DEMOCRATIC JUDICIARY FORUM
ON
LEGAL IMPLICATIONS OF MICHIGAN'S EMERGENCY MANAGER LAW

LEGISLATIVE ALTERNATIVES, OVERSIGHT, ASSISTANCE AND RESTRUCTURING MECHANISMS FOR FINANCIALLY DISTRESSED LOCAL GOVERNMENTS

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I. INTRODUCTION - NEED FOR STATE LEGISLATIVE CONSIDERATION OF THE APPROPRIATE EXTENT FOR ACCESS TO CHAPTER 9 BY MUNICIPALITIES AND FINANCIAL OVERSIGHT, AID AND RESTRUCTURING MECHANISMS FOR FINANCIALLY CHALLENGED LOCAL GOVERNMENTS

It is not surprising that, during the current economic downturn, there would be concern about the effects of lower state and local government revenues and the threat of higher state and local government expenses, especially costs of infrastructure, education, health care and public safety. Since 1949, there have been eleven economic downturns in the United States of America and the states and their local governments have not only weathered those financial storms but have provided substantial support to the eventual economic recovery by expenditures for infrastructure and other purposes that have increased employment and GDP growth. In addition, various states have developed targeted legislation to provide oversight, supervision, direction and relief to financially distressed local governments to refinance, restructure or resolve their financial problems. While the extent and nature of such legislation may vary, its goal is the same: to help that state's local government to continue to provide essential governmental services to its citizens as efficiently and at the lowest cost as possible. Part of that effort is to help ensure continued access of those troubled local governments to the financial markets so that they can continue to obtain necessary funding at the lowest cost of financing possible.

It is not only a demonstration of foresight but also good planning for the Democratic Judiciary Forum to review what has been used in the past by various states to assist their financially troubled local governments and how Michigan's Emergency Manager Law compares or could be changed to foster local government participation and appropriate due process procedures. Unfortunately, there will always be the risk of financial distress for local government just like there will always be financial cycles. But there is no reason that any local government should have to take the last resort and file for Chapter 9 municipal bankruptcy and suffer the stigma and adverse affects of admitted failure of financial management. States can

help local governments detect financial problems and address them before the fate of financial collapse is irreversible. In fact, the tradition has been that states and local governments have done their utmost to avoid financial meltdown and bankruptcy, and there is no reason to believe that will not continue.

As will be described, there are various remedies, provisions, protections, significant market motivations and practical realities that have historically demonstrated that state and local governments will do almost anything they can to pay their debts so that they may have access to the markets to build infrastructure and capital improvements as well as fund essential governmental services. In fact, the Panic of 1837 and the defaults thereafter showed that, while states may sometimes default, as they did following that Panic, in order to gain access to the market, they typically resume payment.[1] Likewise, studies by the rating agencies have indicated that not only is the rate of default drastically lower for rated municipal bonds compared to rated corporate bonds, but the percentage of recovery is significantly higher.[2] Part and parcel of that is the historical precedent of refinancing and refunding troubled situations in order to maintain

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1 Between 1841 and 1843, 7 of 9 states that repudiated payments of their debt between 1841 and 1843 then later resumed payment of their debt between 1843 and 1848. John Joseph Wallis, Richard E. Sylla and Arthur Grinath III, *"Sovereign Default and Repudiation: The Emerging-Market Debt Crisis in the United States 1839-1843,* NBER Working Paper 10753 (Sept. 2004). Indeed, according to a Moody's report, the average 30-day post-default price for defaulted municipal bonds is $59.9, based on a par value of $100, whereas the corresponding recovery for unsecured bonds of corporate issuers is $37.5. Ultimate municipal bond recoveries are even higher, with an average of $67 and a median of $85. Moody's Investors Service, *U.S. Municipal Bond Defaults and Recoveries 1970-2009*, at 11-12.

2 *Compare* Moody's Investors Service, *U.S. Municipal Bond Defaults and Recoveries 1970-2009* (citing 54 municipal defaults from 1970-2009 for a municipal bond default rate of .01 percent based on the average one-year default rate) *with* Moody's Investors Service, *Corporate Default and Recovery Rates, 1920-2009* (citing 1,707 corporate defaults during the same time period for a corporate default rate of 1.57 percent based on the average one-year default rate); *compare* Standard & Poor's, *U.S. Municipal Ratings Transitions and Defaults, 1986-2009* (39 municipal bond defaults from 1986-2009 for an average default rate of .02 percent based on the average default rate) *with* Standard & Poor's, *2009 Global Corporate Default Study and Ratings Transitions* (citing 1,604 corporate defaults from 1986-2008 for a default rate of 1.54 percent based on the average default rate); *compare* Fitch Ratings Inc., *U.S. Public Finance Transition and Default Study (1999-2009)* (10 municipal bond defaults from 1999-2009, with a default rate of .04 percent) *with* Fitch Ratings Inc., *Global Corporate Finance 2009 Transition and Default Study* (238 corporate bond defaults, with a default rate of .89 percent).

credibility in the market necessary for local governments to be able to make their own decisions as to what their infrastructure, improvements and services will be.

The purpose of this presentation is to provide a compilation of various state laws and constitutional provisions relating to state oversight and supervision of financially challenged local governments and rights, remedies, refinancing, refunding and restructuring mechanisms provided by the 50 states in comparison to Michigan's Emergency Manager Law. This compilation is an example of the individual creativity of various states to develop for themselves, given their unique situation and issues, methods of addressing state and local government financial distress. It is not intended to be exhaustive, given the dynamics of our legislative process, and these supervision, rights, remedies and restructuring mechanisms are still evolving and changing.

It is our hope that this presentation will be beneficial to the Democratic Judiciary Forum in considering what Michigan has provided and what others have provided and whether or not Michigan should revisit some of these issues so that Michigan may have the most effective supervision, rights, remedies and mechanisms to address any financial distress that local government may suffer now or in the future. It also is intended to help state and local governments in access to financing in time of financial downturn based upon the proud history they have in doing as much as they can to pay their debts in full and generally on time. All of this is tied to making sure that state and local governments continue to have access to the market at a very economical cost so that they can decide on a local basis what capital improvements and what essential services they will continue to be able to provide to their citizens.

With regard to overview of state protections, supervision and financial distress mechanisms for local government debt financing, there are a number of different, relevant provisions concerning what may happen if the municipality faces significant financial distress:

whether Chapter 9 bankruptcy is authorized by the State, what rights and remedies the investors may have, what options the municipality will possess and what additional support may be available from the state or others to help avoid a financial meltdown.

In this regard, it would be helpful to know whether the state in which the local government is located is one that authorizes its municipalities to file for bankruptcy. As will be noted herein, only 12 states specifically authorize a bankruptcy filing, another 12 states have conditional authorization (including Michigan), 3 states have limited authorization, 2 states generally prohibit a filing and the remaining 21 states provide no authorization for a municipal bankruptcy filing at this time.

In these times of severe economic difficulties, much uncertainty exists in the municipal markets. This uncertainty relates not only to whether municipalities will be able to pay the principal and interest owed on long-term obligations, but also to a lack of clarity as to the rights of bondholders and remedies available should it become clear that a municipal default will occur. While investors may express great concern that a municipality will unilaterally file a municipal bankruptcy petition under Chapter 9 of the U.S. Bankruptcy Code without any attempts to work with investors in restructuring debt, in reality the states have enacted a plethora of laws to help rehabilitate municipalities before they reach such an untenable position. As a last resort, should such restructurings fail, and only in certain states, a municipality could pursue a municipal restructuring under the U.S. Bankruptcy Code. Rarely have municipalities filed for Chapter 9.[3]

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[3] Since 1937 only 633 filings have occurred, and since 1980, only 262 Chapter 9 petitions have been filed as of December 31, 2011. For the most part, these 262 Chapter 9 petitions were filed by small special tax districts and few, if any, municipalities of any size. States, to date, cannot file for Chapter 9 protection. *See Jim Spiotto Speaks Before House Judiciary Subcommittee on State Bankruptcy Proposal*, available at http://www.chapman.com/newsevents. php?PracticeID=-1&SearchType=all&Keyword=&x=67&y=4 and *Testimony of James E. Spiotto*, Hearing on the Role of Public Employee Pensions in Contributing to State's Insolvency and the Possibility of a State Bankruptcy Chapter before the House Judiciary Committee's Subcommittee on Courts, Commercial and Administrative Law, *available at* http://judiciary.house.gov/hearings/pdf/Spiotto02142011.pdf (Feb. 14, 2011).

