

**U.S. HOUSE OF REPRESENTATIVES**

**HOUSE JUDICIARY COMMITTEE**

**DETROIT BANKRUPTCY FORUM**

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**TESTIMONY OF JAMES E. SPIOTTO  
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Thank you for the opportunity to discuss with you the legal and practical concerns raised by the Detroit Chapter 9 filing. I am speaking to you from the perspective of someone who has represented clients (States, municipalities and creditors) in connection with financially-challenged situations related to State and local government debt financings, has studied and been involved with municipal bankruptcy for many years and is familiar with the impact and scope of Chapter 9.

As will be discussed in detail below, the experience of Detroit marks a break from the past. Prior to Detroit, any economically-challenged major city of a State worked with the State to achieve a solution to the economic problems and to develop a recovery plan to avoid the financial difficulties in the future. Part of the resolution of the Detroit economic crisis could be the rekindling of historical precedent. In other words, working with the State, Detroit could develop a recovery plan which would provide necessary funding for the recovery. Long term, such an approach is likely in the best interests of creditors, including employees and retirees. It is only through a robust recovery plan that creditors, including employees and retirees, will be paid to the fullest extent possible.

#### **THE MUNICIPAL BANKRUPTCY EXPERIENCE**

As you may be aware, of the 651 municipal bankruptcies filed in the United States since the adoption of the authorizing legislation in 1937, few debtors have been major municipalities. Orange County, California in 1994, Bridgeport, Connecticut in 1991, Stockton, California and San Bernardino, California in 2012 and Detroit in 2013 are recent notable exceptions. See Appendix for the approximate population and debt for the largest cities and towns to have filed for Chapter 9 in the last 60 years. For the most part, the 651 Chapter 9 filings have been small

municipalities or special tax districts or utilities. Further, in the recent municipal bankruptcy of Vallejo, California, which was filed in 2008, disputes with municipal unions over pensions and benefits bogged down the proceeding and delayed that City's emergence from bankruptcy. It has been reported that the issue of the relative treatment of pension and debt payments likely will take center stage in the confirmation of a plan of adjustment in Stockton and San Bernardino and even lead to appellate review of the issue. The decision on the eligibility of Stockton took almost ten months. After more than a year in bankruptcy, the issue of the eligibility of San Bernardino has finally been determined, paving the way for a battle between the competing interests. It is safe to say that the availability of a bankruptcy option has not proven to be a "quick or easy fix" to municipalities.<sup>1</sup> This is particularly true where there has been contention between the major players in the case. Historically and practically, Chapter 9 debt adjustments should be the last resort after all other alternatives have been unsuccessful and shall seldom be deemed necessary.

#### **THE LESSONS LEARNED FROM CONSTITUTIONAL CHALLENGES TO MUNICIPAL BANKRUPTCY PROVISIONS**

The Tenth Amendment to the Constitution explicitly articulates the Constitution's principle of Federalism by providing that powers not granted to the Federal Government nor prohibited to the States by the Constitution of the United States are reserved to the States respectively or to the people. Accordingly, while Article I, Section 8 of the Constitution gives Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States," that power may not interfere with the power reserved to the States by the Tenth Amendment. While there may be precedent for the Federal preemption of bankruptcy law for corporations and individuals, there was, at our Nation's founding, no precedent for a dual

sovereign passing a law regulating the bankruptcy of the other. This remains the case today. The earliest iterations of statutes providing for municipal debt adjustment (Chapter IX) not unexpectedly resulted in a review of the constitutionality of municipal bankruptcy by the U.S. Supreme Court.

As you know, the current version of Chapter 9 of the Bankruptcy Code attempts to embrace the concept of sovereignty of States and the limitations imposed by the Tenth Amendment. Section 903 of the Bankruptcy Code specifically reserves a State's power to control municipalities.<sup>ii</sup> In addition, § 904 of the Bankruptcy Code specifically limits the jurisdiction and powers of the Court over the municipality.<sup>iii</sup> As a result, the power of a Bankruptcy Court presiding over a Chapter 9 case is limited and cannot interfere with the property, revenue, politics, government and affairs of the municipality. The jurisdiction of the Bankruptcy Court over the municipality flows from the specific authorization of the State in question to allow the municipality to file. Most States have chosen not to specifically authorize their municipalities to file. In fact, only twelve States have unconditionally authorized municipalities to file Chapter 9 petitions.<sup>iv</sup>

Earlier versions of municipal bankruptcy legislation attempted to deal with these concepts as well. Prior to 1934, Federal bankruptcy legislation did not provide a mechanism for municipal bankruptcy, insolvency, or debt adjustment.<sup>v</sup> During the period 1929 through 1937, there were 4,700 defaults by governmental bodies in the payment of their obligations.<sup>vi</sup> In 1934, the House and Senate Judiciary Committees estimated that there were over 1,000 municipalities in default on their bonds.<sup>vii</sup> That was obviously a different stage of financial distress than presently exists today with no State in default of any its general obligation bonds.

Until World War II, units of local government were very heavily dependent upon property tax. During the Depression, there was widespread nonpayment of such taxes. Bondholders brought suits for accountings, secured judgments and obtained writs of mandamus for levies of further taxes. The first municipal debt provisions of the Bankruptcy Act of 1898 as amended from time to time (hereinafter the “*Bankruptcy Act*”) were enacted as emergency legislation for the relief of such municipalities. The municipal provisions became effective on May 24, 1934.<sup>viii</sup> These provisions were to be operative for a two-year period from that date, but this period was later extended to January 1, 1940.<sup>ix</sup>

The municipal debt adjustment provisions of the Bankruptcy Act enacted in 1934 reflected an attempt to protect municipalities from debilitating disputes with creditors.<sup>x</sup> The 1934 legislation provided a procedure whereby a local governmental unit, if it could obtain acceptances from two-thirds of its creditors, could have a plan of readjustment enforced by the Federal courts. The 1934 legislation contained language similar to the policy expressed in the current § 904:

The Judge . . . shall not by any order or decree, in the proceeding or otherwise, interfere with (a) any of the political or governmental powers of the taxing district or (b) any of the property or revenues of the taxing district necessary in the opinion of the Judge for essential governmental purposes or (c) any income producing property, unless the plan of adjustment so provides.

Nevertheless, the Supreme Court determined that, under the 1934 legislation, the court, and to some extent, the creditors through the court, had certain control over the municipality’s revenues and governmental affairs. In 1936, the Supreme Court of the United States held, in the case of *Ashton v. Cameron County Water Improvement Dist., No. 1*,<sup>xi</sup> that the 1934 municipal

bankruptcy legislation was unconstitutional because it infringed upon the sovereign powers of the States and potentially permitted too much control by a Federal court and by Federal legislation over municipalities, sub-sovereigns of the sovereign States.

In 1937, new legislation was passed attempting to cure the defects outlined by the Court in *Ashton* and to protect municipalities from the injurious protracted litigation that some were enduring. The 1937 municipal bankruptcy legislation, enacted in response to the *Ashton* decision, required:

- (1) no interference with the fiscal or governmental affairs of political subdivisions;
- (2) a restriction on the protection of bankruptcy to the taxing agency itself;
- (3) no involuntary proceedings;
- (4) no judicial control or jurisdiction over property and those revenues of the petitioning agency necessary for essential governmental purposes; and
- (5) no impairment of contractual obligations by the States.

This legislation was upheld by the Supreme Court in *United States v. Bekins*,<sup>xii</sup> where the Supreme Court noted that the statute was carefully drawn so as not to impinge upon the sovereignty of the States. Like the 1934 legislation, language similar to the § 904 concept was included, although references to “the opinion of the Judge” were deleted.

Chapter IX then, while part of the Bankruptcy Act, provided a forum in which a municipality could voluntarily seek an adjustment of indebtedness if authorized by the State to file. A Chapter IX proceeding was not a proceeding to adjudge the city a bankrupt. The court's jurisdiction did not extend to declaring the city bankrupt or to administering its affairs as a bankrupt. The court was limited to approving as a matter of law or carrying out a proposed plan for reorganization of a municipality's debt.<sup>xiii</sup>

The principles enumerated in *Ashton* and the 1937 legislation are important in understanding the role of a Bankruptcy Court in a Chapter 9 proceeding today.<sup>xiv</sup> The Court cannot constitutionally interfere with the revenue, politics, or day-to-day operations of the municipality. The Bankruptcy Court cannot replace, by its rulings or appointments, the City Council or any other elected or appointed official. The limited, but vital, role of the Bankruptcy Court is to supervise the effective and appropriate adjustment of municipal debt in accordance with applicable law. (Obviously, the special limitations on the power of the bankruptcy court in a Chapter 9 case would not be applicable if the city consented to the stay or order of the court which affected its political or governmental powers.<sup>xv</sup>) Historically, Chapter IX and its successor Chapter 9 were intended to facilitate rather than mandate voluntary municipal debt adjustment, not municipal debt elimination.

#### **THE TRADITIONAL ROLE OF STATES IN ASSISTING FINANCIALLY TROUBLED MUNICIPALITIES**

States typically play an important role in assisting municipalities in times of financial distress. It is unusual that the largest city in the State of Michigan, Detroit, has chosen

bankruptcy as its best option. States traditionally have enacted legislation designed to protect their cities from financial distress or to aid cities should financial distress befall them.

Traditionally, States have attempted to supervise local government financing and limit volatility through the enactment of debt limitations and laws that permit the refunding of municipal obligations. Over time, States have developed more sophisticated mechanisms of assisting and providing oversight to their municipalities through the use of receivers, financial managers, and oversight and refinance authorities. Each state has its own, unique approach to these mechanisms. Various States have adopted different vehicles to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. At their most basic, these methods, which may be found in legislation or constitutional provisions, include limitations on debt and taxes and on the authority to refinance outstanding debt. More hands-on involvement by the States arises in the event of financial distress. Procedures devised for such situations generally start with the requirement to balance the budget and progress to review, assistance and oversight by the States of municipal budgets and financial issues.

