excise taxes without specific language deemed levied to finance a specific project or system. In a typical tax increment financing referred to in clause (C), public improvements are financed by bonds payable solely from and secured by a lien on incremental tax receipts resulting from increased valuations in the benefited area. Although these receipts may be part of the general tax levy, they are considered to be attributable to the improvements so financed and are not part of the preexisting tax base of the community. Examples of revenues from particular functions under clause (D) would include regulatory fees and stamp taxes imposed for the recording of deeds or any identified function and related revenues identified in the municipality’s financing documents, such as tolls or fees related to a particular service or benefit. Under clause (E), an incremental sales or property tax specifically levied to pay indebtedness incurred for a capital improvement and not for the operating expenses or general purposes of the debtor would be considered “special revenues.” Likewise, any special tax or portion of a general tax specifically levied to pay for a municipal financing should be treated as “special revenues.”⁷⁸

D. Statutory Liens Protect Bondholders

In certain situations, even if holding general obligation bonds for which the contractual pledge of a municipality’s taxes or revenues generally would terminate on the filing of a

⁷⁸ See *Heffernan Memorial Hospital District*, 202 B.R. 147 (Bankr. S.D. Cal. 1996).

municipal bankruptcy petition, a bondholder may continue to receive payment in the wake of a Chapter 9 filing if the underlying statute authorizing the issuance contains a statutory lien, which lien comes into existence by virtue of the statute and arises by force of the statute on specific circumstances or conditions and not requiring further action by the municipality.⁷⁹ A statutory lien cannot be canceled on the filing of a bankruptcy petition or by the bankruptcy court. This approach was recognized by the district court on appeal in the Orange County bankruptcy. There, the court found that the lien securing tax and revenue anticipation notes pursuant to a California statute authorizing the county to pledge assets to secure notes was a statutory lien. Since the statute imposed the pledge, not a security agreement, it survived the filing of a Chapter-9 petition.⁸⁰ Twenty-seven states recognize some form of a statutory lien in relation to their bond obligations.⁸¹

The significance of special revenues and statutory liens was illustrated recently by the case of *Sierra Kings Health Care District*, in which a court order reaffirmed the fact that a Chapter 9 proceeding and any order or Plan of Debt Adjustment cannot interfere with notes, bonds or municipal obligations that are paid from the pledge of taxes or revenues which are special revenues or subject to a statutory lien.⁸² Of special significance is the fact that the *Sierra Kings* court confirmed, for the first time, the post-petition effectiveness of a municipality's pledge of *ad valorem* taxes which qualified as both a special revenue pledge and a statutory lien.

⁷⁹ *In re County of Orange*, 189 BR. 499 (CD Cal. 1995).

⁸⁰ *Id.*

⁸¹ The states include: Alaska, Arkansas, California Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, North Carolina, North Dakota, South Carolina, South Dakota, Tennessee, Texas, Vermont, Virginia and West Virginia.

⁸² *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

The Chapter 9 proceeding, orders and plan would not affect the timely payment on these bonds according to their terms.

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>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 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 § 552 of the U.S. Bankruptcy Code. This position may be questioned under § 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 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 post-petition.</p>

General obligation bonds without any pledge of revenue or special constitutional priority can be treated like any other unsecured claim of vendors, workers or pension; however, in Medley, Florida, in 1968, there was a distinction made to pay bond indebtedness on schedule and stretch out the payments to other unsecured creditors over a 10-year period since failure to make payment on the bonds might cause the municipality to lose access to the market or to pay a

significantly higher price for access that would justify a better treatment for bond indebtedness for the benefit of all.

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

E. Payments to Bondholders Are Not Preferences

The U.S. Bankruptcy Code also provides assurance to holders of all municipal bond or note obligations that payments received within 90 days of the commencement of a municipal bankruptcy petition are not preferences that may be clawed back.⁸³ Specifically, § 926(b) of the Bankruptcy Code provides that a transfer of property of 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 § 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 intent appears to be that § 926(b) should be applicable to all forms of municipal debt and allow such holders to keep such payments where the U.S. Bankruptcy Code would otherwise require any payments made within 90 days of a bankruptcy filing to be returned to the estate.

⁸³ 11 U.S.C. § 926.