This presentation will provide a general overview of the various state laws enacted to aid troubled municipalities and to protect bondholders in a default situation and examine those mechanisms that states have enacted to remedy financial distress and an evolving default situation. For instance, in all but three states, certain debt or tax limitations have been enacted to limit the amount of debt that a municipality may hold at any one time. In virtually all states, there is some form of a limitation on debt, a tax limitation or a combination of both. In addition, all states recognize refunding bond provisions, which may aid municipalities in simply "refunding" or "refinancing" a default away. At some point, however, issuing refunding bonds may no longer be the effective answer to a municipality's financial situation.

In addition to these mechanisms that may help protect a municipality from entering a default situation (financial oversight, financial control boards, intergovernmental cooperation, local government cooperation and others), certain states have enacted debt resolution provisions to help aid troubled municipalities in developing a plan for paying their debts. In addition to these debt resolution provisions, many states contain provisions explicitly setting forth remedies for bondholders in a default situation. While many of these remedies are available for holders of revenue bonds and not general obligation debt, the availability of such remedies may be important to any municipal investor and important to maintaining credibility in the financial markets. Examples of such remedies include actions for mandamus; suits to force the payment of debt; suits for declaratory relief; suits to appoint a receiver; and suits for injunctive relief[4].

The final and last resort for local governments authorized by their state is filing a petition under Chapter 9 of the U.S. Bankruptcy Code. Filing under Chapter 9 of the U.S. Bankruptcy Code can be an alternative to municipalities but it is an admission of financial management

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

failure and can have severe consequences as to future access to the financial markets or at least the cost of future borrowing. These materials will analyze the viability of Chapter 9 as the last resort for municipalities.[5] While state authorization is required and not all states authorize their municipalities to file a municipal bankruptcy petition, municipal bankruptcy could be a powerful tool for municipalities on the brink of disaster to restructure their debt. Along with a general overview of the municipal bankruptcy provisions of the U.S. Bankruptcy Code, this presentation will pay particular attention to provisions allowing for the continued payment of two types of bond issuances – special revenue bonds and bonds to which a statutory lien applies – even after a municipal bankruptcy filing has occurred.

In addition, the materials aim to highlight those states that have adopted monitoring and rehabilitation provisions to aid their municipalities at the first sign of trouble.

II. CAUSES OF DEFAULTS

The United States contains the most extensive and sophisticated public works system in the world including 4,042,778 miles of roadways, 603,259 bridges, 1,100 local bus systems, 19,750 airports (of which 5,178 are for public use), 25,320 miles of inland and intercoastal waterways, almost 84,000 dams, more than 2 million miles of pipe in water supply systems and over 15,000 wastewater treatment plants provided mostly by municipalities and political subdivisions of a state.[6] Not only our local but also our national welfare and economic growth

[5] Of the states, 12 states allow their municipalities to file Chapter 9 petitions; 12 states place conditions on the filing by municipalities; three states include limitations; and two states prohibit such a filing, although one prohibiting state provides an exception to its prohibition. The remaining 21 states are either unclear or do not have specific authorization. Without specific authorization from the state, a municipality may not file a petition under the U.S. Bankruptcy Code. The District of Columbia and Puerto Rico are not authorized to make use of Chapter 9 and are not "municipalities" as defined in the U.S. Bankruptcy Code.

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

depend upon the efficient operation of municipal facilities, most of which are financed by bonds purchased by the municipal bond market.

In fact, our ability to supply jobs and encourage business growth in metropolitan areas will require construction of new public work systems and the continued maintenance and operation of our present public works and infrastructure. Significant increases in infrastructure spending at both the federal and local levels are not only necessary, but inevitable.[7] There will be an increasing demand on the municipal bond market to finance these infrastructure improvements over the next 20 years. According to the American Society of Civil Engineers, over the next five years it is estimated that $2.2 trillion in debt financing will be needed to bring our infrastructure to acceptable levels.[8] Obviously, access to the market will be enhanced by workable state laws with respect to municipalities and a workable federal statute governing municipal debt adjustment.

III. STATE PROVISIONS REGARDING LOCAL GOVERNMENT DEBT ISSUANCE

At the front lines of protecting the financial status of local government are debt limitations imposed by state constitutions and statutory law to restrict the amount of debt that a municipality may issue at any one time. In addition to debt limitation provisions, all states contain provisions in their statutory law for the issuance of refunding bonds. This next section will discuss protective measures taken by the various states.

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[7] During economic downturns, the increased issuance of state and local bonds is followed by increases in employment and GDP growth. For charts presenting this correlation, see James E. Spiotto, *Historical and Legal Strength of State and Local Government Debt Financing*, 8-9 (Nov. 2010), *available at* http://www.chapman.com/events/20101116/SpiottoWebinar_111610.pdf.

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

A. Debt Limitations

One of the most important protections for bondholders 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 exception of Alaska, Florida, and Tennessee impose some sort of limit on the amount of debt a municipality may have outstanding at any one time.[9] Municipalities in 28 states are restricted by limits imposed by their respective constitution. The other 21 states that impose debt limitations on their municipalities do so via statutory provisions.

These municipal debt limits range from a percentage of a valuation of assessed property in the local unit of government to a set monetary amount.[10] In addition, states handle debt for certain "essential" services differently. For instance, in Arizona, while the constitutional debt limit with voter consent is 15 percent of the taxable property in the local unit of government, if bonds are issued for supplying a town or city with water, artificial light or sewers or for purchasing and developing land for open space preserves, parks, playgrounds and recreational facilities, public safety, law enforcement, fire and emergency services facilities or streets and transportation facilities, the debt limit increases to 20 percent.[11] In Kansas, bonds issued by cities with respect to sewer systems, to acquire or enlarge a municipality utility, and certain street improvement bonds are not counted towards the issuing city's bond indebtedness calculation.[12] Revenue bonds issued in Kansas are also not included in this calculation.[13] In Arkansas, industrial development bonds do not count towards the state's debt limit.[14]

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[9] Even Alaska and Florida have some indirect control on debt. Alaska has a limitation on taxes and a municipality may not levy ad valorem taxes for any purpose in excess of 3 percent assessed value of the property in the municipality. Florida has a limitation on ad valorem taxes to finance or refund capital projects only if approved by the voters.

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

[11] ARIZ. CONST. art. IX, § 8.

[12] KAN. STAT. § 10-309.

In Idaho, two-thirds of voters must approve bond issuances in which a local government would incur debt exceeding the income and revenue the local government would receive in a year. Should voters approve a bond issuance, the state constitution requires that the local government collect an annual tax sufficient to pay the bond interest as it comes due and to establish a sinking fund for payment of the principal within 30 years.[15] A few states, such as Louisiana, have set debt limits based on the type of project rather than a blanket limit into which all debt issued by a particular local government falls.[16] In Puerto Rico, the Puerto Rican constitution directs the Puerto Rican legislature to fix municipal debt limits, but the limits may not be less than 5 percent or more than 10 percent of the aggregate tax valuation of the property within the municipality.[17] In other states, such as Rhode Island, a debt limit has been set for cities and towns, but the debt measurement is net of any tax anticipation bonds and the amount in any sinking fund.[18]

There have been recent attempts in some states to tighten local debt limits. For instance, in November 2010, Colorado voters considered a state constitutional amendment that would have greatly limited the ability of local governments to borrow funds. This amendment, which was overwhelmingly defeated by 73 percent of voters, would have prohibited local government borrowing after 2010, unless the voters approved the borrowing. Specifically, the amendment would have required voter approval for all borrowing, limited local government borrowing to

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13 *Id*. at § 10-311.

14 ARK. CONST. Am. 62.

15 IDAHO CONST. art. VIII, § 3.

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

17 P.R. CONST. art. VI, § 2.

18 R.I. GEN. LAWS § 45-12-2.

bonded debt, and established a debt limit for local governments to 10 percent of the assessed value of the real property therein. The length of borrowing would also have been reduced from the typical term of 20 to 30 years to a constitutional limit of 10 years. Currently, Colorado imposes a debt limit on school districts of 20 percent of the last valuation on taxable property or 6 percent of the most recent determination of actual value of the property.[19] Rhode Island has recently enacted (July 2011) legislation that payment of bond debt will have a first priority lien on revenues of a municipality in order to assure the municipal market of the dedication to payment.[20]

Although states attempt to limit the amount of debt that their municipalities may incur, local governments sometimes take certain actions to avoid these debt limitations. For instance, revenue bonds financed by particular rents, tolls or charges generated from a project are exempt from debt limitation calculations in many states. Similarly, many local governments issue tax increment financing (*"TIF"*), which is generally not counted in the debt limitation valuation. In fact, the Supreme Court of Iowa has held that a TIF district's issuance of bonds does not count towards a city's constitutional debt limit because the bonds are not a legally enforceable obligation to the city.[21] In other situations, a local government may attempt to use "nonappropriation" financing, in which a local government agrees to make rental payments on a facility built by either a private company or a public entity. The payment of the rent is contingent on the local governing board appropriating money for the rental payment. Courts have had a mixed reaction as to whether so-called "nonappropriation" funding should be counted

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[19] COLO. REV. STAT. § 22-42-104.