In addition, States have developed unique approaches to the oversight, supervision, and assistance of local governments in times of emergency. These include advisory commissions that review the financials, the budgeting and financing done by municipalities, receiverships, financial managers, financial control boards, refinance authorities, oversight commissions, and others. These mechanisms will be briefly reviewed here and are discussed in more detail in Municipalities in Distress? referenced in endnote 1.

#### **FINANCIAL CYCLES REQUIRE THAT STATE AND LOCAL GOVERNMENTS PREPARE FOR ECONOMIC DOWNTURNS**

The impact of economic cycles has been demonstrated throughout the history of state and local government debt financing.<sup>xvi</sup> Unfortunately, we all recognize an adverse effect of

downturns, namely, lower state and local government revenues. Nevertheless, economic downturns provide no holiday from the threat of higher state and local government expenses, which are highlighted by the ever-increasing need for improvement in infrastructure, education, health care, and public safety. Over time, various new mechanisms have been introduced to provide supervision and assistance to those local governments that are experiencing financial distress. There does not appear to be a reason any local government should have to endure, without supervision or assistance, the devastating effects of a financial meltdown and possibly to resort to the filing of municipal bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. Traditionally, States have worked with their local governments to avoid financial meltdowns and bankruptcy, and there is no reason to believe that tradition will not continue.

#### **HOW STATES HAVE ATTEMPTED TO SUPERVISE STATE AND LOCAL GOVERNMENT FINANCING AND VOLATILITY IN TIMES OF ECONOMIC DISTRESS**

Historically, States have adopted various mechanisms to provide supervision, oversight, and assistance to their municipalities on an ongoing basis and especially in times of financial distress. In the past, these mechanisms primarily have started with basic limitations on debt and taxes and authorization to issue refunding bonds.

At the front lines of protecting the financial status of local government are constitutional and statutory limitations on the debt municipalities may have outstanding at any time. In addition to debt limitations, all States include provisions in their statutory law for the issuance of refunding bonds.

#### **DEBT LIMITATIONS**

One of the most important protections for municipalities and their creditors is the limitation 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 exceptions of Alaska, Florida, and

Tennessee impose some sort of limit.<sup>xvii</sup> Municipalities in 28 States are restricted by limits imposed by their respective constitutions. Twenty-one 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.<sup>xviii</sup>

### **REFUNDING BONDS**

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 more favorable interest rate or restructure its outstanding obligations to 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. In most cases, the issuance of refunding bonds does not result in an increase in outstanding debt, because the refunded bonds no longer count toward the legal limits. 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. In addition to these provisions, some steps have gone a step further to help beleaguered municipalities resolve their financial issues at the initial signs of a problem.

### **THE USE OF VARIOUS MECHANISMS BY STATES TO PROVIDE FINANCIAL OVERSIGHT AND ASSISTANCE TO MUNICIPALITIES IN DISTRESS**

The limitation on indebtedness and authorization to issue refunding bonds are the basic tools in the States' arsenal to assist municipalities. However, in times of financial distress, these basic approaches have been enhanced by additional mechanisms. These methods have started with reaffirming statutory requirements to balance budgets and progressed to greater state

assistance and oversight of municipal budgets and finances in times of financial emergency as well as the use of receivers and financial managers and oversight authorities. States have approached the task of supervising and assisting their municipalities in a variety of ways. Although these mechanisms vary by type and degree of supervision and assistance, the widespread development of these mechanisms indicates the growing trend of more active oversight and supervision of municipalities by States in order to build better credibility with citizens and creditors, including the municipal bond market.

### INTRODUCTION

Twenty-five States have implemented municipal debt supervision or restructuring mechanisms to aid municipalities. These programs, many of which are identified in the Table below and which are described in detail in Municipalities in Distress?, 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 a municipality’s level of financial instability. States with these provisions have effectively used these mechanisms to control the restructuring of their municipalities.

<b>Table: State-Implemented Programs to Aid Municipalities</b>	
<b>State</b>	<b>Intervention Provision</b>
Arizona	School District Receivership
California	Debt and Investment Advisory Commission
Connecticut	Ad hoc State Intervention
District of Columbia	Financial Responsibility and Management Assistance Authority
Florida	Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program
Georgia	Government Monitoring
Idaho	Debt Readjustment Plans

<b>Table: State-Implemented Programs to Aid Municipalities</b>	
<b>State</b>	<b>Intervention Provision</b>
Illinois	Financially Distressed City Law and Financial Planning and Supervision
Indiana	Distressed Political Subdivision Protections and Township Assistance and Emergency Manager
Kentucky	County Restructuring Provisions
Maine	Board of Emergency Municipal Finance
Massachusetts	Ad hoc State Intervention
Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act and Local Financial Stability and Choice Act
Minnesota	Back-Up Payment Procedures for Municipalities and School Districts
Nevada	Local Government Financial Assistance and Audit Enforcement Act
New Hampshire	Emergency Financial Assistance
New Jersey	Local Government Supervision Act and Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act
New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board
North Carolina	Local Government Finance Act
Ohio	Fiscal Watch; Fiscal Emergency; and the Fiscal Emergencies and Financial Planning and Supervision Commission
Oregon	County Public Safety Emergency and Fiscal Control Board and Municipal Debt Advisory Commission
Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act
Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission
Tennessee	Emergency Financial Aid to Local Government Financially Distressed Municipal Procedures
Texas	Municipal Receivership
Wisconsin	Deficiency Protection for Public

<b>Table:</b>	<b>State-Implemented Programs to Aid Municipalities</b>
<b>State</b>	<b>Intervention Provision</b>
	Improvement Bonds

**STATES RECOGNIZING MUNICIPAL RECEIVERS: RHODE ISLAND AND TEXAS**

Some States provide for the appointment of a receiver for troubled municipalities. For example, in June 2010, Rhode Island enacted a law providing a process of progressive state intervention for municipalities in financial distress. The new law created a three-step process for distressed government, 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.<sup>xix</sup>

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.

**FINANCIAL CONTROL BOARDS AND THEIR PROGENY**

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, receivers, 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.

**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, for more than ten years, New York City had been using questionable accounting and borrowing practices to eliminate its annual budget deficits.<sup>xx</sup> 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 be resolved only by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York City 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.<sup>xxi</sup> 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 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.<sup>xxii</sup> Under these provisions, if the state's 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.

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.

**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.<sup>xxiii</sup> These provisions were subsequently replaced by the Local Government and School District Fiscal Accountability Act.<sup>xxiv</sup> Under this act, if a school district or municipality was in a perilous financial situation, the governor of Michigan could declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager be appointed, the emergency manager had broad powers to operate and restructure the municipality, including the ability to reject, modify, or renegotiate contractual obligations.<sup>xxv</sup> As a last resort, this emergency manager could file a Chapter 9 municipal bankruptcy petition on behalf of the municipality.<sup>xxvi</sup> This Public Act 4 of 2011 provided for a Michigan emergency manager with extraordinary power. The act was very controversial, especially to local government bodies and elected officials. A referendum placed on the November 6, 2012, ballot defeated Public Act 4 of 2011, the Michigan Emergency Manager Law.

On December 27, 2012, the governor of Michigan signed into law the Local Financial Stability and Choice Act,<sup>xxvii</sup> which replaced the defeated Public Act 4. Also, in 2012, Indiana passed legislation allowing its Distressed Political Subdivisions Appeal Board to appoint an emergency manager for its distressed subdivisions on grounds and with powers similar to the Michigan emergency manager.<sup>xxviii</sup>

**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 legislation on an ad hoc basis to create a financial control board or overseers for municipalities in severe financial distress.

**The California Experience: Neutral Evaluator.** California also has experimented with the concept of introducing a third party to assist in the resolution of municipal financial difficulties. California recently enacted a provision restricting the ability of its municipalities to file petitions to institute Chapter 9 proceedings.<sup>xxix</sup> The thrust of the legislation is to provide a period of objective and dedicated negotiation and resolution of issues affecting major creditors or financial problems. The legislation provides for a neutral evaluation process, otherwise known as mediation, for major creditors and parties to the financial problems. The neutral evaluator process provides a professional, independent, neutral advisor to serve as the supervising adult, which is the essence of a neutral evaluator. The neutral evaluator can foster negotiations among the municipality and representatives of major creditor constituencies, including workers and union representatives, vendors, contract suppliers, holders of major claims including bondholders, judgment creditors, or others whose interests could affect the financial fate of the municipality. The neutral evaluator process may not last more than 60 days from the date the evaluator is chosen unless the municipality or a majority of participating interested parties elect to extend the process up to an additional 30 days. The neutral evaluator procedure

is intended to be an expedited process and cannot last more than 90 days from the date of the selection of the neutral evaluator.