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 used primarily 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. ^e There should be no delay in payment since automatic stay is lifted under § 922(d).
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 the language of §§ 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 § 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 § 929 of the U.S. 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 § 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under § 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to § 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.
6. Unsecured debt includes:	

TYPE OF CLAIM

EXPLANATION

- 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 *pro rata* distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

- a Chapter 9 incorporates § 506(c) of the U.S. 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 U.S. 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 Revenues may be attached as not being a valid continuing Post-Petition Lien under § 552 of the U.S. Bankruptcy Code.
- 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.
- 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 U.S. Bankruptcy Code, which imposes special provisions for the rejection of collative bargaining agreements (making the standard less restrictive, *i.e.*, “impairs ability to rehabilitate”) or §§ 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.

F. Rejection of Executory Contracts and Unexpired Leases Including Collective Bargaining Agreements

On February 22, 1984, in *National Labor Relations Board v. Bildisco & Bildisco*, the U.S. Supreme Court held that § 365(a) of the U.S. Bankruptcy Code provides that, with certain limitations, the debtor may unilaterally assume or reject any executory contract of the debtor, including a collective bargaining agreement.⁸⁴ The test set forth in *Bildisco* was whether the debtor could show both that the agreement burdens the estate and that the equities balance in favor of rejection. Congress responded to that decision with § 1113 of the U.S. Bankruptcy Code, which set a much more difficult test, in addition to setting a detailed procedure that must be followed for the rejection of a collective bargaining agreement. Under § 1113(c), the court will approve an application for rejection of a collective bargaining agreement only if the court finds that (a) the debtor has, prior to the hearing, made a proposal to modify the collective bargaining agreement that is necessary to permit the debtor to reorganize, (b) the authorized representative of the employees has refused to accept such proposal without cause and (c) the balance of the equities clearly favors rejection of such agreement. This more difficult test has *not* been incorporated into Chapter 9, and the *Bildisco* standard appears to be applicable to Chapter 9 debtors. However, as evidenced by the recent *Vallejo* case, despite the more lenient test to reject a municipal collective bargaining agreement, the nature of the litigation process and the time and expense involved in obtaining a final order with respect to such an emotional and political issue are likely to absorb the attention of a municipality and take many months to reach a conclusion.⁸⁵

⁸⁴ 465 U.S. 513 (1984).

⁸⁵ See *Int'l Brotherhood of Elec. Workers, Local 2376 v. City of Vallejo (In re City of Vallejo)*, 432 B.R. 262 (E.D. Cal. 2010) (upholding bankruptcy court's decision to permit the debtor-city to reject a collective bargaining agreement).

G. Conclusion

The above was meant to provide a general overview of issues that may be helpful to bondholders and other investors regarding the effects of a municipal bankruptcy on the payment of principal and interest on bonds. Because of the complexities of the U.S. Bankruptcy Code, and indeed of the Chapter 9 municipal restructuring process, if the municipal security is being issued in a state permitting municipal bankruptcy consideration should be given to disclosure of this fact, including a discussion of the process and, given the structure of the security being sold, the anticipated treatment of such security in a Chapter 9 proceeding.

VII. CONCLUSION

State and local government financial officers have recognized the necessity of having the availability of financing at a low cost in the market so that they, on a local basis, can decide what infrastructure and services should be provided to their citizens. In this way, the municipalities do not have to rely upon the state or federal government to make those decisions subject to the vagaries of the broader perspective and needs. That ability to finance essential government services or an infrastructure has led to the largest world economy, and the basic infrastructure remains superior to all others. It is suggested that more extensive disclosure with respect to state remedies in the event of financial distress and the nature and priority of the treatment expected for the security in the event of a bankruptcy will assist municipal issuers by strengthening and expanding the market of potential investors. Market participants will increasingly demand and issuers should facilitate the disclosure of such information which will enhance the sale and liquidity of the municipal bond market.