[20] 2011 R.I. Pub. Laws 277 (signed into law July 12, 2011). This provision has successfully been tested in the bankruptcy proceeding involving the City of Central Falls, Rhode Island.

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

in a local government's debt limit.[22] In California, there are three major exceptions to the state constitution's debt limit, including the "Offner-Dean" lease exception allowing for certain long-term lease obligations, if meeting certain criteria, to be exempt from the State's debt limit; the "Special Fund Doctrine," which is a judicially created debt limit exception applicable to long-term indebtedness financed through a special fund, such as enterprise revenues; and the "Obligation Imposed by Law" exception applicable to involuntary indebtedness such as a money judgment.[23] Also in California, municipalities sometimes issue "certificates of participation," a strategy generally exempt from state constitutional debt limits where local governments market lease obligations through the retail securities market by means of certificates of participation that pay tax-exempt interest and are liquid.[24] These are just a few examples of strategies that a municipality might utilize to circumvent a constitutionally or statutorily imposed debt limit. For specific questions an attorney familiar with the laws and process of a particular state should be consulted.

B. Refunding Bonds

Perhaps the most common way that municipalities restructure their debt is through the issuance of refunding bonds. Refunding bonds, as the name implies, are bonds that are issued to redeem the principal of outstanding bonds. Every state provides some sort of refunding bond provision for its municipalities. By issuing refunding bonds, a municipality may be able to

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

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

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

refinance its debt at a rate more favorable to itself or to let its debt mature at a time when the municipality believes it will be more flush with money. Refunding bonds also may help a municipality to push off its debt troubles for another day. Generally, the issuance of refunding bonds does not constitute indebtedness for the purposes of debt limitations imposed by almost all of the states. This is because the purpose of refunding bonds is to refinance already existing bonds.

Refunding bonds generally may be issued any time before the final maturity of the debt to be refinanced. Although municipalities generally have flexibilities in refunding their current obligations, many states impose provisions limiting the use of refunding bonds in an attempt to protect the financial solvency of a particular municipality. For instance, in Pennsylvania refunding bonds may only be issued to (1) reduce total debt service over the life of the bond issuance; (2) reduce annual debt service; (3) eliminate unduly burdensome or restrictive covenants or restrictions; (4) refund any maturity or maturities to a later date; (4) substitute bonds for notes or bond anticipation notes or to substitute notes for bonds; or (5) adjust lease rentals.[25] Pennsylvania law further limits municipalities in their issuance of refunding bonds by disallowing local governments from extending the term of the outstanding debt through refunding to a maturity date that could not have been included in the original issue, unless "in the case of an emergency refunding of stated maturity date to avoid a default occasioned by an unforeseen shortage in total revenues . . . ."[26] This provision, however, would only apply if the municipality in question were to first petition the state government and the petition receive state

[25] 53 PA. STATS. §§ 8241-8251.

[26] *Id*. at § 8243.

approval.[27] Other states have similar provisions with respect to circumstances under which a municipality may issue refunding bonds.

C. Conclusion

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

IV. DEBT RESOLUTION MECHANISMS

A. Introduction

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

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[27] *Id.*

States that contain provisions allowing for state intervention into a municipality's finances include:

	STATE	INTERVENTION PROVISION
1.	Arizona	School District Receivership
2.	California	Debt and Investment Advisory Commission
3.	District of Columbia	Financial Responsibility and Management Assistance Authority
4.	Florida	Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program
5.	Idaho	Debt Readjustment Plans
6.	Illinois	Financially Distressed City Law and Financial Planning and Supervision
7.	Indiana	Distressed Political Subdivision Protections and Township Assistance
8.	Kentucky	County Restructuring Provisions
9.	Maine	Board of Emergency Municipal Finance
10.	Massachusetts	*Ad hoc* State Intervention
11.	Michigan	Emergency Financial Management and Local Government and School District Fiscal Accountability Act
12.	Minnesota	Back-up Payment Procedures for Municipalities and School Districts
13.	Nevada	Local Government Financial Assistance and Audit Enforcement Act
14.	New Hampshire	Emergency Financial Assistance
15.	New Jersey	Local Government Supervision Act and Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act
16.	New York	Emergency Financial Control Board; Municipal Assistance Corporation; New York Financial Control Board
17.	North Carolina	Local Government Finance Act
18.	Ohio	Fiscal Watch; Fiscal Emergency; and the Fiscal Emergencies and Financial Planning and Supervision Commission
19.	Oregon	County Public Safety Emergency and Fiscal Control Board and Municipal Debt Advisory Commission

	STATE	INTERVENTION PROVISION
20.	Pennsylvania	Financially Distressed Municipalities Act; Intergovernmental Cooperation Act
21.	Rhode Island	Fiscal Overseer; Municipal Receiver; Budget Commission
22.	Texas	Municipal Receivership
23.	Wisconsin	Deficiency Protection for Public Improvement Bonds

B. States Recognizing Municipal Receivers – Rhode Island and Texas

Similar situations occur even today. For instance, in Rhode Island, the city of Central Falls petitioned a state court and was placed into judicial receivership for its financial woes in May 2010. The city of 18,000 had over $20 million of G.O. debt.[28] In response to the city's filing for judicial receivership, in June 2010 the Rhode Island legislature passed and the governor signed into law a process of progressive state intervention for municipalities in financial distress. The new law created a three-step process for distressed governments, in what was possibly an attempt by Rhode Island to prevent *ad hoc* efforts by municipalities to restructure with tactics that could be unfriendly to the municipal markets.[29] The law applied retroactively to prevent the Central Falls judicial receivership from continuing.

After the legislation became law, Central Falls was placed into municipal receivership when a state commission found that the municipality had insufficient power to restore fiscal responsibility. The city council of Central Falls attempted to challenge the new state law, but a state court judge in October 2010 upheld the constitutionality of the state-appointed receiver. Shortly thereafter, in November 2010, the receiver exercised his significant power to disband the

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[28] Patrick McGee & Taylor Riggs, Central Falls Aims to Protect GOs, THE BOND BUYER, Aug. 1, 2011, http://www.bondbuyer.com/news/central-falls-bankruptcy-1029523-1.html (last visited Aug. 19, 2011).

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

Central Falls city council and replace it with a three-member advisory council. The receiver publicly stated that he fired the council because "several members of the City Council have chosen to continually obstruct our efforts to return fiscal stability to the City."[30] Recently the Governor of Rhode Island signed into law legislation to give the municipal debt holders a guarantee of first rights to property taxes and general revenues in the event of bankruptcy. This was in an apparent effort to demonstrate the creditworthiness and improve the availability of Rhode Island's municipal debt that is vital to ensuring financing for essential infrastructure improvement and recoveries.[31] On August 1, 2011, Central Falls' state-appointed receiver filed a Chapter 9 petition for municipal bankruptcy on behalf of the City. General obligation bondholders have continued to receive payment on their bonds even with this filing because of the new Rhode Island law.

In addition to the recent Rhode Island law and a law in Texas allowing for a judicially appointed municipal receiver, other states have chosen to allow for a financial control board, emergency managers, coordinators, overseers or a financial commission to aid troubled municipalities. As background, the concept of a financial control board first made its appearance with the creation of a financial commission to oversee Manchester, New Hampshire, in 1921.[32] Although the Manchester financial commission was appointed by the governor, the mayor and alderman of Manchester fixed the commission's compensation. The commission was allowed to control and regulate appropriations, expenditures and bond issuances but could not control the collection of taxes.

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

31 2011 R.I. Pub. Laws 277 (signed into law July 12, 2011).

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

C. Financial Control Boards

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

1. The New York Experience

Perhaps the most well-known appointment of a financial commission was the implementation of the New York City Financial Control Board in 1975. In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that New York had, for more than ten years, been using questionable accounting and borrowing practices to eliminate its annual budget deficits.[33] Banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could only be resolved by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. New York nearly defaulted on the payment of its notes in October 1975, and it was predicted that a default was likely in December absent federal aid.[34] In response, the State Municipal

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

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

Assistance Corporation issued a series of securities on behalf of the city and a financial control board was appointed.

The New York City Financial Control Board was given the power and responsibility to review and provide oversight with respect to the financial management of New York City's government. Among other things, the act establishing the board required the city to prepare and submit a "rolling" four-year financial plan to the Financial Control Board prior to the beginning of each city fiscal year. The Financial Control Board, today, although essentially dormant since the mid-1980s, can be reactivated if certain conditions are triggered, including the inability of the city to meet its debt service payments.[35]

In addition to the New York City Financial Control Board, the New York legislature may implement Emergency Financial Control Boards for any municipality outside of New York City. For instance, this provision was used in November 1975 to take control of the City of Yonkers (the board was terminated on December 31, 1978) and most recently with regard to Nassau County in January 2011.[36]

2. The Pennsylvania Experience

Similar to the New York experience, Pennsylvania has implemented a series of provisions to aid ailing cities. Pennsylvania law contains the Financially Distressed Municipalities Act, which applies to any county, borough, incorporated town, township or home-rule municipality.[37] Under these provisions, if the state Department of Community Affairs determines that a municipality is financially distressed based on certain triggering events, the department may appoint a coordinator to guide the municipality in getting its financial affairs in

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[35] *See* THE BOND BUYER, Nov. 30, 1990, pp. 1, 45.