### **DEVELOPMENT OF THE MUNICIPAL PROTECTION COMMISSION: A PROPOSAL**

The experience of the New York Financial Control Board, the Rhode Island receiver approach, and the mediator of the California statutory scheme have coalesced in the concept of a municipal protection commission. (See Appendix for charts illustrating how such a commission would function.) Under consideration by some States is the use of a municipal protection commission utilizing some of the best aspects from the mediation process of the neutral evaluator and the oversight and supervision of financial control boards and a receiver. Under this municipal debt resolution mechanism, the state would establish an entity that would have a quasi-judicial function and power similar to a commission or special master appointed by a state supreme court or other objective nonpolitical process. The members of the commission would be independent, experienced experts in governmental operation or finance as well as mediation and debt resolution techniques, including bankruptcy. The commission would start with those municipalities that petition for help or those municipalities that have triggered certain established criteria where the jurisdiction of the commission is mandated by state law. The first phase is mediation and consensual agreement by the municipality and the affected creditor constituencies similar to the neutral evaluator process. However, participation by the commission may be required, and negotiation and discussion of positions are strictly confidential. The state law establishing the commission would have an exception to its open meetings law and its freedom of information law to allow for open discussion of these sensitive and confidential topics. If additional tax revenues or loans or grants from the state are needed, recommendations to the state by the commission would take effect unless blocked by the state legislature within a specified period of time. The commission can likewise call for a referendum on a local basis for

increased taxes or other actions. Specified time periods for resolution will be set forth and, if the voluntary process is not successful, the second phase is mandatory if the commission so requires.

In the second phase, the commission and its designated members turn into a quasi-judicial panel, and the municipality is required to set forth the steps to be taken to address its specific financial problem (recovery plan). Creditors, workers, and taxpayers will have the ability to comment and to attempt, through negotiation, to modify the recovery plan within a set period of time. Then, the recovery plan is presented to the panel members of the commission for determination of the plan's feasibility and whether it is reasonably fair to creditors' interests in relation to the requirement that, under all circumstances, essential governmental services, at least at an established necessary level, must be maintained for the reasonable future. One of the triggers for the commission's jurisdiction is the petition by the municipality, its workers, or taxpayers that a governmental function emergency exists. The municipality or petition must state that essential services as to the health, safety, and welfare of its residents are being threatened and that the forced reduction in services, given the municipality's financial condition and its revenues, impairs the health, safety, and general welfare of its residents. The commission, after hearing all sides (municipality, workers, taxpayers, affected creditors), will determine:

- What is sustainable and affordable;
- What the municipality can afford;
- What adjustments must be made to the recovery plan to allow the municipality to continue to provide essential governmental services to its residents at established mandated levels to preserve the health, safety, and welfare of its residents and to pay what is feasible to its creditors, including workers' wages and pensions.

The commission will act as an “honest broker” to mandate increases in taxes, where necessary; increases in contributions by the municipality or workers for pension or other benefits, if necessary; or reduction, delay, or stretching out of payments to creditors. Further, if necessary to preserve the public health, safety, and welfare of the municipality’s residents, the commission will have the power to reduce workers’ wages, pensions, or other benefits.

A municipality that underestimates in its recovery plan its ability to pay creditors and workers will have necessary increases in the payments imposed with the benefits going to the workers and the creditors. A municipality that overestimates its ability to pay or makes promises that are not sustainable and affordable will suffer reduced payments to workers and creditors and possibly increased taxes. The findings of the commission will specify if they are final and enforceable by the parties or if further negotiations or proceedings are necessary. The commission will be charged to make sure that the municipality and the state maintain access to the financial markets, and the ability to borrow will be protected if possible. This commission process should help protect all parties, workers, vendors, and creditors and the taxpayers and the municipality so they will have needed means of continued financing credibility that can be accomplished on the local level based upon maintaining market credibility. The commission can authorize the municipality to enforce its findings. The findings, determinations, and rulings of the commission can have the force of law by providing that, if the legislature does not act within a short, specified period and overturn the act of the commission, it is the law. This may provide conflicted or fractured legislatures with a graceful resolution with political deniability. Such means of enforcement can include having the recovery plan approved or revised by the commission as the basis for a pre-negotiated or “pre-packaged” Chapter 9 plan. The commission can authorize the municipality to file a Chapter 9 proceeding based on the recovery plan as a pre-packaged Chapter 9 plan. Such a pre-packaged Chapter 9 plan can significantly reduce costs,

expenses, uncertainty, and financial market risk of a free-fall Chapter 9 proceeding. In the corporate world, for instance, pre-packaged Chapter 11 plans (corporate plans of reorganization) have been confirmed in weeks rather than months or years with reduced costs, risks, and uncertainties.

This municipal protection commission concept is still in its formative stages and is being discussed in various States. It could be the means of providing state and local government cooperation and oversight while allowing the municipality, its elected officials, workers and unions, creditors and bondholders to have a means of participation with a definitive end result. Further, the resolution for affected workers and creditors can be hard-wired for a payment source of dedicated taxes for assured payment of wages, benefits, and creditor claims rather than the speculative hope of future payment at the willingness of future legislative actions.<sup>XXX</sup>

#### **THE STRUCTURE FOR OVERSIGHT AND EMERGENCY FINANCING**

Local governments that have encountered financial distress have resorted to financing and oversight authorities (such as New York City and Philadelphia). This approach can involve various degrees of formal oversight and control. In the beginning, it can be as simple and benign as a “commission” that reviews the city budget and makes recommendations based on new revenue sources. If necessary, the commission can develop into a refinancing authority with full power to refinance existing debt of the local government and to authorize collection of new revenue sources or withdraw use of new revenue sources if budget recommendations are not followed or met. There are two basic advantages to this approach:

- The new independent issuer can have financial credibility and, therefore, access to borrowing in the capital marketplace if it has an assured source of revenue to pay debt service that is isolated from the bankruptcy and other legal risks; and

- An independent authority can use various tools to enforce fiscal discipline on the local government because it can be removed from political pressures.

The basic idea is that the authority is given a revenue source. It then borrows and assigns the revenue source to pay debt service on the bonds, payments to creditors and to provide funds for necessary infrastructure enhancement to foster improved economic growth. The authority makes the bond proceeds available to the local government to pay its expenses and retire the deficit. A basic legislative choice is whether the local government levies the new taxes and pledges the proceeds to the authority or the authority is the taxing body authorized to levy taxes. In addition, the sub-sovereign's ability to levy new taxes may be conditioned on a balanced budget or approval of the authority.

Financing through the authority can be used both for a long-term amortization of the cumulative deficit and, if necessary, for an interim period, to accomplish the annual revenue anticipation note borrowings that are necessary for the sub-sovereign to operate. Different revenue sources might be used for each type of borrowing.

The disciplinary tools are important and a wide range of tools can be constructed, including the following:

**Grants from the Federal, State or Regional Governmental Bodies.** Obviously, a source of funds has to exist from which to make grants. The grant becomes a tool if the federal, state, or regional governmental body<sup>xxxix</sup> imposes performance conditions as a precondition to any grant. The federal, state, or regional governmental body can make the process more politically palatable by freely making a grant to the authority while requiring either in the legislation or in the grant documents that the authority impose performance requirements.

**Loans from the Federal, State or Regional Governmental Bodies.** Instead of a grant, the federal, state, or local governmental body can make loans that require ultimate repayment.

The repayment terms can be varied depending upon the local government's compliance with an approved financial plan and the achievement of goals over time. That is, interest rates can be increased or decreased as needed; in a worst-case scenario, principal payment can be accelerated for a default. There can also be in certain States the assumption of the obligations by the state.

**Intercepts.** Part of the discussion in structuring grants and loans should consider “intercepting” the payments to the local government. Legislation can be written that permits the state or regional governmental body to withhold these payments if the local government acts inappropriately or fails to act, or that permits those revenues to be pledged (*e.g.*, paid directly) to lenders or bondholders. In the implementation stage, there is an issue of whether special interest groups, such as unions, local financial institutions, or pension funds might have the ability and willingness to invest in such financing. New York City had support from unions in purchasing significant positions of its refinancing debt.

**Budget Process Involvement.** Having a financial plan to work out of the deficit, following that plan, and changing the plan as experience dictates are the keys to a successful workout. The first step is to identify the problems and to stop the financial bleeding to the degree possible.

**Required Financial Performance.** The authority can legislatively be given powers to participate in and monitor the local government's budget process across a broad spectrum. Ultimately, the teeth in the program are that bond proceeds or new tax revenue sources are not made available to the local government until it complies with the plan, and that continued compliance is required for a continuing revenue flow. The legislation itself can contain the requirements, or it can authorize the authority to develop and establish the requirements.

**Legislative Assistance.** A financially distressed local government comes as a somewhat recalcitrant beggar to the legislature. An authority that is monitoring (and actively participating

in) the local government's recovery can give it credibility with the legislature or, alternatively, if the local government fails to make progress, can assist the legislature in developing new criteria and programs.

**Moral Obligations of the State.** Some States may be constitutionally able to assume debt of a local government. In such States an "extra-legal" state guaranty called a "moral obligation" is sometimes used to credit enhance bonds.

**Appointment of Authority Members.** The makeup of the governing body of the authority is critical to its success. Payment of its staff is important. It is conceivable that some community leaders may be willing to serve without compensation if they believe the authority and its tools are capable of success. Whether or not the local government is able to appoint or be represented on the authority is a question for the drafters of the legislation.

**Acceleration of Loans.** If the authority makes loans to the local government, the loan could include the right to accelerate repayment of the obligations if the local government fails to comply with the recovery plan.

**Publicity.** By participating in the local government recovery process, the authority can become a mechanism for disseminating both good and bad information about the progress of the local government's recovery efforts. Such information flow and disclosure will be helpful in building credibility with the investment community. The experiences of New York City, Cleveland, and Philadelphia stress the importance of accurate and clear communication with the financial market.