In summary, as we have seen, adequate disclosure is an essential part of an efficient and effective market. With respect to distressed communities, there are a number of disclosure items that should be considered in connection with the issuance of security:

1. Whether the issuer is authorized to file for Chapter 9 under state law;
2. Whether the structure includes a pledge of special revenues or a statutory lien which will not be impaired or interfered with by a Chapter 9 filing so that payments will continue post-petition;
3. The vehicles that are available to the issuer if it finds itself in distress, including oversight by a state refinance authority, the availability of intergovernment cooperation, loans and grants, mandamus, the right to have a receiver appointed and other provisions;
4. Encouragement of the municipal issuer to, in real time, provide financial information (annually or quarterly) on a timely basis so that the securities market is aware of the position of the issuer; and
5. Encouragement of the municipal issuer to provide voluntary secondary market relating to its financial condition and problems so that the securities market is fully and uniformly informed of its status and progress.

State and local governments have traditionally taken whatever action is necessary to avoid defaulting on their public debt obligations in order to ensure continued access to the municipal bond market at the lowest cost possible. There is a practical reason for this tradition since access to the market at a low cost allows state and local governments to decide locally what infrastructure improvements (schools, roads, bridges, waste and water treatment facilities, public buildings) and essential services should be provided rather than to request the national government for approval or funding.

The consideration of enhanced disclosure or providing additional information to the marketplace helps all investors, both retail and institutional, better understand the possibility of a Chapter 9 bankruptcy filing, the rights and remedies provided for the investor, the ability of the

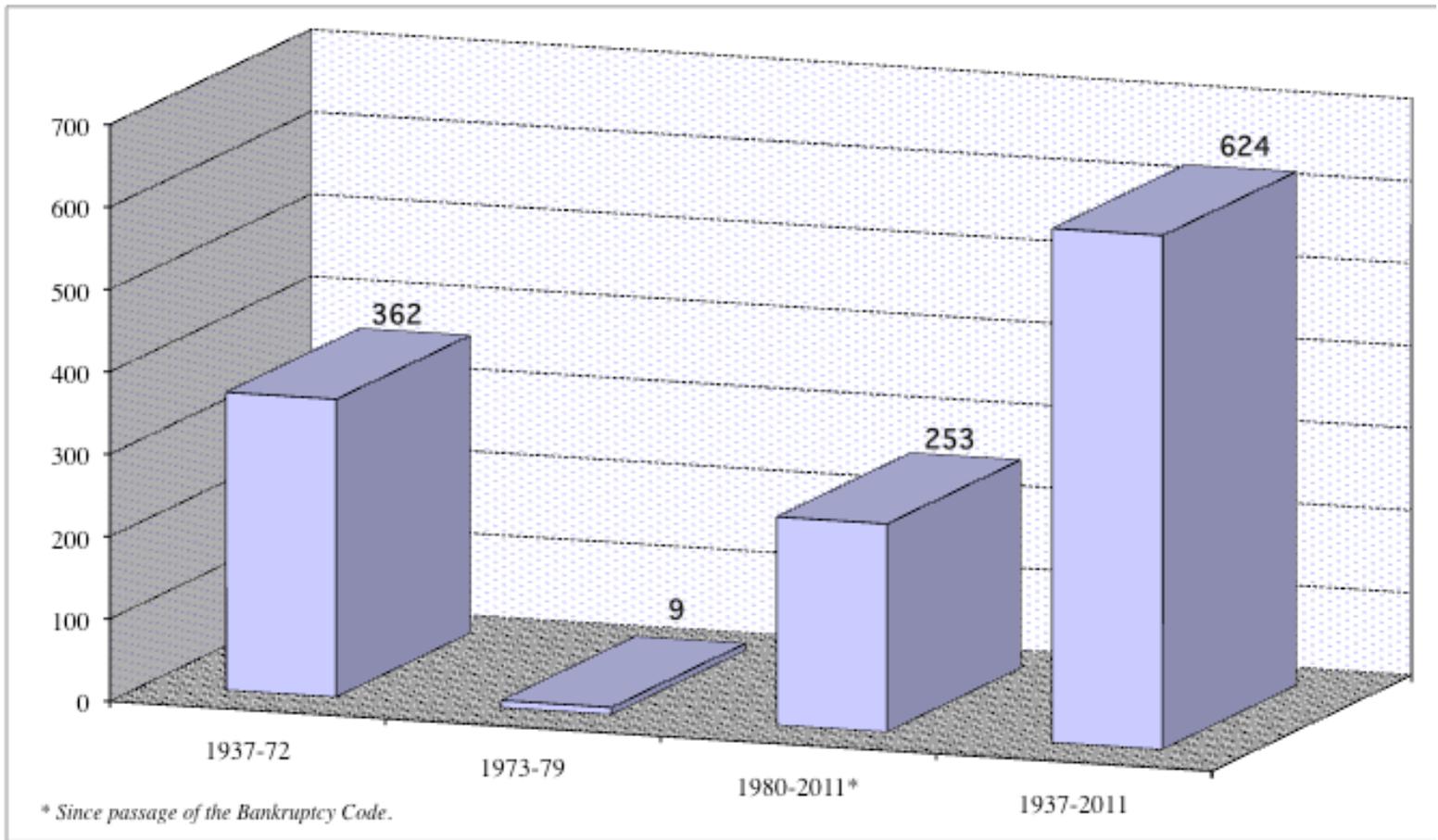
state and others to provide restructuring supervision, loans, grants or refinancing, whether the securities have a pledge of special revenues or statutory lien so that they will continue to be paid on a timely basis from the pledged collateral revenues and the current financial condition of the municipality will all assist the municipality and the state in the successful issuance of securities. In addition, such disclosure will assist the investor in better assessing the risks and benefits presented. As a result, such disclosure should help continue and enhance access to the capital markets by states and local governments at the lowest cost possible, in good times and in bad.