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

[37] 53 PA. STAT. §§ 11701.101 - 11701.501.

order. There have been 26 filings under these provisions since 1987 and six rescissions of such filings. Examples of municipalities that were determined to be financially distressed include Pittsburgh in 2003, the Borough of Wilkinsburg in 1988, and most recently Harrisburg in October 2010.

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

3. The Michigan Experience

Likewise, the State of Michigan, under its former Local Government Fiscal Responsibility Act, has taken over the Detroit Public Schools; the City of Pontiac; the City of Escorse; the Village of Three Oaks; the City of Hamtramck; the City of Highland Park; and the City of Flint.[38] These provisions have recently been replaced by the Local Government and School District Fiscal Accountability Act.[39] Under this Act, if a school district or municipality is in a perilous financial situation, the Michigan governor may declare a financial emergency. Should the municipality or school district enter into a financial emergency and an emergency manager is appointed, the emergency power has broad powers to operate and restructure the

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[38] Former MICH. COMP. LAWS. § 141.2802 (this provision has been replaced by the Local Government and School District Fiscal Accountability Act). *See also* Eric Scorsone, *Local Government Financial Emergencies and Municipal Bankruptcy*, Michigan Senate Fiscal Agency Issue Paper, *available at* http://www.senate.michigan.gov/sfa/publications/issues/localgovfin/localgovfin.pdf (last visited July 8, 2011).

[39] MICH. COMP. LAWS §§ 141.1501-141.1531 (2011).

municipality including the ability to reject, modify or renegotiate contractual obligations.[40] As a last resort, this emergency manager may file a Chapter 9 municipal bankruptcy petition on behalf of the municipality.[41] Showing the seriousness with which Michigan and states with similar provisions take the filing by their municipalities of a municipal bankruptcy petition, in November 2010 the Emergency Financial Assistance Loan Board for the City of Hamtramck rejected a request by Hamtramck to file a municipal bankruptcy petition. This request was denied by the state that same month. The issues raised by the Emergency Manager Law in Michigan is "Does it vest too much power in one person who holds executive power and is not and cannot be a judiciary or legislative power?" Unlike court-appointed receivers or even court procedures, there is no guaranty of due process as certain rights are determined or abrogated. Further, the local government is surplanted by the Emergency Manager. This is a substantial difference from the financial control boards in New York, Act 47 in Pennsylvania or oversight or financial review authorities in other states. Further, there are more inclusive and effective mechanisms that can be considered to enhance the ability to provide financial assistance and oversight while including local participation.

4. The Massachusetts *Ad Hoc* Experience

Similar to the laws of states establishing specific authority for financial control boards or similar commissions, Massachusetts has typically employed a system of implementing legislation on an *ad hoc* basis to create a financial control board or overseers for municipalities in severe financial distress. For instance, in the 1990s the City of Chelsea was placed into a state receivership. The receiver cut city payroll by 25 percent and cut non-pecuniary employment benefits. In one year, the receiver was able to cut city expenses by 10 percent of the city's

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[40] MICH. COMP. LAWS. § 141.1519 (2011).

[41] MICH. COMP. LAWS. § 141.1523.

budget (by $5 million).[42] In March 2010 the Governor signed into law provisions allowing the City of Lawrence to borrow $35 million from the market and establishing a fiscal overseer for the municipality.[43] In a July report the financial overseer reported that Lawrence's fiscal emergency was the result of years of mismanagement and fiscal challenges. The fiscal overseer has aided the city in producing a balanced budget.[44] In another instance, in 2004 Massachusetts made a $52 million state loan to the City of Springfield and established a Financial Control Board to oversee the city.[45]

D. Conclusion

As indicated by the case studies discussed above, the states have divergent techniques for addressing the financial woes of their municipalities. In addition, should a state's guidance to a troubled municipality fail, a number of provisions, as will be overviewed next, exist establishing investors' rights and setting forth remedies in the event of default.

V. BONDHOLDER RIGHTS AND REMEDIES

In addition to the more general provisions of the states addressing municipal restructuring issues, the states have implemented a series of patchwork provisions, allowing bondholders to protect their rights and granting certain remedies in the event of a default.

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

43 *See* chapter 58 of Acts of 2010.

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

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

As background, state laws generally allow for the issuance of bonds within two broad categories – general obligation and revenue bonds. General obligation bonds are those bonds to which the state or local government has pledged its full faith and credit.[46] Revenue bonds are those bonds issued by state and local governments that are paid solely based upon the revenues to be collected by the municipal body in connection with the financed improvement. State revenue bond laws are generally project specific. An example of a revenue bond would be bonds payable solely from and secured as to payment of principal and interest by a pledge of the net revenues – fees – of a water or sewer system. As a further example, in Arkansas separate laws provide authorization for the issuance of numerous types of revenue bonds including, but not limited to, parking meters; suburban improvement district bonds; property owners' improvement district bonds; municipal property improvement district bonds; water distribution district bonds; drainage and levee improvement district bonds; public corporations for municipal facility bonds; public utility bonds; and bridge improvement district bonds.[47] In general, each of these provisions contains different mechanisms in protecting bondholder rights.

When a municipality defaults on a bond issuance, bondholders may institute a lawsuit requesting that the municipality take certain actions, immediately pay all amounts due and owing to bondholders, or otherwise cure the default.[48] Such actions may be in the form of a suit for money judgment, mandamus, specific performance or other equitable relief, such as requesting the issuance of an injunction. Where bondholders are owed principal or interest by a municipal

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

[47] For a more detailed list of revenue bond issuance provisions, see Arkansas laws.

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

body that has not been paid, they may bring a suit for payment of that debt and the municipal body, absent filing a petition under Chapter 9 of the U.S. Bankruptcy Code, cannot take any action to obtain a moratorium of such a suit.[49] In light of these principles the next few sections will provide an overview of the general rights and available remedies.

A. Mandamus

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

> It is not to be used to establish rights but to enforce rights that have already been established. The writ can be used to compel a tribunal to act but cannot control its discretion. If there is a plain, speedy, and adequate remedy at law, mandamus does not lie.

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

> When such a remedy is available through certiorari or appeal, mandamus should not be ordered. The other available remedy, however, "must be competent to afford relief on the very subject matter in question, and be equally convenient, beneficial and effectual."[50]

The Seventh Circuit Court of Appeals, in *Connett v. City of Jerseyville*, 125 F.2d 121 (7th Cir. 1941), held that where a mortgage or a statute requires a city to adopt rates for a waterworks sufficient to pay the indebtedness of the waterworks, a court may compel the city to adopt the schedule. The Seventh Circuit found, however, that although a court had the power to compel the city to adopt the statutory schedule, it had no power to fix the rates for the waterworks. Thus, if a local government is provided discretion in its act, mandamus would be a difficult remedy to assert unless the local board's acts were arbitrary or capricious.[51]

In the event a local board refuses to take some action required by law, such as collecting taxes on fees to pay for a bond issuance, if a consensual restructuring fails, pursuing a writ of mandamus may be an alternative.[52]

B. Receivership

In addition to allowing bondholders or their representative to file a petition with a court for a writ of mandamus to force a local government to take a required action, many bond issuances allow for the appointment of a receiver to oversee the particular project in question, and if appropriate, raise rates or taxes sufficient to pay debt issued to finance the public

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

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

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

improvement.[53] A modern example of such an action occurred recently in Jefferson County, Alabama. In September 2010 an Alabama state court appointed a receiver to operate and administer the county's sewer system. The county had $3.2 billion in sewer debt that it was unable to pay, related largely to a failed interest-rate swap transaction. The receiver was given the power to operate and administer the sewer system, including, as allowed by the bond indenture, the ability to raise rates.

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

As mentioned, the underlying bond indenture in the Jefferson County situation allowed for the appointment of a receiver and for that receiver to have control over sewer rates in the county. Similarly, authorizing provisions for revenue bond financing in 46 states, allow for the appointment of a receiver in the event of a default. These provisions are generally tied to specific revenue bond issuances. For instance, Maryland law contains certain provisions allowing for the appointment of a receiver should a municipality default on sewage facility

53 Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Ohio, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming.

bonds.[54] Under Maryland law, should a local unit of government default on bonds for sewage facilities, a receiver may enter, take possession of the facility to operate and maintain it, and set facility rates, fees or charges. In addition, the receiver may collect, receive and apply all revenue of the facility. Such receivership provisions are generally tailored by a state's laws to address the type of bond that is being issued.