**Powers.** The authority can have as many or as few powers as the legislature may require, including but not limited to:

Authorizing filing of a judicial action for municipal debt adjustment by the local government;

1. Granting, after hearing and notice, a stay against litigation and debt enforcement;
2. Approving or withdrawing future use of increased tax revenues;
3. Rejecting or approving budget, financial plans, and future financing;
4. Determining financial emergency or recovery;
5. Approving, expediting, or withholding state aid and entitlement to taxes distributed to the local government;
6. Approving or issuing bonds for refinancing or paying local government deficit or extraordinary operating expenses;
7. Reporting to the state regarding the need for further legislative or disciplinary tools; and
8. Transferring certain governmental services to other governmental bodies or consolidating governmental services on a regional basis or with other municipalities.

**Consolidation of Regional Essential Governmental Services.** One interesting proposition for States is whether certain essential governmental services such as public safety (police and fire) or public health or education should be consolidated and combined on a regional basis to gain the benefits of the efficiencies and elimination of duplicative and overlapping services and administration.

Legislation can be written so that some or all of the above-described tools are available to the authority. These tools can be designed and enacted so that they are mandatory or discretionary. The choices and variations can be further delineated. A variation of the intercept and periodic financial reporting has been used in connection with troubled debt securities issued by local government as a mechanism to ensure the flow of payments from taxes or fees to the bondholders.

Any state municipal refinancing or restructuring board should have sufficient power and authority under state law to effectively supervise a distressed local government. Accordingly, any such municipal oversight and reference authority should be authorized to be able to:

1. Require balanced budgets and provide economic discipline and reporting;
2. Issue debt in the state's name or as a separate entity to obtain market credibility and access;
3. Have the power to negotiate debt restructuring and quasi-judicial jurisdiction;
4. Review services or costs that can be transferred to other governmental bodies;
5. Have the right to intercept tax revenue and ensure payment for essential services and necessary operating costs;
6. Have the power to authorize a Chapter 9 filing if needed;
7. Obtain bridge financing of, or refinance, troubled debt;
8. Transfer certain services to other governmental agencies to reduce expenditures;
9. Grant funds to the municipality to bridge the financial crisis;
10. Provide funds to the municipality by means of a loan with terms that are realistic or payable from out-of-state tax sources that can be offset;
11. Use an intercept of state tax payable to the municipality to ensure essential municipal service;
12. Create private-public partnerships to lease and sell municipal properties to provide bridge financing and cash-flow relief;
13. Develop a vendor assistance program to provide vendor payments through financing by purchase of vendor claims at a discount (fixed discount) and secured by payment from dedicated tax revenues over time or provide current cash flow relief from current or future vendor payments;

14. Explore the consolidation on a regional basis of certain governmental services;  
and
15. Monitor compliance with any restructuring plan to ensure compliance and prevent financial erosion.

### **THE COMPETING FORCES IN A CHAPTER 9**

Chapter 9 is generally viewed as the remedy of last resort for troubled municipalities. If permitted by its state law, a municipality typically does not seek Chapter 9 relief unless it is in extreme financial distress with no obvious solution. Among the factors that can lead to such serious financial distress include the decline of urban areas, the decline of industry and related shrinking of the tax base, unaffordable and unsustainable personnel costs and large debt obligations in excess of the ability to pay. Chapter 9, however, is a vehicle not for elimination of debt, but for debt adjustment. (See Appendix for Charts regarding the differences between Chapter 9 and Chapter 11 of the Bankruptcy Code.) The primary purpose of Chapter 9 is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims. Faced with the necessity to adjust debt, cities who recently have filed for Chapter 9 have been faced with heated battles between public employees and representatives of public debt with respect to the conduct of the case and the plan of adjustment to be confirmed. Accordingly, a brief discussion of the provisions in Chapter 9 governing the rights of employees and public debtholders is instructive.

The following chart summarizes the priorities of creditor payments in Chapter 9.

**SUMMARY OF CHAPTER 9 PRIORITIES**

	<b>TYPE OF CLAIM</b>	<b>EXPLANATION</b>
1.	<p>Obligations secured by a statutory lien to the extent<sup>ab</sup> of the value of the collateral.</p>	<p>Debt (bonds, tax anticipation notes, revenue anticipation notes) 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.) One may expect the bondholders secured by a state statutory lien to argue that the municipality must pay on time the pledged revenues since to do otherwise is contrary to state law and §§ 903 and 904 of the Bankruptcy Code.</p>
2.	<p>Obligations secured by special revenues (subject to necessary operating expenses of such project or system) to the extent<sup>ab</sup> of the value of the collateral.</p> <p>These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.</p>	<p>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.<sup>c</sup></p> <p>There should be no delay in payment since automatic stay is lifted under § 922(d).</p>
3.	<p>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</p>	<p>Under the language of §§ 522 and 928, 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. One may expect the creditor to argue that</p>

	<b>TYPE OF CLAIM</b>	<b>EXPLANATION</b>
	proceeds thereof.	pursuant to §§ 903 and 904, the court cannot interfere with the power of a State to control a municipality in exercise of political or governmental powers 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 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). 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:	
	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

	TYPE OF CLAIM	EXPLANATION
		goods or services. <sup>c</sup>
	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. <sup>f</sup>
	E. Unsecured portion of secured indebtedness.	
	F. Subordinated unsecured claims.	Any debt subordinated by statute or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive <i>pro rata</i> distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

- a Chapter 9 incorporates § 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. *But see* numbers 3 and 4.
- b Chapter 9 incorporates § 364(d) of the Bankruptcy Code, which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.
- c A pledge of revenues that is not a Statutory Lien or Special Revenue Pledge may be attached as not being a valid continuing Post-Petition Lien under § 552 of the Bankruptcy Code.
- 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 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 \$12,475 per employee.

**THE U.S. CONSTITUTION DOES NOT PRECLUDE THE CITIES THEMSELVES  
FROM SOLVING THEIR PENSION PROBLEMS**

Cities may pursue changes to pension contracts that are not sustainable and affordable and impair the State's ability to provide essential governmental services. In fact, the U.S. Supreme Court has held that an impairment to a contract may be upheld where reasonable and necessary to serve an important public purpose.<sup>xxxii</sup> In *U.S. Trust Company v. New Jersey*, the impaired obligation was a statutory covenant between New York and New Jersey addressing revenues and reserves pledged as security for bonds related to the Port Authority.<sup>xxxiii</sup> A New Jersey statute repealed the covenant.<sup>xxxiv</sup> The Court concluded that New Jersey's action was a contractual impairment and violated the Contract Clause of the U.S. Constitution in the absence of showing that the impairment was necessary and reasonable to serve an important public purpose.<sup>xxxv</sup>

Courts employ a four-part inquiry under the Contract Clause.<sup>xxxvi</sup> First, a contractual obligation must be involved. Secondly, the legislation must impair that obligation. Next, the impairment must be substantial. Finally, in order to be valid, the impairment must be "reasonable and necessary to serve an important public purpose."<sup>xxxvii</sup> "An impairment rises to the level of substantial when it abridges a right which fundamentally induced the parties to contract initially or when it abridges legitimate expectations which the parties reasonably and heavily relied upon in contracting."<sup>xxxviii</sup>

Determining that there is an impairment does not end the inquiry. As the Supreme Court in *U.S. Trust* noted:

The Contract Clause is not an absolute bar to subsequent modification of a state's own financial obligations. As with laws impairing the obligations of private contracts, an impairment may be constitutional if it is reasonable and necessary to serve an important public purpose. <sup>xxxix</sup>

In *Faitoute Iron & Steel Co. v. City of Asbury Park*, the court sustained the alteration of a municipal bond contract. In *Faitoute*, the New Jersey Municipal Finance Act provided that a state agency could place a bankrupt local government into receivership. Under the law, similar to a Plan of Adjustment for a Chapter 9 municipal bankruptcy action, the interested parties could devise a plan that would be binding on nonconsenting creditors if a state court decided that the municipality could not otherwise pay its creditors and the plan was in the best interest of all creditors.<sup>x1</sup> After certain bondholders dissented, the court determined that the plan helped the city meet its obligations more effectively. “The necessity compelled by unexpected financial conditions to modify an original arrangement for discharging a city’s debt is implied in every such obligation for the very reason that thereby the obligation is discharged, not impaired.”<sup>xli</sup> The court then found that the plan protected creditors and was not in violation of the Contract Clause.

There is a difference between inability to pay and an unwillingness to pay. Any modification of pension benefits must be tied to being fair to the workers. Benefits can be adjusted to the extent the labor costs or pension obligations prevent the providing of essential governmental services where no further tax increase is possible. It is essential that sufficient funds are available to fund a recovery plan to create the new jobs that will lead to new taxpayers and new revenues for a successful recovery. In other words, to effectuate a recovery plan, it is necessary to stimulate increased business activity so that new jobs will be created, especially for the younger workforce. Accordingly, under the right set of facts, where the record demonstrates that the City cannot in good faith marshal any additional revenues or cut any required services without impairing the public welfare, the Contract Clause should not bar the action. Paying what is sustainable and affordable permits the municipality to recover and grow. This recovery and

growth is required in order to have sufficient funds to employ current workers and to pay benefits to retired employees.

### **THE TREATMENT OF PENSION AND RETIREE HEALTH BENEFITS IN OTHER RECENT CASES**

Vallejo faced a dramatic decline in revenues coupled with rising public safety costs and overwhelming obligations to its employees. In that case, Vallejo was able to modify its collective bargaining agreements and saved substantial sums otherwise owed to current employees. It also reduced retiree health care obligations. The pension obligations to existing retirees were not modified.

In Stockton and San Bernardino, both filed in 2012, the tension between public employees and representatives of public debt initially played out in disputes over the eligibility of the debtors to file for Chapter 9. Both cases ultimately resulted in decisions affirming the validity of the petitions. As a result, the next battle looming in those cases is whether the cities can propose and confirm a plan that would impair the rights of the California Public Employees Retirement System (“CALPERS”). The two cities appear to be taking different approaches with Stockton keeping current on all payments to the pension fund and San Bernardino, which previously had halted bi-weekly payments to CALPERS apparently receptive to a modification of the existing position of CALPERS.