This document has been prepared for information purposes only. It is general in nature and based on authorities that are subject to change. It is not intended as legal advice. It is solely the personal view of James E. Spiotto and is not a statement, position or opinion of the firm of Chapman and Cutler LLP or any of its other partners.

APPENDIX A

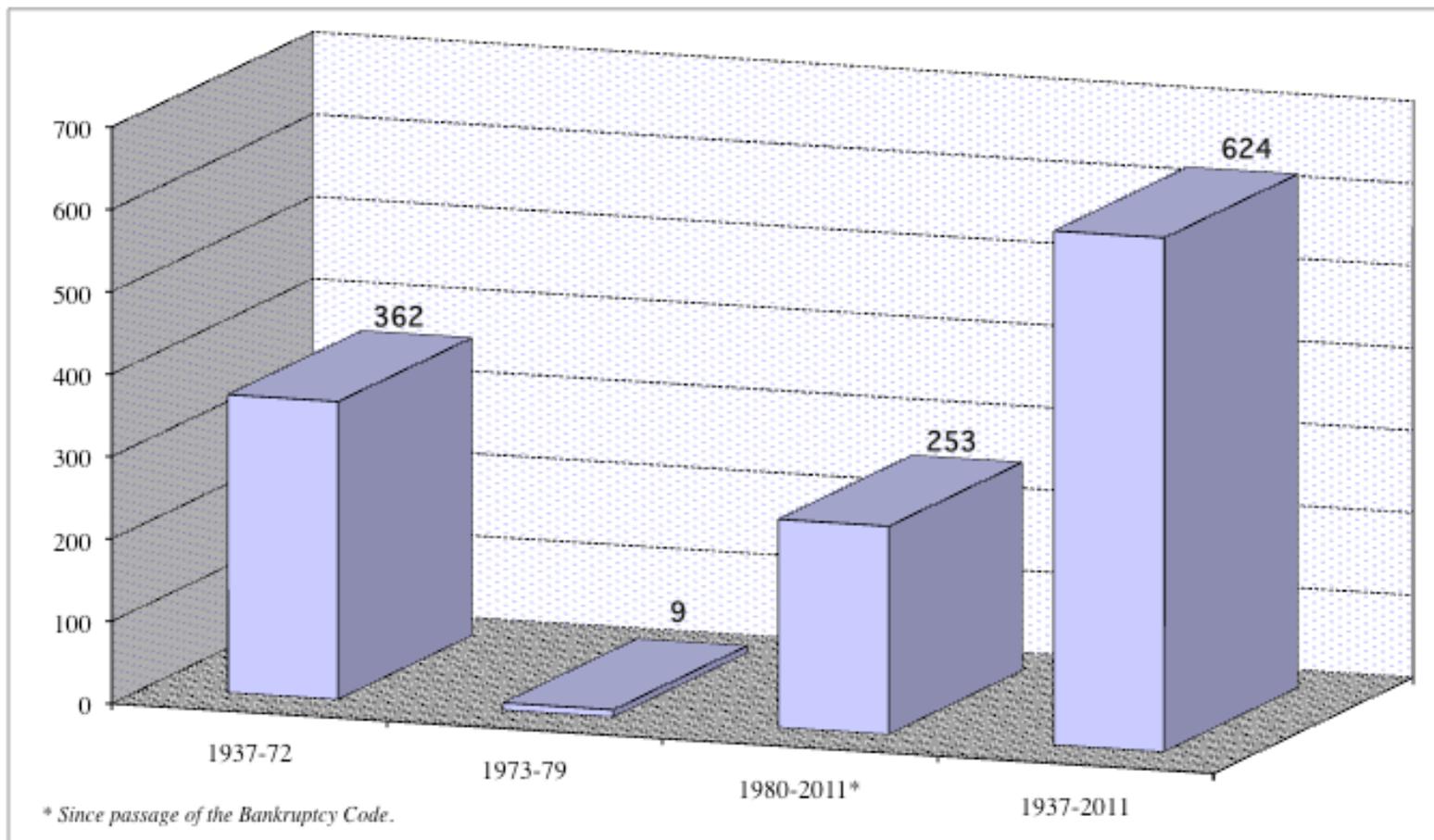
FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-2011