Such provisions are generally bond specific. Thus, to establish the rights and remedies, including the ability to appoint a receiver with respect to a particular bond issuance, specific review and analysis may be required to determine the particular legal authorization and thoroughly review the authorizing language in the bond indenture.

C. Accounting

In addition to the provisions discussed above, some states, depending on the type of bond, may allow for bondholders to seek an accounting. Specifically, at least 21 states, allow for bondholders or a representative trustee to bring an action for an accounting to require the local government to account for how a bond fund has been spent as a trustee would be required to take such action.[55] If a municipality has diverted or has threatened to divert funds collected and reserved for a specific bond issuance, a bondholder or trustee, depending on the specific indenture, may bring an equitable action for an accounting and recovery of any amount diverted. Along with this, the bondholder could seek an injunction to enjoin any diversion. A bondholder considering this option must act quickly, however, because the equitable doctrine of laches could

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[54] MD. CODE, ENVIR. § 9-807.

[55] California, Colorado, District of Columbia, Florida, Hawaii, Idaho, Indiana, Kansas, Kentucky, Mississippi, Missouri, Nevada, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, Tennessee, West Virginia and Kentucky. This list could be more expansive based on facts and analysis of the individual situation and a determination of whether a bondholder could pursue an action for an accounting with respect to a particular bond issuance. A court may require in a default situation the issuer of the bond debt to account for the use of the proceeds of the debt issue or the taxes collected for payment of the debt.

apply, causing the bondholder to lose its right to bring such an action if a court finds the bondholder waited too long after learning of a diversion of funds to bring the action.[56]

D. Foreclosure Action

Much like in a civil context where a mortgagee holds a mortgage on a mortgagor's home and may bring a foreclosure action if obligations are not paid, some states allow bondholders or their representative to pursue a foreclosure action against a certain project generally in the conduit finance context against property owned or financed by a private concern.[57] For instance, in California, state law has established an industrial development authority for each public agency. Each agency may issue industrial development revenue bonds to help private business purchase property for certain uses, such as industrial uses, energy development, research and development activities, commercial uses, processing or manufacturing recycled or reused products, business activities, residential real property for families, airports, sewage and solid waste disposal activities, water furnishing activities, or any other activity qualifying as exempt under § 501 of the Internal Revenue Code.[58] The authorities may issue bonds for a project payable solely as special obligations out of the revenues or other sources specified in the bond proceedings.[59] In the event of default, the bond indenture may include, among other remedies,

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

[57] Foreclosure is generally allowed in conduit financing. There, collateral owned or financed by the private concern is involved. Alabama, Alaska, Arizona, California, Hawaii, Idaho, Illinois, Indiana, Kansas, Louisiana, Maine, Missouri, Mississippi, Nebraska, Nevada, New Jersey, New York, North Carolina, Ohio, Oregon, Rhode Island, South Carolina, Texas, Vermont, Washington, West Virginia, Wisconsin and Wyoming. This list could be more expansive and further review and evaluation as well as the specific facts should be considered to determine whether a bondholder could pursue a foreclosure remedy with respect to a particular bond issuance.

[58] CAL. GOV. CODE §§ 91502-91503.

[59] *Id*. at § 91535.

enforcement by foreclosure or sale.[60] Generally, foreclosure is not permitted for essential governmental property as it would be against public policy.

E. Other Relief

In addition to the forms of relief discussed previously, a wide variety of provisions exist in the states to allow bondholders to protect their interests. For instance, at least 15 states specifically allow for injunctive relief in the event of a default.[61] One such example is Kentucky, where certain bondholders may petition a court for injunctive relief to enjoin any unlawful act or any act taken violating bondholders' rights.[62] Other states allow bondholders to pursue any action necessary, including contractual remedies, to enforce and protect their rights.[63] The attached charts provide a more general analysis of the types of relief available in each state.

F. Conclusion

Originally municipal and state debt obligations were viewed as moral obligations and, in the early 1800s, few if any statutes or constitutional provisions permitted a legal basis for such obligations. The repudiation of debt by 13 states after the Civil War brought about statutory and constitutional provision debt limits and other statutory provisions and remedies to provide assurance to the market that state and municipal debt was a safe and protected investment. Since

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

61 This is in addition to the general availability of injunctive relief under the civil procedure code for most states to prevent irreparable harm when there is no adequate remedy at law. This issue is a difference as to public policy and irreparable harm with respect to municipal debt and, thus, a specific state statute may provide more expansive relief. *See, e.g.,* Alabama, California, Colorado, Connecticut, District of Columbia, Florida, Illinois, Indiana, Kentucky, Mississippi, Montana, Nevada, Ohio, Washington, West Virginia, and Wyoming.

62 *See* KY. REV. STAT. § 96.184(5)(b).

63 *See, e.g.,* Arizona, California, Colorado, Connecticut, Georgia, Hawaii, Illinois, Maine, Minnesota, Mississippi, Missouri, Montana, New Hampshire, Ohio, South Carolina, Utah, and Virginia.

the late 1800s the states have implemented a wide array of provisions to protect the rights of bondholders and allow for certain remedies in the event of a default. While these rights provide bondholders with protection once a default occurs, these provisions cannot replace state supervision and oversight and attempts to work with a municipality or local form of government when it becomes more likely than not that a default will occur. As will be discussed next, however, if a municipality is truly in trouble and is located in a state authorizing its municipalities to file a municipal bankruptcy petition. Some state statutes have provided bondholders with statutory liens or make the bonds payable from special revenues so that the access to financial markets is not adversely effected by a Chapter 9. This is because the bankruptcy filing would not cut off payments of principal and interest to special revenue bondholders, although in most cases the municipality would be required to pay the operations costs of the particular project before paying bondholders. In addition, those holding bonds secured by a statutory lien are guaranteed payment of collected taxes since a bankruptcy court cannot invalidate or interfere with the rights granted by state law to debt holders.

VI. MUNICIPAL BANKRUPTCY

Historically, Chapter 9 has been used generally by small tax districts and small municipalities while major issuers of municipal debt have refrained from proceeding with a Chapter 9 filing. Since 1937, when Chapter 9 was instituted, there have been 635 Chapter 9 filings as of December 31, 2011. Since 1980 there have been 264 filings as of December 31, 2011. Of those who have filed since 1980, only four have been municipal debt issuers of any significance, namely: (1)-Orange County in 1994, in which the public debt was refinanced and paid, (2)-the City of Bridgeport, Connecticut, in 1991, which ultimately was dismissed, (3)-the City of Vallejo in 2008, which exited bankruptcy in August 2011, and (4) Jefferson County, Alabama, which filed its petition in November 2011. About a third of 262 Chapter 9 filings

since 1980 have been dismissed, rather than being completed, by confirming a Plan of Debt Adjustment. While corporate issuers utilizing Chapter 11 have filed in recent years over 1,000 Chapter 11 filings per year, the Chapter 9 filings, even during the current economic downturn, have been small: 5 in 2007, 4 in 2008, 10 in 2009, 6 in 2010 and 13 in 2011. Chapter 9 has been viewed by major municipal issuers as clearly the last resort and an alternative to be avoided at virtually all costs. It is no accident that New York City in 1975, Cleveland in 1978, Philadelphia in 1991 and other significant issuers of municipal debt, when faced with a financial crisis, chose other viable alternatives rather than filing Chapter 9. Chapter 9 provides no additional revenues or tax sources to solve the problem, and it affects all creditor relationships and not just the few that are the problem. Chapter 9 tips over those desired creditor relationships that are not the problem and are working just fine. Further, the stigma and complexity and travail of Chapter 9 is more than what many local governments can tolerate.

The last resort for troubled municipalities in certain states is the filing of a petition under Chapter 9 of the U.S. Bankruptcy Code. Chapter 9 is a vehicle not for elimination of debt but rather for debt adjustment. Specifically, a Chapter 9 proceeding is a mechanism for a debtor municipality, through a court-supervised proceeding, to attempt to settle disputes with its creditors. Since a municipal unit cannot liquidate its assets to satisfy creditors and continue to function as a municipality, the primary purpose of Chapter 9 of the U.S. Bankruptcy Code is to allow the municipal unit to continue operating while it adjusts or refinances creditor claims. Indeed, one of the stated purposes of the U.S. Bankruptcy Code was to provide a "workable procedure so that a municipality of any size that has encountered financial difficulties may work with its creditors to adjust its debts."[64]

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[64] H.R. Rep. No. 137, 93rd Cong. 1st Sess. 237248.