The court in the Stockton case has examined the issue of the impairment of retirees’ contract on a preliminary basis.<sup>xlii</sup> There, the court noted that, while the “Contracts Clause is a key navigational star in the firmament of our constitution and economic universe, it is subject to being eclipsed by the Bankruptcy Clause: ‘The Congress shall have power to . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.’ U.S. CONST., article 1, § 8, clause 4.”<sup>xliii</sup> Significantly, the court notes, the Contract Clause bans a state from making a law impairing the obligations of contract. It does not ban Congress from making a law

impairing the obligation of a contract. Accordingly to the Stockton judge, “this asymmetry is no accident. The Bankruptcy Clause necessarily authorizes Congress to make laws that would impair contracts. *Sturges v. Crowninshield*, 17 U.S. (4WHEAT.) 122, 191 (1819).”<sup>xliv</sup> In its 1938 decision validating the second municipal insolvency statute, the Stockton court noted the Supreme Court explained that “ ‘natural and reasonable remedy through composition’ is not available under state law ‘by reason of the restriction imposed by the Federal Constitution upon the impairment of contracts by state legislation’ but the ‘bankruptcy power is competent to give relief.’ Hence, a state by authorizing a municipality to file a case legitimately ‘invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue.’ *United States v. Bekins*, 304 U.S. 27, 54 (1938).”<sup>xliv</sup> In the Stockton case, Judge Klein concluded that “while a state cannot make a law impairing the obligations of contract, Congress can do so and the goal of the Bankruptcy Code is adjusting the debtor/creditor relationship. “It follows then,” according to Judge Klein, “that contracts may be impaired in this Chapter 9 case without offending the Constitution.”<sup>xlvi</sup> According to the Stockton court, that included even retired city employees’ health benefits. The Judge ruled that the federal bankruptcy power, by operation of the Supremacy Clause, trumps the contracts clause in the California state constitution.

#### **POSTURE OF PENSION ISSUES IN THE DETROIT CASE**

The first major briefing in the Detroit bankruptcy involved the eligibility of Detroit to be a debtor under Chapter 9. In the process, the ability of the bankruptcy court to diminish or impair pensions has already been raised. In the court’s order of August 26, 2013 regarding eligibility objections, notices of hearings and certifications pursuant to 28 U.S.C. § 2403(a)&(b), the court indicated it would not be addressing the legal ability of the court to impact the rights of City employees and retirees at the present time stating:

The Court fully recognizes and appreciates the extraordinary importance of the pension rights of the City employees and retirees in this case and how the City will ultimately propose to treat those rights. It is an important question not only to the City's employees, retirees and unions, but also to all of the parties in this case.

However, the requirement of eligibility that the City desires "to effect a plan to adjust such debts" under 11 U.S.C. § 109(c)(4) does not obligate the City to prove that any particular plan that it might later propose is confirmable. Accordingly, the Court will not consider the issue of the treatment of pension rights when considering the eligibility objection . . . The court fully preserves the opportunity of all parties to present their positions relating to the City's treatment of pension rights when the debtor requests confirmation of plan, or, perhaps in some other appropriate context.<sup>xlvi</sup>

In a separate filing in the case, the Attorney General of the State of Michigan has noted that Article IX, § 24 of the Michigan Constitution is an express and unambiguous statement of the will of the people of the State of Michigan that the accrued financial benefits of each pension plan and retirement system of the State and its political subdivisions "shall not be diminished or unimpaired."<sup>xlvi</sup> While conceding that it cannot reasonably be disputed that the City of Detroit is eligible to file for Chapter 9 bankruptcy,<sup>xlix</sup> the Attorney General stated that, in moving forward and proposing the plan, the City and its managers are bound by the strictures of Michigan law, including Article IX, § 24 of Michigan's Constitution.<sup>l</sup> The Attorney General distinguished the situation from that facing the court in Stockton because the California Constitution contains no specific protection for pensions, only a generic Contract Clause.<sup>li</sup> The position of the Michigan Attorney General is not absolute: "Importantly, Article IX, § 24 is not an absolute bar on the City's ability to adjust its debt in a Chapter 9 proceeding. The City may negotiate to adjust contractual terms under pension plans and retirement systems. . . . Similarly, the City is not prevented from taking even unilateral action with respect to unaccrued financial benefits . . . and § 24 does not implicate the City's obligations with respect to promised health

benefits . . . ('The ratifiers of our Constitution would have commonly understood financial to include only those benefits that constitute of monetary payments and not benefits of a non-monetary nature such as health care benefits.')lii The Attorney General concluded that there are constitutionally acceptable ways for the City of Detroit to reduce its liabilities for its pension plans without violating the constitutional rights of existing retirees. "But to the extent the City or its manager desire to diminish or impair vested pension benefits, Michigan law prohibits them from even proposing such a plan."<sup>liii</sup> Various other parties, including the unions, have expressed the same view as part of their objections to the eligibility of Detroit to file a Chapter 9 case.

The City previously has argued that the crushing burden of the City's debt service, pension and retiree benefit obligations, absent a restructuring, will lead to further reductions to the City's operating expenses at the increased risk to citizens' health, safety and quality of life. In response to the eligibility objections, it is likely the City will argue that public workers and unions want prior payment based on the Constitutional provision that pensions are not to be impaired or diminished, but they fail to consider that such Constitutional provisions only insure that pensioners have a contractual right to be paid rather than having pensions being a gratuity. In the second half of the 1900s, there was a demand that pensions no longer be treated as gratuities. Pay as you go obligations are only paid if there are funds available and the government is so inclined to make payment. In order to make sure that there would be sufficient funds, there was push to treat such pensions as enforceable, contractual obligations. Six States, including Michigan, have constitutional provisions that state pension obligations cannot be impaired or diminished based upon the Contract Clause. The legislative history of such constitutional provisions does not support a superpriority for such pension obligations to crowd out funds for essential governmental services necessary for the survival, growth and economic

future of the municipality. The City can be expected to argue that, viewed in the context of the Contract Clause, such obligations can be adjusted, including in a bankruptcy proceeding. Pension obligations as contractual obligations may be impaired for a higher public purpose such as the health, safety and welfare or in bankruptcy. Pension benefits that crowd out essential governmental services and infrastructure at the level needed for a turnaround or recovery of the municipality are counterproductive and only impair the future of the municipality and the ability in the future to pay workers and make pension payments. The City likely will assert that paying all that can be paid realistically is not an impairment or diminishment but reality.

#### **MUNICIPAL OPERATIONS AND CREDITOR 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 public safety (police and fire), public health and welfare (education and health, transportation, building and zoning and, under certain instances, sewer, water and electrical services). Also, in order to effectuate a recovery plan, which is necessary for a turnaround, and to prevent future financial distress, there must be funding of essential government services. This will produce a stimulation of the economy and encourage growth of the municipality which will attract new businesses and new citizens. This economic growth will create needed jobs, especially for younger workers who will in turn become taxpayers and which will result in increased tax revenues. In order to accomplish the recovery plan, improved infrastructure is required in order to ensure the required movement of goods, services and workers. In addition, enhanced education programs are important to train young workers for the specific jobs created. Further, improved public safety and welfare programs that will lead to a constructive environment fostering economic growth and recovery.

Defining what these necessary municipal services are is a question of state law and local choice 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 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 Bankruptcy Code, is subject to the payment of necessary operating expenses.

#### **“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 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 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.<sup>liv</sup>

Section 928 was incorporated into the Bankruptcy Code by the Municipal Bankruptcy Amendments, which were adopted in 1988, as part of an Act to Amend the Bankruptcy Law to Provide for Special Revenue Bonds, and for Other Purposes, Pub. L. No. 100-597 (1988) (“1988 Amendments”). As noted by the Bankruptcy Court in the *Jefferson County, Alabama* Chapter 9 bankruptcy proceeding, the 1988 Amendments became necessary because at the time the 1988 Amendments were adopted, there was great concern in the municipal bond market that the application of general commercial finance concepts rendered the extension of credit to a troubled municipality fraught with risk.<sup>lv</sup> In fact, “[a] major purpose was to change from using corporate debt principles in the municipal financing context when their application would be at odds with how municipal financing has evolved. This was and remains especially<sup>lvi</sup> apt for revenue based municipal financing transactions.”<sup>lvii</sup> As is clearly set forth not only in the specific provisions added to Chapter 9 by the 1988 Amendments but also in the legislative history for the 1988 Amendments, Congress concluded that, without the 1988 Amendments, the uncertainty of the effect of Chapter 9 as it then existed on municipal debt could have dire effects. This was especially true with respect to concerns regarding the continuation of a lien on revenues in a Chapter 9 proceeding.<sup>lviii</sup> The Senate Report for the 1988 Amendments, Senate Report No. 100-506, 100th Cong., 2d Session (1988) (the “*Senate Report*”), made it clear that the intention of the 1988 Amendments was to address the real worry in the marketplace that revenues dedicated to the repayment of municipal revenue obligations would be diverted to other purposes once a local government entered bankruptcy; that this worry rendered clarification of the law a necessity; and that revenue debt could not be impaired in a Chapter 9.<sup>lix</sup> The same concern was reflected in the House Report for the 1988 Amendments, which noted that the bill “remedies the inconsistencies between bankruptcy law and principles of municipal finance to remove the potential for problems that now exist.”<sup>lx</sup> As noted by the *Jefferson County* Bankruptcy Court,