(as of 06/27/2011)



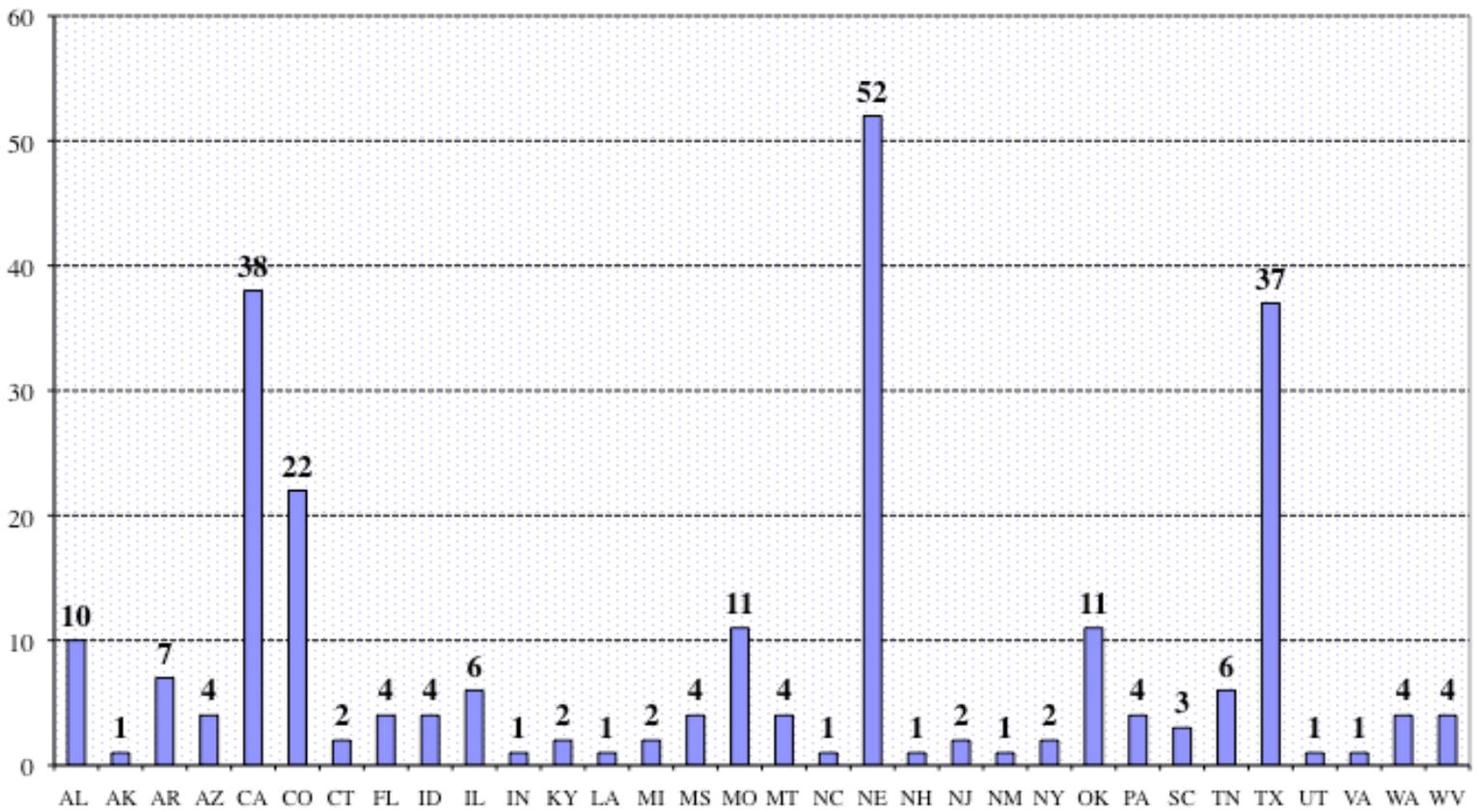