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

Only a municipality may initiate an action and be a debtor under Chapter 9 of the U.S. Bankruptcy Code.[65] Moreover, in order for a municipality to proceed under Chapter 9, state law must have specifically authorized the entity to be a debtor under Chapter 9.[66] The chart at the end of this presentation summarizes the law in the 50 states. In addition to the requirement that a municipality be a subdivision of an agency or a subdivision or instrumentality of the state, it must be specifically authorized to file a Chapter 9 proceeding by the state. The states have adopted different approaches to this requirement. Eleven states have statutory provisions specifically authorizing the filing by an in-state municipality of a Chapter 9 petition.[67] Another 12 states authorize a filing conditioned on a further act of the state, an elected official, a state entity or some other issue.[68] Three states grant limited authorization[69] and two states prohibit filing, but one of them has an exception to the prohibition.[70] The remaining 21 states are either unclear or do not have specific authorization with respect to filing. The District of Columbia and Puerto Rico are not permitted to file.[71]

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65 11 U.S.C. § 109(c).

66 11 U.S.C. § 109(c)(2).

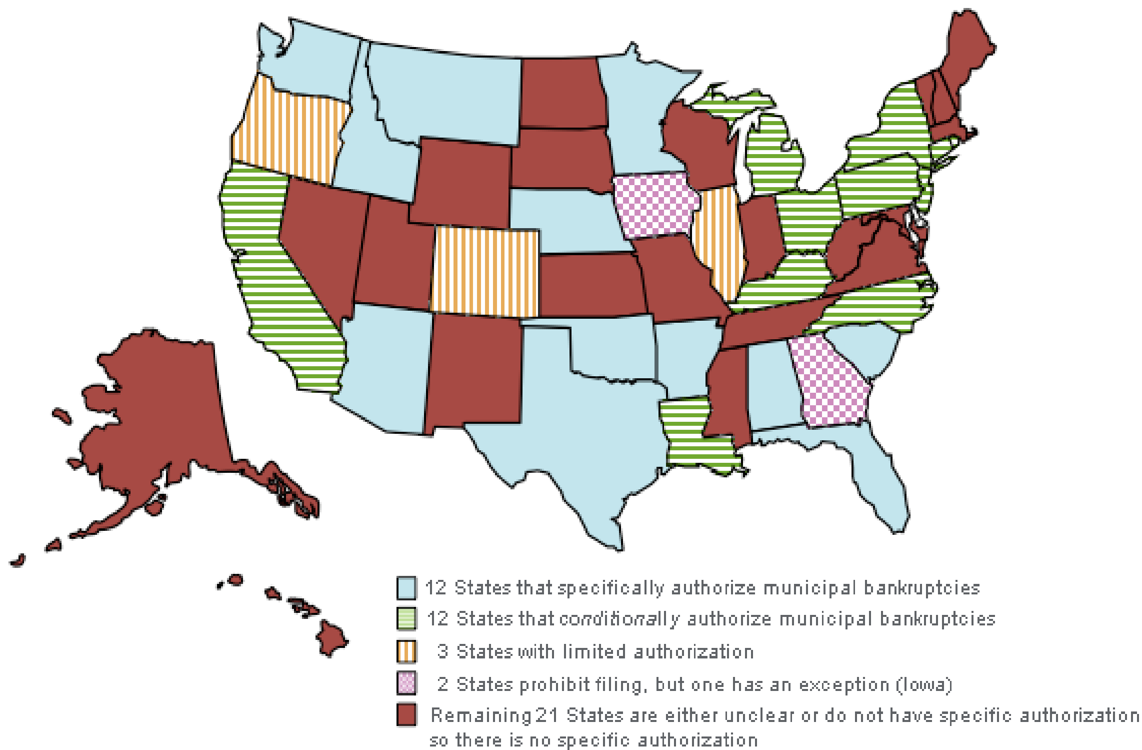
67 *See* Alabama (Bonds only) Arizona, Arkansas, Idaho, Minnesota, Missouri, Montana, Nebraska, Oklahoma, South Carolina, Texas and Washington. The limitation of Alabama's Code with respect to that state's municipalities filing chapter 9 petitions limited to issuance of Bonds as opposed to other forms of indebtedness is currently being considered by the Alabama Supreme Court.

68 *See* California, Connecticut, Florida, Kentucky, Louisiana, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania and Rhode Island.

69 *See* Colorado, Illinois and Oregon.

70 *See* Georgia and Iowa.

71 The term "State" is defined in the U.S. Bankruptcy Code as including "the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor" under Chapter 9. 11 U.S.C.A. § 101(52).



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

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

(2) The municipality has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in the amount of claims of each class that such entity intends to impair under a plan in a case under Chapter 9;

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[72] 11 U.S.C. §§ 109(c)(3) and (4).

(3) The municipality is unable to negotiate with creditors because such negotiations are impractical; or

(4) The municipality reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under § 547 of the U.S. Bankruptcy Code.[73]

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

The fact that a municipality has filed a petition does not necessarily ensure that its debts will be adjusted in that proceeding. Section 921(c) of the U.S. Bankruptcy Code's municipal provisions provides that, after objection to the petition, the court, after notice and a hearing, may dismiss the petition if it can be shown to the bankruptcy court that a petition was not filed in good faith or not in accord with the requirements of Chapter 9.[75]

B. Municipal Operations and Bondholders Protections

While in a Chapter 9 proceeding, the municipality will still have to function as a municipality. Depending upon the statutory mission of the municipality, there are certain necessary and basic municipal services that must be provided, such as police, fire and, under certain instances, sewer, water and electrical services. Defining what these necessary municipal services are is a question of state law and may by itself be a complex issue. A bankruptcy court

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[73] 11 U.S.C. §§ 109(c)(5) (A)(B).

[74] 11 U.S.C. § 921(a).

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

and creditors will not be able to successfully interfere with such service. Section 904 of the U.S. Bankruptcy Code recognizes this reality. Accordingly, certain revenues and activities of the municipal body that may be the cause of the "insolvency" may not be able to be restrained, curtailed or modified without a compelling reason. Even municipal debt secured by "special revenues," which pledge is preserved by reason of § 928 of the U.S. Bankruptcy Code, is subject to the payment of necessary operating expenses.

C. "Special Revenues" Pledged to Bondholders

Many municipal bonds are revenue bonds secured by a pledge of revenues derived from a specific project or a special tax levy. In fact, all states recognize some form of a revenue bond. As background, in a corporate bankruptcy context, § 552 of the U.S. Bankruptcy Code provides that property acquired by the estate or the debtor after commencement of a case is not subject to any lien resulting from a security agreement entered into by the debtor before the commencement of the case. Thus, in a corporate bankruptcy, if a revenue pledge were to exist, such as a lien on inventory or accounts receivable, the pledge likely would not survive the filing of a bankruptcy petition (namely any property or revenue created post-petition, such as inventory manufactured or accounts receivable received from sales of inventory after the filing of the case). In a municipal bankruptcy, however, this is not the case. Specifically, § 928 of the U.S. Bankruptcy Code provides that in the case of "special revenues," the security interest in "special revenues" remains valid and enforceable even though such revenues are received after a Chapter 9 filing. Subsection (b) of § 928 provides that in the case of project or system financing, the bondholders' lien on "special revenues" is subject to necessary operating expenses of the project or system. Thus, subject to the payment of operating expenses, holders of special

revenue bonds would continue to receive payment on those bonds, regardless of the bankruptcy filing.[76]

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

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

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

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

77 11 U.S.C. § 902(2).

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

D. Statutory Liens Protect Access to Financial Markets

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

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

circumstances or conditions and not requiring further action by the municipality.[79] A statutory lien cannot be canceled on the filing of a bankruptcy petition or by the bankruptcy court. This approach was recognized by the district court on appeal in the Orange County bankruptcy. There, the court found that the lien securing tax and revenue anticipation notes pursuant to a California statute authorizing the county to pledge assets to secure notes was a statutory lien. Since the statute imposed the pledge, not a security agreement, it survived the filing of a Chapter-9 petition.[80] At least twenty-seven states recognize some form of a statutory lien in relation to their bond obligations.[81]

The significance of special revenues and statutory liens was illustrated recently by the case of *Sierra Kings Health Care District,* in which a court order reaffirmed the fact that a Chapter 9 proceeding and any order or Plan of Debt Adjustment cannot interfere with notes, bonds or municipal obligations that are paid from the pledge of taxes or revenues which are special revenues or subject to a statutory lien.[82] Of special significance is the fact that the *Sierra Kings* court confirmed, for the first time, the post-petition effectiveness of a municipality's pledge of *ad valorem* taxes which qualified as both a special revenue pledge and a statutory lien. The Chapter 9 proceeding, orders and plan would not affect the timely payment on these bonds according to their terms. As noted above, Rhode Island, in anticipation of the City of Central Falls filing a Chapter 9 bankruptcy and seeking to avoid limited access to financial markets or

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

80 *Id*.