“[i]f nothing more is evident from . . . the legislative history, it is that Congress intended that certain of the corporate finance principles be modified including changing how the automatic stay applies to revenue based financing for municipalities.”<sup>lxi</sup>

In fact, the Bankruptcy Court in *Jefferson County* found that it was clear from the legislative history accompanying the 1988 Amendments that the elimination of the potential loss of a municipal creditor’s lien on special revenues was critical to Congress.<sup>lxii</sup> Indeed, the 1988 Amendments were enacted, in part, to protect the municipal bond market from the uncertainty common in other commercial credit markets, provide for readily available inexpensive financing for municipalities and municipal project and ensure that municipal revenue bondholders receive the benefit of their bargain without the uncertainty typical in non-government financing. In enacting the 1988 Amendments, Congress specifically recognized that “the proposed amendments reflected the principles that have long been the premise for municipal finance but have not been expressly stated in the Bankruptcy Code.”<sup>lxiii</sup> The Senate Report stated:

The problems created by the incorporation of general commercial finance concepts into municipal bankruptcy provisions first came to light as a result of the financial crisis confronting the City of Cleveland, Ohio in 1979. Cleveland needed additional financing but lenders were unwilling to lend for a variety of reasons, including the incorporation into Chapter 9 of the general bankruptcy concepts of Section 552 of the Code. . . . Thus lenders who contemplated providing financing during financial troubles of the City were discouraged given the concern that their security interest might terminate upon a Chapter 9 filing of the city. . . . Such uncertainty may have dire effects in the future . . . .

Thus, § 928 provides that special revenues acquired by the debtor after the commencement of a bankruptcy case are subject to any lien granted on special revenues prior to the bankruptcy filing. Section 928 is intended to ensure that revenue bonds do not become transformed into general obligation bonds with a call against all the assets of the municipality upon the filing of bankruptcy petition.<sup>lxiv</sup> The Bankruptcy Court in *Jefferson County* explains:

The bigger picture of what was to be accomplished by the 1988 Amendments comes from knowing that the post-bankruptcy loss of a security interest in pledged special revenues via § 552(a) or the § 547 avoidance of a payment to a bond or warrant holder pursuant to a special revenue financing could have made the obligation or avoided transfer unsecured. As an unsecured indebtedness, it was then potentially repayable from the general revenues of the municipal entity. Under this scenario, it might have been changed by the pre-1988 version of the Bankruptcy Code from an obligation repayable solely from the revenues of the system or project or a specified tax into one repayable from the general revenues of the municipality. Essentially, it may have been turned from a nonrecourse into a recourse obligation of the municipal government.<sup>lxv</sup>

As background, prior to the addition of § 928 to the Bankruptcy Code, § 552(a) of the Bankruptcy Code was applicable to revenue debt in a Chapter 9. That section provides that property acquired by a debtor after the commencement of the bankruptcy case is not subject to a lien created prior to the bankruptcy filing unless the acquired property constituted proceeds of the property pledged prior to the bankruptcy filing. The result of the application of § 552(a) in the municipal context generally was to strip the lien of revenue bondholders. Therefore, the revenue bondholders would become unsecured creditors with a claim against the postpetition revenues that had previously secured the revenue bonds and their claims would become part of the general obligations of the municipality. The general funds would then be used to pay all creditors including the revenue bondholders. As a result, rather than taking the risk that a specific revenue stream would be sufficient to pay debt service on their bonds, revenue bondholders were, in fact, taking the risk that the general fund of the municipality would not be sufficient to repay all debts of the municipality. Section 928 resolved this problem by providing that revenue bondholders continue to have a lien on special revenues generated after the bankruptcy case. As the legislative history makes clear, the addition of § 928 was motivated by the desire to make it easier for municipalities to obtain needed financing for public projects.

In addition to providing that the lien on special revenues continues after a Chapter 9 filing, the 1988 Amendments also dealt with the problem of timely payment. In order to avoid the delay in payment caused by the automatic stay of § 362, the 1988 Amendments added a new subsection to § 922 of the Bankruptcy Code that makes the automatic stay provision inapplicable to the payment of pledged special revenues to the holders of municipal indebtedness.<sup>lxvi</sup>

The Senate Report observed that the payment of the net revenues, after payment of operation and expenses of the income producing property, should be paid to the holders of secured bonds without the application of the automatic stay, which is the derivation of § 922(d) in the Code, as the Senate Report states:

This provision [362] is overly broad in Chapter 9, requiring the delay and expense arising from a request for relief from automatic stay to accomplish what many state statutes mandate: the application of pledged revenues after the payment of operating expenses to the payment of secured bonds. The automatic stay should specifically be inapplicable to application of such revenues.<sup>lxvii</sup>

In fact, as the Senate Report noted at page 21,

Reasonable assurance of timely payment is essential to the orderly marketing of municipal bonds and notes and continued municipal finance.

The clear intent of Congress in enacting the 1988 Amendments was to provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing. “[T]he amendments insure that revenue bondholders receive the benefit of their bargain with the municipal issuer, namely, they will have *unimpaired rights to the project revenue pledged to them.*”<sup>lxviii</sup>

New Section 927 [928] along with the definition of Special Revenues in Section 902(3) protect the lien on revenues.<sup>lxix</sup>

In sum, Congress made clear that revenue bondholders are entitled to receive the revenues pledged to them without any interference and on a timely basis.

Particular attention should be directed to the definition of “special revenues,” the pledge of which survives bankruptcy.<sup>lxx</sup> “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...<sup>lxxi</sup>

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."<sup>lxxii</sup>

#### **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 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.<sup>lxxiii</sup> 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.<sup>lxxiv</sup> At least thirty-two States recognize some form of a statutory lien in relation to their bond obligations.<sup>lxxv</sup>

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 that are special revenues or subject to a statutory lien.<sup>lxxvi</sup> 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. The Chapter 9 proceeding, orders and plan would not affect the timely payment on these bonds according to their terms.

The following chart summarizes the intended treatment of bonds and notes, depending on how they are secured, in a Chapter 9 proceeding.

**SUMMARY OF BASIC TREATMENT OF BONDS AND NOTES IN CHAPTER 9**

<b>TYPE OF BONDS/NOTES</b>	<b>BANKRUPTCY EFFECTS</b>
General Obligation Bonds	<p>Post-petition, a court may treat general obligation bonds as unsecured debt absent a statutory lien or a pledge of revenues that classifies as special revenues 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 Bankruptcy Code. This position may be questioned under §§ 903 and 904 of the</p>

<b>TYPE OF BONDS/NOTES</b>	<b>BANKRUPTCY EFFECTS</b>
	Bankruptcy Code given the prohibition that the court not interfere with the power of a State to control a municipality in exercise of political or governmental powers the government affairs or revenues of the municipality.
Special Revenue Bonds	A pledge on special revenue bonds will survive a bankruptcy filing. Pre-petition, a special revenue bond is an obligation to repay solely and only from revenues of a municipal enterprise (net of operations and maintenance costs) that are pledged to bondholders. The contemplated remedy for default often focuses on a covenant to charge rates sufficient to amortize the debt. Defaulted bondholders are expected to seek mandamus in court to require the municipal borrower to raise its rates.
Revenues Subject to Statutory Lien	Assuming the pledge is authorized under state law through a statutory lien, the bankruptcy court should respect that statutory lien. Thus, as long as the revenues are subject to a statutory lien, payments to the bondholders should be protected post-petition.

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 of New Jersey. The plan

adopted by Asbury Park paid general obligation bondholders a compromise payment (less in amount and a delay in payment).

#### **PAYMENTS TO BONDHOLDERS ARE NOT PREFERENCES**

The 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.<sup>lxxvii</sup> 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 Bankruptcy Code would otherwise require any payments made within 90 days of a bankruptcy filing to be returned to the estate. Special revenues and statutory liens are designed to provide a municipality experiencing financial distress with additional available sources of financing through various options of refinancing or refunding old debt or obtaining additional liquidity with the use of special revenues or statutory liens that are intended to continue to pay and have a continuing lien on taxes collected even if the municipality should authorize filing a Chapter 9 proceeding.

#### **LENGTHY LITIGATION ON THE COMPETING RIGHTS OF CREDITORS, INCLUDING PUBLIC EMPLOYEES AND RETIREES, MAY NOT BE IN THEIR BEST INTEREST**

Detroit is the largest United States city to file for bankruptcy and, unlike the examples referenced above, was also the first instance in which the largest city in any state has been unable to work with the state to come up with a solution to the city’s financial struggles. Pensions are long-term obligations. As we are seeing the Detroit case, the failure to fund them today can lead

to insurmountable problems tomorrow. A municipality's ability to adequately fund pensions is extricably intertwined with its ability both to have funds to pay the pensions and also to meet the necessary costs to govern effectively and survive.<sup>lxxviii</sup>

Municipalities cannot pay that which they have no revenues to fund. Further, when obligations become so overwhelming to a municipality as to crowd out necessary expenses for a essential governmental services and infrastructure, the consequences can be devastating and can lead to the meltdown of the bankruptcy.

Participants in the Detroit bankruptcy are presently engaged in the legal and metaphysical question of whether specific state constitutional provisions can mandate that, unlike other contracts, unfunded pension obligations must be paid in a municipal bankruptcy without any impairment or reduction. This appears to be the first instance in which the type of specific constitutional provision protecting public employees' pension rights as exist in Michigan has been tested in a Chapter 9. If the issue is litigated in the bankruptcy court and appealed to the higher courts, including possible review by the United States Supreme Court, it could take years to decide the matter. In the meantime, what should be the principal goal of the case may be ignored. That is, developing a successful recovery plan that is sustainable and affordable.