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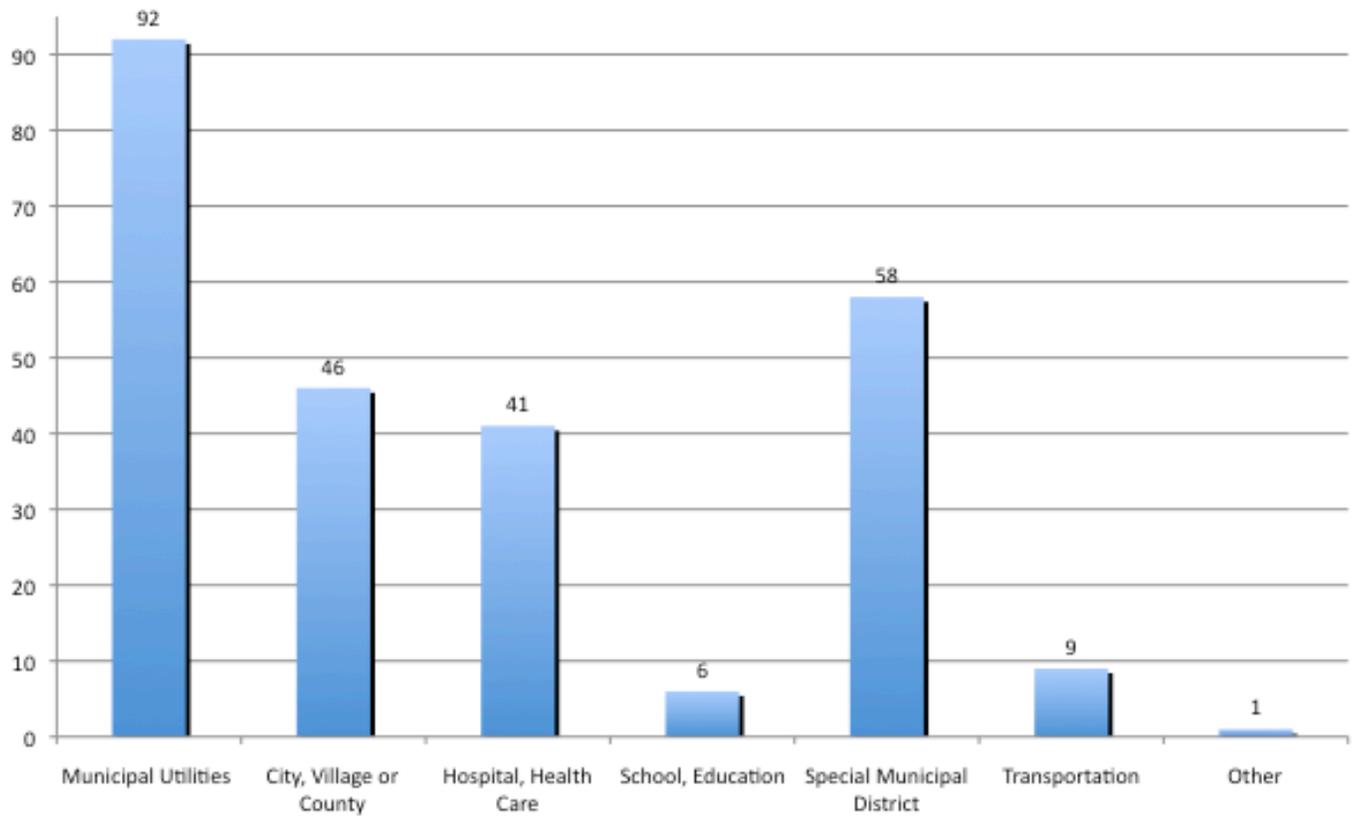