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

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

increased cost of financing, passed legislation in the summer of 2011 granting all noteholders and bondholders of its municipalities a first lien on all ad valorem tax revenues and general funds to ensure payment and continue market credibility.[83]

Summary of Basic Treatment of Bonds and Notes in Chapter 9

TYPE OF BONDS/NOTES	BANKRUPTCY EFFECTS
General Obligation Bonds	Post-petition, a court may treat general obligation bonds without a statutory lien as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease. Pre-petition, general obligation bonds are backed by the unlimited taxing power of the municipality (its "full faith and credit") and are historically subject to conditions such as voter authorization, limitations on particular purposes, or debt limitation to a percentage of assessed valuation on the power of municipal entities to incur such debts.
General Obligation Bonds plus Pledged Revenues	Assuming that the general obligation pledge is an actual pledge of revenue and to the extent that it may be classified as a statutory lien or special revenues, this secured issuance will be respected to the degree it is consistent and authorized under state law. A pledge of revenues that is not a statutory lien or special revenues may be attacked as not being a valid continuing Post-Petition Lien under § 552 of the U.S. Bankruptcy Code. This position may be questioned under § 904 of the Bankruptcy Code given the prohibition that the court not interfere with the government affairs or revenues of the municipality.
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

[83] 2011 R.I. Pub. Laws 277 (signed into law July 12, 2011).

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).

E. Payments to Bondholders Are Not Preferences

The U.S. Bankruptcy Code also provides assurance to holders of all municipal bond or note obligations that payments received within 90 days of the commencement of a municipal bankruptcy petition are not preferences that may be clawed back.[84] Specifically, § 926(b) of the Bankruptcy Code provides that a transfer of property of the debtor to or for the benefit of any holder of a bond or note on account of such bond or note may not be avoided under § 547. While this section refers to "bonds or notes," there is nothing in the legislative history to support the view that this provision is limited only to instruments bearing such titles. The intent appears to be that § 926(b) should be applicable to all forms of municipal debt and allow such holders to keep such payments where the U.S. Bankruptcy Code would otherwise require any payments

[84] 11 U.S.C. § 926.

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.

Summary of Chapter 9 Priorities

	TYPE OF CLAIM	EXPLANATION
1.	Obligations secured by a statutory lien to the extent of the value of the collateral.[ab]	Debt (bonds, trans, rans) issued pursuant to statute that itself imposes a pledge. (There may be delay in payments due to automatic stay – unless stay is lifted – but ultimately will be paid.)
2.	Obligations secured by special revenues (subject to necessary operating expenses of such project or system) to the extent of the value of the collateral.[ab] These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets.	Special revenue bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are 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.[c] There should be no delay in payment since automatic stay is lifted under § 922(d).
3.	Secured lien based on bond resolution or contractual provisions that does not meet test of statutory lien or special revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof.[c]	Under the language of §§ 522 and 958, liens on such collateral would not continue postpetition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or debtor. You may expect the creditor to argue that pursuant to § 904, the court cannot interfere with the property or revenues of the debtor, and that includes the grant of security to such secured creditor.
4.	Obligations secured by a municipal facility lease financing.	Under § 929 of the U.S. Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5.	Administrative expenses (which would include expenses incurred in connection with the Chapter 9 case itself).[d] Chapter 9 incorporates § 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under § 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to § 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.
6.	Unsecured debt includes:	

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

a Chapter 9 incorporates § 506(c) of the U.S. Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. *But see* numbers 3 and 4.

b Chapter 9 incorporates § 364(d) of the U.S. Bankruptcy Code, which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected.

c A pledge of revenues that is not a Statutory Lien or Special Revenues may be attached as not being a valid continuing Post-Petition Lien under § 552 of the U.S. Bankruptcy Code.

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

e Section 503(b)(9) provides for a priority claim to be paid on confirmation of a plan for the value of goods provided prepetition within 20 days of the petition date.

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

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

On February 22, 1984, in *National Labor Relations Board v. Bildisco & Bildisco*, the U.S. Supreme Court held that § 365(a) of the U.S. Bankruptcy Code provides that, with certain limitations, the debtor may unilaterally assume or reject any executory contract of the debtor, including a collective bargaining agreement.[85] The test set forth in *Bildisco* was whether the debtor could show both that the agreement burdens the estate and that the equities balance in favor of rejection. Congress responded to that decision with § 1113 of the U.S. Bankruptcy Code, which set a much more difficult test, in addition to setting a detailed procedure that must be followed for the rejection of a collective bargaining agreement. Under § 1113(c), the court will approve an application for rejection of a collective bargaining agreement only if the court finds that (a) the debtor has, prior to the hearing, made a proposal to modify the collective bargaining agreement that is necessary to permit the debtor to reorganize, (b) the authorized representative of the employees has refused to accept such proposal without cause and (c) the balance of the equities clearly favors rejection of such agreement. This more difficult test has *not* been incorporated into Chapter 9, and the *Bildisco* standard appears to be applicable to Chapter 9 debtors. However, as evidenced by the recent *Vallejo* case, despite the more lenient test to reject a municipal collective bargaining agreement, the nature of the litigation process and the time and expense involved in obtaining a final order with respect to such an emotional and political issue are likely to absorb the attention of a municipality and take many months to reach a conclusion.[86]

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[85] 465 U.S. 513 (1984).

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

G. Confirmation of Plan

The confirmation requirements of § 1128 of the Bankruptcy Code are applicable to a Chapter 9,[87] and there are additional Chapter 9 requirements.[88] After notice to all interested parties, the court shall hold a hearing on the confirmation of a plan. A party in interest and a special taxpayer may object to the confirmation of a plan.[89]

The court shall confirm a plan only if it meets the specific requirements of Chapter 9, including being proposed in good faith and not by any means forbidden by law. This means that there are no hidden agreements between the parties not specifically set forth in the plan nor any acceptances of the plan obtained through such hidden agreements.

In addition, at least one class of claims which is impaired under the plan and which is not an insider claim must have accepted the plan, or the court must have determined that the plan does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.[90] In other words, even if such claimants constituted impaired classes, the acceptance of the plan by affiliates, elected officials or relatives of elected officials would not support confirmation since such claimants are insiders.[91]

In addition to the requirements set forth above, the court shall confirm the plan if:

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87 11 USC § 901. See generally Norton Bank L & Prac § 63.01 et seq for confirmation under Chapter 11.

88 11 USC §§ 1128 and 1129.

89 11 USC §§ 1128(a) and (b); 934(a). A "special taxpayer" means record owner or holder of legal or equitable title to real property against which a special assessment or special tax has been levied, the proceeds of which are the sole source of payment of an obligation issued by the debtor to defray the cost of an improvement relating to such real property. 11 USC § 912(2). A general change in all assessments or in the tax rate would not qualify any property holder in the district as a special taxpayer affected by the plan.

90 11 USC § 1129(a)(2), (3), (8), (10) and (b).

91 An affiliate may include the municipality which leases substantially all of the property of a municipal lease authority. 11 USC § 101(2)(D).

(A) The plan complies with the provisions of Chapter 9;[92]

(B) The plan complies with the provisions of other Chapters of the Bankruptcy Code made applicable to Chapter 9;

(C) All amounts to be paid by the municipality to any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;[93]

(D) The municipality is not prohibited by law from taking any action necessary to be taken to carry out the plan;[94]

(E) The plan provides that each holder of a claim of the kind specified in § 507(a)(1) of the Bankruptcy Code (administrative expenses during the course of the proceeding) will receive, on account of such claim, property of a value, as of the effective date of the plan, equal to the amount of such claim, except to the extent that the holder of a particular claim of such kind has waived such payment on such claim; and

(F) The plan is in the best interest of the creditors and feasible.[95]

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92 11 USC § 1129(a)(1).

93 11 USC § 1129(a)(4).

94 11 USC § 1129(a)(3).

95 11 USC §§ 943, 1129. The "best interest of creditors" test does not mean liquidation value. It is expected that the court will be guided by standards set forth in Kelly v. Everglades Drainage District, 319 US 415, 87 L Ed 1485, 63 S Ct 1141 (1943) and Fano v. Newport Heights Irrigation District, 114 F2d 563 (CA9, 1940). In Kelly, the court found that, in approving a plan, the bankruptcy court must make adequate findings bearing on the probable future tax revenues of the district, such as the revenues received in the past from each source of taxation, the present assessed value of property subject to each tax, the tax rates currently prescribed, the probable effect on future revenues of a revision made in the tax structure, the extent of past tax delinquencies, and any general economic condition of the district which may reasonably be expected to affect the percentage of future delinquencies. Similarly, in Fano, which involved a Chapter IX filed by an irrigation district which had a $15,000 deficit on accrued interest on its bonds, a plan to pay 62.50 cents on the dollar was not confirmed as "equitable" or in the "best interest of creditors" where the district was debt free, except for interest, with assets in good condition and in value greatly exceeding the indebtedness of the district, and there was no sufficient showing as to why the district's tax rate could not have been increased sufficiently to meet the district's obligations.