Without a successful recovery plan, there will not be enough funds to employ workers, provide essential services or pay pensions, impaired or unimpaired. In reality, the future of pension funding, workers continued employment and a recovery plan for Detroit is dependent upon determining what costs and expenses are sustainable and affordable. This would include determining what amount of pension obligations can be paid that is reasonable, prudent and feasible. Such determination must take into account the necessity of sufficient funding for a

recovery plan whereby essential governmental services can be raised to an acceptable level and infrastructure provided to encourage, stimulate and insure business growth and expansion with its accompanying creature of good new jobs, especially for the young citizens of Detroit. This will insure not only Detroit's short-term recovery, but its long-term success.

If we were honest with ourselves, we would all admit that there is a simple answer to this controversy. Workers (current and retired) who have labored hard and especially those who are necessary for the recovery and success of a municipality deserve to be paid for past efforts, and as much as can be paid should be paid to meet these obligations as promised. Likewise, workers and retirees rely on the continued success and growth of the municipality for continued employment and pension payments. However, if the municipality continues to erode and does not succeed with its recovery plan, there will be less not more to fund pensions and to keep workers employed. It is truly unfortunate that some promises made to public employees may not have been attainable, may not have been realistic, and may not have been founded on any prudent notion of governance. Insistence on full payment of those obligations would lead to the very result all parties fear: the failure of the efforts to restore Detroit to a sound financial footing.

#### **A SIMPLE ANSWER**

Fortunately, the answer to all of this is simple. Rather than positioning and fighting as to what can be paid, what cannot be paid and what must be paid, it is in the best interests of all parties striving for the recovery and success of the municipality to recognize and determine what is sustainable and affordable acknowledging the resulting adjustments are simply a recognition of reality. In the long term, this will pay more than the best litigation strategy.

Pension obligations can be appropriately adjusted to what is sustainable and affordable, allowing the municipality to invest in that which will help it recover and grow. There would be

the determined affordable fixed payments and contingent payments that would only be paid if there are increased revenues from the success of the recovery. If the municipality does better, there will be more funding. Pensions are not impaired or diminished because realistically all that can be paid is being paid. Pension plan beneficiaries have improved expectations that the municipality operating under a realistic recovery plan will make future payments to fund their pensions based on anticipated recovery and success of the municipality. Also, there could be periodic adjustments to the fixed and contingent payments based on actual results of the recovery and what is affordable.

There should be a periodic review of the progress in the recovery plan. If there is a need to adjust payments on pension obligations so that what is paid is sustainable and affordable, those adjustments should be made. Further, if the recovery plan is a success and stimulates economic growth and new jobs, there should be an increase in revenues to pay unfunded pension obligations. In addition, States or the Federal government should consider creating a **Pension Safety Net** so that, in the event of a shortfall in municipal pension funds, public workers who did not or could not pay into social security could obtain at least the maximum benefit payable under social security guaranteed by a governmental or private insurance program.

#### **LET'S DO IT**

The reason why this approach has not been followed to date in Detroit or in other situations is because we are presently playing the game of blink. Everyone believes that the other side should give in and blink. From the standpoint of the workers and the retirees, they can achieve a resolution that is better than what can be obtained in the best fought litigation or any other mechanism by working with the municipality and recognizing that, together, they must (1) determine what is sustainable and affordable to allow recovery and growth for the municipality and (2) develop how the municipality can stimulate and attract business and new jobs to the

community. In that way, workers and retirees hopefully can participate in a share of the new tax revenues as the fulfillment of their future pension funding needs. In doing so, the solution to underfunding can be obtained. Namely, the price for the adjustment to what is sustainable and affordable is the hardwiring of pension funding going forward. The municipality must identify and dedicate a sustainable and sufficient revenue source for the funding of pension obligations so that we will never again repeat the unfortunate scenario that to balance budgets we forego pension contributions and promise future pension benefits that are not sustainable and affordable.

### CONCLUSION

As discussed above, Chapter 9 is not a solution to the problems of a financially-troubled municipality. Rather, Chapter 9 is a process. As a result, debt adjustment without a recovery plan does not create an economic turnaround and raises the question of the futility of the process. Essential governmental services must be funded. A recovery plan that stimulates the economy while providing adequate funds for the payment of essential governmental services will lead to economic opportunities and resulting job opportunities for the citizens of Detroit, especially for the young workers. This recovery plan can only be accomplished by assuring participants that essential governmental services will be provided, including improved infrastructure and essential services so the blighted areas are transformed into areas where businesses and citizens will desire to reside and flourish and good jobs are available for all. Such a process will lead to new and expanded business and job opportunities, which result is in the best interest of all creditors. The recovery plan necessarily must be based upon the payment of what is sustainable and affordable. The increased revenues that flow from the creation of new jobs and new taxpayers under the recovery plan should permit the additional funds to ensure payment of these obligations that should be paid, including continued employment of public workers and

appropriate funding of pensions. Without a successful recovery plan, the repayment of obligations will not only be difficult but practically impossible. However, restructuring of the obligations in a manner that pays what is feasible is in the best interest of all.

## ENDNOTES

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i In fact, not all fifty States permit their municipalities to file for Chapter 9. Only twelve States specifically authorize municipal bankruptcies.

ALA. CODE 1975 § 11-81-3  
ARIZ. REV. STAT. ANN. § 35-603  
ARK. CODE ANN. § 14-74-103  
IDAHO CODE ANN. § 67-3903  
MINN. STAT. ANN. § 471.831  
MO. ANN. STAT. § 427.100  
MONT. CODE ANN. §§ 7-7-132 and 85-7-2041  
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

Twelve States specifically authorize municipal bankruptcies. Twelve States conditionally authorize municipal bankruptcies. Three States grant municipalities limited authorization, two States prohibit filing but one has an exception and twenty-one remaining States are either unclear or do not have specific authorization to file. For more detail, see the book entitled Municipalities in Distress? published by Chapman and Cutler LLP, which is a 50 state survey of State laws dealing with financial emergencies of local governments, rights and remedies provided by States and State authorization of municipalities to file for Chapter 9 bankruptcy.

ii “This Chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise . . .” 11 U.S.C. § 903.

iii “Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with - (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor’s use or enjoyment of any income producing property.” 11 U.S.C. § 904.

iv See States listed in Note 1.

v See The Bankruptcy Act of 1800, 2 Stat. 19 (1800); The Bankruptcy Act of 1841, 5 Stat. 440 (1841); The Bankruptcy Act of 1867, 14 Stat. 517 (1867); The Bankruptcy Act of 1898, 30 Stat. 544 (1898). That is not to say that there were no defaults in government obligations in the nineteenth century. Indeed, the 1842 default by the State of Pennsylvania on its bonded debt inspired William Wordsworth to pen the sonnet “To the Pennsylvanians” in which he spoke of “won confidence, now ruthlessly betrayed.” It was the defaults of local utility districts and

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municipalities in the 1800s that tarnished the integrity of the “new frontier’s” obligations. George Peabody, an eminent financier, sought to be admitted to polite English Society only to be rebuffed, not due to his lack of social grace, but because his countrymen did not pay their debts. It was the defaults by State governments in the early nineteenth century and municipalities in the late nineteenth century that brought about the procedures which are now taken for granted, including debt limitations on municipal issues, bond counsel, and clearly defined bondholders’ rights and State statutory provisions relating thereto.

vi See A Commission Report, *City Financial Emergencies: The Intergovernmental Dimension* (Advisory Commission on Intergovernmental Relations, Washington, D.C., July 1973) (“*ACIR Report*”).

vii S. Rep. No. 407, 73rd Cong., 2d Sess. (1934).

viii 48 Stat. 798 (1934).

ix 49 Stat. 1198 (1936).

x See generally H.R. Rep. No. 207, 73rd Cong., 1st Sess. 103 (1933); H.R. Rep. No. 517, 75th Cong., 1st Sess. 3-4 (1937); H.R. Rep. No. 686, 94th Cong., 1st Sess. 541, 542 (1975); H.R. Rep. No. 595, 95th Cong., 1st Sess. 397-398 (1977); S. Rep. No. 95-989, 95th Cong., 2nd Sess. 110 (1978), reprinted in 1978 U.S.C.C.A.N. 5787.

xi *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 80 L. Ed. 1309, 56 S. Ct. 892 (1936), *reh’g denied* 299 U.S. 619, 81 L. Ed. 457, 57 S. Ct. 5 (1936).

xii *United States v. Bekins*, 304 U.S. 27, 82 L. Ed. 1137, 58 S. Ct. 811 (1938), *reh’g denied* 304 U.S. 589, 82 L. Ed. 1549, 8 S. Ct. 1043 (1938).

xiii *Leco Properties, Inc. v. R.E. Crummer & Co.*, 128 F.2d 110 (5th Cir. 1942). Further, the court had no jurisdiction to determine the existence the city or boundary disputes in the nature of *quo warranto*. *Green v. City of Stuart*, 135 F.2d 33 (5th Cir. 1943), *cert. denied* 320 U.S. 769, *reh’g denied* 320 U.S. 813, 88 L. Ed. 491, 64 S. Ct. 157 (1943).

xiv Upon the adoption of the Bankruptcy Reform Act of 1978, the roman numerals which had previously been used to identify chapters of the Bankruptcy Act were abandoned in favor of arabic numbers. Hence, since the effective date of the Bankruptcy Code, “Chapter IX” has become Chapter 9.

xv See, *In re Richmond Unified School District*, 133 B.R. 221 (Bankr. N.D.Cal. 1991), (a chapter 9 debtor may voluntarily divest itself by consent of its autonomy rights under § 904 of the Bankruptcy Code.