CHAPTER 9 FILINGS BY STATE • 1980-2011

(as of 06/27/2011)

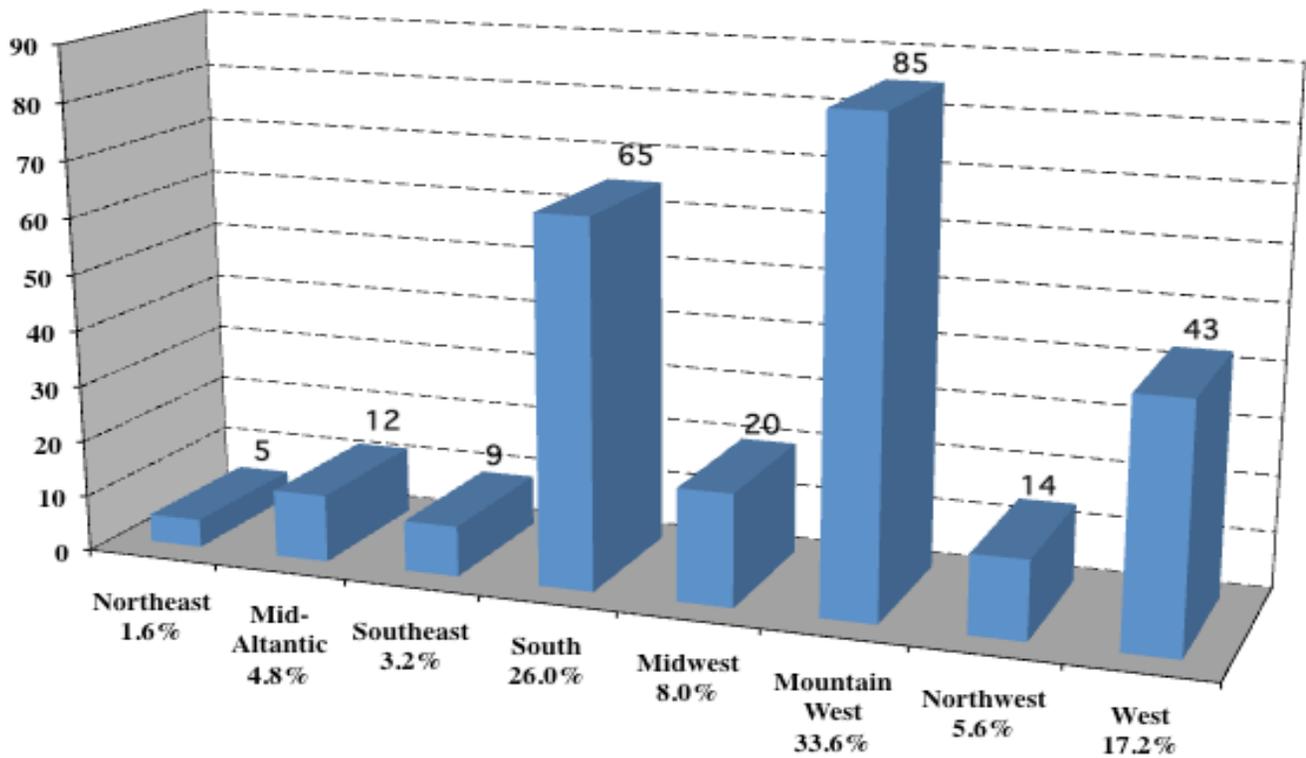


CHAPTER 9 FILINGS BY TYPE • 1980-2011 (as of 06/27/2011)



CHAPTER 9 FILINGS BY REGION • 1980-2011

(as of 06/27/2011)