xvi Since 1949, there have been 11 economic downturns in the United States, and the states and their local governments not only have weathered those financial storms but have provided

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substantial support to the eventual economic recovery by expenditures for infrastructure and other purposes that have increased employment and GDP growth. In each of these economic downturns, increased government debt financing for needed essential infrastructure and improvements was what helped provide the stimulus for recovery. These bond-funded projects have stimulated the economy by providing increased employment for construction, purchase of goods, and the ripple effect that such increases in salaries and purchases have on tax revenues, employment, and GDP. See *“The Role of the State in Supervising and Assisting Municipalities, Especially in Times of Financial Distress,”* by James E. Spiotto in the MUNICIPAL FINANCE JOURNAL, Winter/Spring 2013.

xvii 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% assessed value of the property in the municipality. However, these limitations do not apply to taxes levied for payment of principal and interest on bonds. Alaska Stat. §§ 29.45.090, 29.45.100 and 29.47.200 (2012). Florida has a limitation on ad valorem taxes to finance or refund capital projects only if approved by the voters.

xviii Compare Alabama—Ala. Const. Art. XII, § 225 and Ark. Const. § 342 (2012) (debt may not exceed a particular percentage of valuation) with Washington, DC—D.C. Code § 47-102 (setting debt limit at 1878 levels). Alabama is somewhat unique in providing that any tax to be levied must be levied by the state legislature and does not grant the local government the power to levy taxes on its own.

xix See “Assembly and Governor OK Measure to Prevent Municipal Receivership”; Available at <http://www.rilin.state.ri.us/news/pr1.asp?prid=6591>.

xx For a detailed study of the New York City fiscal crisis see Donna Shalala and Carol Bellamy, “A State Saves a City: The New York Case,” *Duke Law Journal*, 1976(6) (January 1977); 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).

xxi *New York Times*, October 19, 1975, Section 4 at 1.

xxii 53 Pa. Stat. §§ 11701.101-11701.501.

xxiii 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>.

xxiv Mich. Comp. Laws §§ 141.1501-141.1531 (2011).

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xxv Mich. Comp. Laws. § 141.1519 (2011).

xxvi Mich. Comp. Laws. § 141.1523 (2011).

xxvii Local Financial Stability and Choice Act, Mich. Pub. Act 436 of 2012, Mich. Comp. Laws, § 141.1541 *et seq.* The new act contains 19 different possibilities that would allow for the state financial authority to conduct a preliminary review of a local government's finances to determine the existence of probable stress. The state financing board is required to complete a final report and then to submit that report to the local emergency financial assistance loan board to determine if probable financial stress exists for the local government.

If probable stress is found, the governor is then required to appoint a review team for that local government, and that review team, after investigating the circumstances and meeting with the local government, must submit a written report to the governor within 60 days following its appointment, although it may be granted one extension of 30 days to conduct its analysis. In its report, the review team must conclude either that a financial emergency exists or that one does not exist, and within 10 days of receiving the report, the governor must also make a determination as to the existence or not of a financial emergency. The decision is appealable to the Michigan Court of Claims within 10 business days by a resolution approved by two-thirds of the members of the local government's governing body.

Should a financial emergency be found, the local government must either (1) enter into a consent decree with the state, (2) agree to the appointment of an emergency manager, (3) enter into a neutral evaluation process or (4) file a Chapter 9 bankruptcy petition if so approved by the governor. If it does not choose an option, the local government must proceed under a neutral evaluation process. Each of the options provides a process for resolving the causes of financial distress.

If the neutral evaluation process or other options do not result in a resolution, the governing body of the local government must adopt a resolution recommending that it proceed under Chapter 9 and submit that resolution to the governor and state treasurer for consideration and approval by the governor.

xxviii Ind. Code § 6.1.1-20.3 *et seq.* (2012).

xxix Cal. Gov't Code §§ 53760; 53760.1; 53760.3; 53760.5; and 53760.7 (as amended and added by Cal. A.B. 506; signed into law on October 9, 2011). This provision was first put to the test by the City of Stockton, California, which filed a Chapter 9 petition in June 2011 after going through a neutral evaluator process. San Bernardino in August 2012 avoided the neutral evaluator process by declaring a fiscal emergency, as discussed below.

xxx Chapman and Cutler LLP has been working with the Civic Federation of Chicago and its pension committee with regard to the development of the municipal protection authority or commission as an alternative to the rush to Chapter 9 or the continued inability to effectively address financial distress by municipalities.

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xxxi “Regional Governmental Bodies” could include counties, municipalities, or regional governmental bodies for special purposes such as transportation, public safety, or health services.

xxxii *U.S. Trust Company v. New Jersey*, 431 U.S. 1, 52 L. Ed. 2d 92, 97 S. Ct. 1505 (1977).

xxxiii *Id.*

xxxiv *Id.*

xxxv *Id.* at 32.

xxxvi For example, *In Royal Liquor Mart, Inc. v. City of Rockford*, the Illinois Second Judicial District identified this test as a three-step test including (1) whether the action in question has operated a substantial impairment of a contractual relationship; (2) if such impairment is found, whether the State can show a significant and legitimate public purpose behind the regulation; and (3) whether the change in rights is based upon reasonable conditions and is of a character appropriate to the public purpose of the regulation. 479 N.E.2d 485, 491, 133 Ill.App.3d 868, 877 (Ill.App.Ct. 1985).

xxxvii *Bricklayers Union Local 21 v. Edgar*, 922 F.Supp. 100, 105 (N.D. Ill. 1996) (citing *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411, 74 L. Ed. 2d 569, 103 S. Ct. 697 (1983)).

xxxviii *Id.* at 106-07 (citing *Allied Structural Steel Co. v. Spannaus*, 438 U.S. 234, 246, 57 L. Ed. 2d 727, 98 S. Ct. 2716 (1978)).

xxxix *U.S. Trust*, 431 U.S. at 25.

xl *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502, 504 (1942).

xli *Id.* at 511.

xlii *In re City of Stockton, California*, 478 B.R. 8 (Bankr. E.D. Ca. 2012).

xliii 478 B.R. at 15.

xliv *Id.*

xlv *Id.*

xlvi *Id.* At 16.

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xlvi *In re: City of Detroit, Michigan, United State Bankruptcy Court Eastern District of Michigan, Southern Division, Order Regarding Eligibility Objections, Notices of Hearings and Certifications Pursuant to 28 USC § 2403(a) and (b)*, August 26, 2013.

xlvi *In re: City of Detroit, Michigan, United State Bankruptcy Court Eastern District of Michigan, Southern Division, Attorney General Bill Schuette’s statement regarding the Michigan Constitution and the Bankruptcy of the City of Detroit.* August 19, 2013.

xlix Id., at p. 10.

l Id.

li Id. at p. 14 n. 2.

lii Id. at pp. 15-16.

liii Id. at p. 16.

liv *In re Jefferson Cnty., Alabama*, 474 B.R. 228 (Bankr. N.D. Ala. 2012) (discussion of nature of special revenues); *Bank of N.Y. Mellon v. Jefferson Cnty., Ala. (In re Jefferson Cnty., Ala.)*, 482 B.R. 404 (Bankr. N.D. Ala. 2012) (analysis of necessary operating expenses); *In re Sierra Kings Health Care Dist.*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).

lv *In re Jefferson Cnty.*, 474 B.R. 228, 267 (Bankr. N.D. Ala. 2012).

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lvii *Id.* at 271.

lviii *Id.*

lix For further discussion on the importance of the 1988 Amendments, *see In re Jefferson Cnty., Ala.*, 474 B.R. 228 (Bankr. N.D. Ala. 2012); *Bank of N.Y. Mellon v. Jefferson Cnty., Ala. (In re Jefferson Cnty., Ala.)*, 482 B.R. 404 (Bankr. N.D. Ala. 2012) (analysis of necessary operating expenses).

lx H.R. Rep. No. 100-1011 (1988) at 3.

lxi *Jefferson Cnty.*, 474 B.R. at 268.

lxii *Id.* at 268-69.

lxiii *Jefferson Cnty.*, 474 B.R. at 753 (quoting Senate Report, p.1).

lxiv *Id.* at 754.

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- lxv *Id.*
- lxvi *See generally Jefferson Cnty.*, 474 B.R. at 268 (“It is clear from both the House and Senate Reports accompanying the 1988 amendments that eliminating the potential loss of a creditor’s lien on revenues was a critical purpose behind the enactment of § 928 and § 922(d).”)
- lxvii *Id.* at 271 (quoting Senate Report at 11).
- lxviii *Id.* at 270 (emphasis in original) (quoting Senate Report at 12).
- lxix Senate Report, at 12 (emphasis added).
- lxx 11 U.S.C. § 902(2).
- lxxi 11 U.S.C. § 902.
- lxxii *See Heffernan Memorial Hospital District*, 202 B.R. 147 (Bankr. S.D. Cal. 1996).
- lxxiii *In re County of Orange*, 189 BR. 499 (C.D. Cal. 1995).
- lxxiv *Id.*
- lxxv The states include: Alabama, Alaska, Arkansas, California Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Nevada, New Jersey, New York, North Carolina, North Dakota, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Vermont, Virginia and West Virginia.
- lxxvi *In re Sierra Kings Health Care District*, Case No. 09-19728 (Bankr. E.D. Ca. Sept. 13, 2010).
- lxxvii 11 U.S.C. § 926.
- lxxviii *See All Eyes on Detroit: What Happens to Unfunded Pension Liabilities When a Municipality Files for Bankruptcy?*, MUNINET GUIDE (August 21, 2013), <http://www.muninetguide.com/print/php?id=604>.