APPENDIX B

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

**13 STATES THAT SPECIFICALLY
AUTHORIZE MUNICIPAL BANKRUPTCIES**

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

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

**11 STATES THAT *CONDITIONALLY* AUTHORIZE
MUNICIPAL BANKRUPTCIES**

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

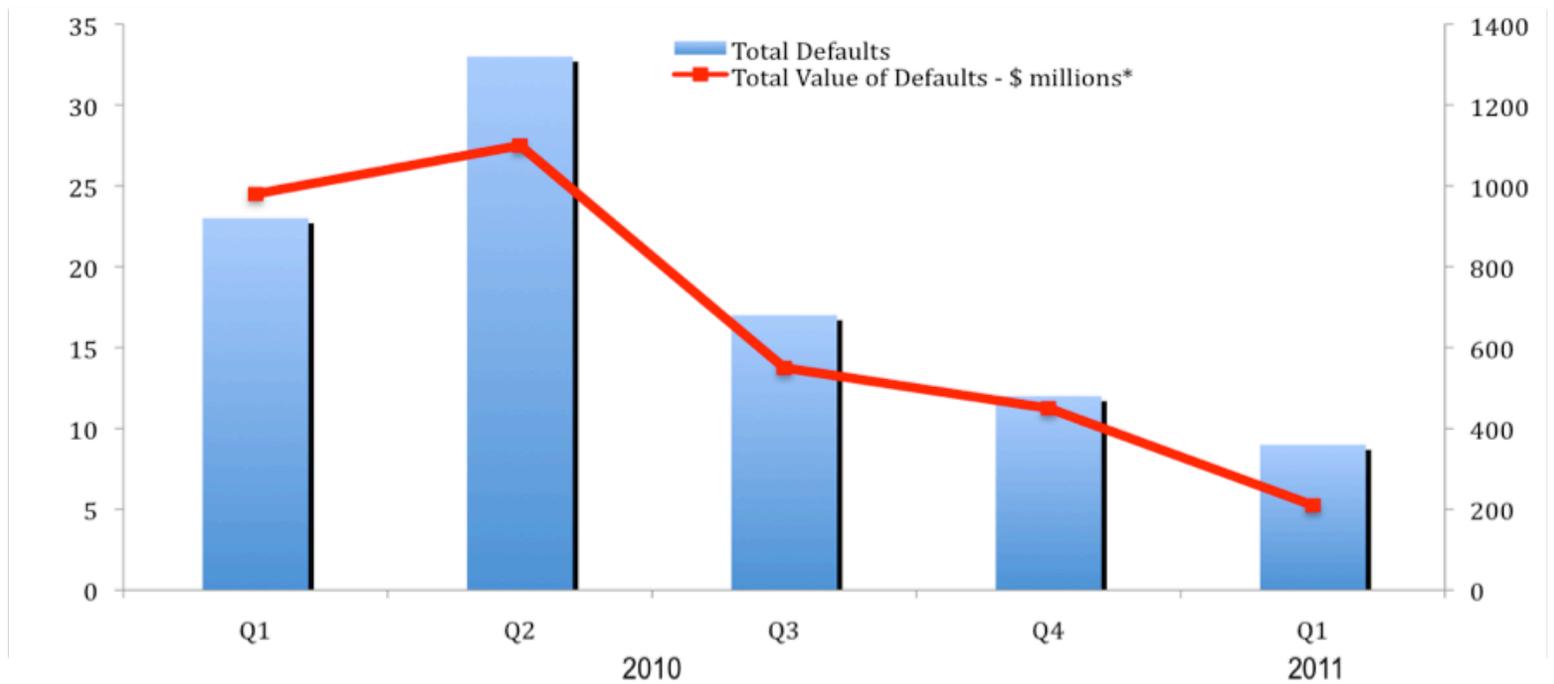
§Iowa generally prohibits filing Chapter 9 (Ia. Code Ann. § 76.16) but allows filing for insolvency caused by debt involuntarily incurred not covered by insurance proceeds (Ia. Code Ann. § 76.16A)

§Georgia prohibits the filing of Chapter 9 Bankruptcy (Ga. Code Ann. § 36-80-5)

APPENDIX C

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

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



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