It may by helpful in evaluating whether the requirements of Chapter 9 are met to review other cases applying the more stringent "fair and equitable" test. Where a court was presented with a dismal history and bleak financial future of a drainage district, it approved a play for payment of 20 cents for each dollar of principal amount of the bonds. Delno v. Market St Ry Co., 124 F2d 965 (CA9, 1942). See also Mason

The debtor may modify a plan at any time prior to confirmation so long as the modified plan meets the requirements of Chapter 9.[96] The court will dismiss a case under Chapter 9 if confirmation of a plan under Chapter 9 is refused.[97] If a plan is confirmed, the Court may retain jurisdiction over the case for such period of time as is necessary for the successful implementation of the plan.[98]

A party in interest (creditor, special taxpayer or debtor) may request the court within 180 days after the date of confirmation to revoke such order if and only if the order was procured by fraud.[99] Such an order revoking an order of confirmation should contain necessary provisions to protect any equity acquiring rights in good faith reliance on such an order and should also revoke the discharge of the debtor.

A decision reflects the interplay between the various requirements for plan confirmation imposed by Chapter 9 and state law considerations.[100] Like so many of the Chapter 9 filings, the case involves a special district. The debtor had issued unsecured bonds and warrants pre-petition. Under state law, bonds had priority over warrants. That is, the law required that bonds be fully paid according to their terms prior to utilizing revenues for payments

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v. Paradise Irrigation District, 326 US 536, 90 L Ed 287, 66 S Ct 290 (1946) (52.521 cents on each dollar of principal). Also interesting is the decision in Getz v. Edinburg Consol. Independent School District, 101 F2d 734 (CA5, 1939) which approved a plan pursuant to which refunding bonds which included accrued overdue interest were issued and 51% of moneys held in the sinking fund were permitted to be used to fund the maintenance of schools.

Of course, a plan cannot benefit some unfairly. Where some bondholders who purchased the bonds at bargain prices acquired an appreciable quantity of taxable property in the city, a plan which would result in the lowering of tax levies would not be approved. Town of Belleair, Fla v. Groves, 132 F2d 542 (CA5, 1942) cert den 318 US 769, 87 L Ed 1140, 63 S Ct 762 (1943).

[96] 11 USC § 942.

[97] 11 USC § 927(b).

[98] 11 USC § 945(a).

[99] 11 USC § 1144.

[100] In re Sanitary & Improvement District No. 7, 98 BR 970 (BR Neb, 1989).

of warrants. The plan of adjustment did not pay the bondholders the full amount of their claim with interest but paid some recovery to warrantholders. Despite the state law constraints, the court held that under the Bankruptcy Code, the debt of the municipality could be adjusted, and therefore, the plan was not objectionable in this respect.

However, the new bonds and warrants to be issued to the holders under the plan received different scrutiny. The zero bonds had a call provision that permitted payment at less than par and permitted payments on the new warrants even if the bonds were taken out at less than par. In other words, the bondholders, as contemplated under the plan, could receive securities under the plan which would not be paid in full. Because of the state law requiring priority of the bondholders, the court held that such treatment was in violation of state law and the plan could not be confirmed. The case stands for the proposition that the plan can modify the existing pre-petition debt, regardless of state law prohibitions, but the plan cannot contemplate the violation of the law going forward.

Chapter 9 is one mechanism for resolution of disputes regarding the allocation of resources of a troubled municipality. It is difficult to achieve a consensual plan after a contested confirmation hearing. As a result, a debtor should consider negotiation with trade and public debt and employee groups to work out the terms of the plan. To be confirmed, a plan must be fair. If creditors are unreasonably "crammed down" so that the distribution to public debtholders is less than justified, the municipality may find it difficult to have any plan confirmed. Further, the market will recall such unfair treatment the next time the municipality attempts to enter the market

H. Conclusion

The above was meant to provide a general overview regarding the effects of a municipal bankruptcy on the payment of principal and interest on bonds and the ability of a municipality to

reduce its debt burden in order to continue to provide essential governmental services to its citizens. Because of the complexities of the U.S. Bankruptcy Code, and indeed of the Chapter 9 municipal restructuring process, an attorney should be consulted regarding any specific questions an investor may have related to his individual situation.

VII. CONCLUSION

The purpose of this presentation is to provide an overview of the various ways in which state and local governments have attempted in the past to address their issues and the various alternatives, remedies and vehicles of assistance that they have created in order to help municipalities find a resolution to financial distress before the situation goes too far. This current economic downturn has led some to question the continued merit of historical precedent and whether the issues presented in this downturn will lead to a different result. The practical reality is that state and local government financial officers have recognized the necessity of having the effect supervision and oversight of the financial status of its local governments and effective mechanisms for those in financial trouble protects the availability of financing at a low cost in the market. This allows local government on a local basis, to be able to decide what infrastructure and services should be provided to their citizens. In this way, the municipalities do not have to rely upon the state or federal government to make those decisions subject to the vagaries of the broader perspective and needs. This ability of state and local governments to decide their own destiny is predicated on sound financial status through the use of effective statutory or constitutional provisions that provide supervision, oversight, relief and resolution mechanisms for financially troubled local governments. That ability to finance essential government services or an infrastructure has led to the largest economy the world has, and the basic infrastructure remains superior to all others and has been admired by all other countries. This presentation is meant to aid you in deciding what possible legislative changes are wise and

needed to aid local government debt by providing oversight, protection and assurances to those who may need it. The above analysis of the provisions that states have adopted to monitor and rehabilitate municipalities at the first sign of financial distress provide food for further consideration. This overview of what limitations exist with regard to taxes and revenue as well as the availability of various alternatives, including whether local governments should have access to Chapter 9 and be specifically authorized to file Chapter 9 by their own determination without further review or approval of the state. This overview given the fluidity of legislation and state laws, cannot be said to be exhaustive. Any compilation is meant to provide an indication of the direction and trend that has been taken. Issues have been raised that the Emergency Manager Law in Michigan does not respect the nature of local government participation or the due process protection of court procedures as to dealing with the affected interests. Obviously, specific situations, based upon specific facts and documents, require specific analysis and specific advice. This material is provided in hopes of showing you what has been done by others and what might be helpful to you, to provide a view of what is presently there and what has been done on a state-by-state basis, and to provide examples of legislation that helps local governments live up to their obligations so that they can continue, as they have in the past, to make those vital decisions as to what essential governmental services and infrastructure improvements can be made on a local basis and finance them on a local basis.

Analysis of 50 State Survey of Rights and Remedies Provided by States to Investors in Municipal Bond Debt and Authorization to File Chapter 9 Bankruptcy

(This is an analysis of a 50 State Survey by Chapman and Cutler LLP)

General Overview of Municipal Insolvency Provisions

STATE	MUNICIPAL BANKRUPTCY AUTHORIZATION	DEBT LIMITATION	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDING BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTING	FORECLOSURE	INJUNCTION	MANDAMUS	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTORY LIENS
ALABAMA	Y (Bonds only)	X		X	X			X	X	X		X	
ALASKA	N				X	X (taxing limits; appointment of trustee)		X		X		X	X
ARIZONA	Y	X		X	X			X		X	X (any action necessary)	X	
ARKANSAS	Y	X		X	X	X (taxing limits and appointment of an assessor)				X		X	X
CALIFORNIA	Conditional (Use of a Neutral Evaluator or declaration of fiscal emergency)	X	X (California Debt and Investment Advisory Commission)	X	X	X (negotiations)	X	X	X	X	X (bondholder action and any other action and special tax bonds)	X	X
COLORADO	Limited	X		X	X		X		X	X	X (bondholder action)	X	X
CONNECTICUT	Conditional	X		X	X	X (appointment of a trustee; revenue set-aside)			X	X	X (bondholder action/garnishment and contractual remedies)	X	X
DELAWARE	N	X			X					X		X	
DISTRICT OF COLUMBIA	N	X	X (District of Columbia Financial Responsibility and Management Assistance Authority)		X		X		X	X	X (declare all bonds due and payable)	X	
FLORIDA	Conditional		X (Bond Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program)	X	X		X		X	X		X	X
GEORGIA	N (specifically prohibited)	X		X	X	X (debt compromise)				X	X (court action to enforce collection)	X	
HAWAII	N	X		X	X		X	X		X		X	
IDAHO	Y	X	X (debt readjustment plans for certain districts)	X	X	X (Bond Guaranty Act)	X	X		X		X	X
ILLINOIS	Limited	X	X (Financially Distressed City Law and Financial Planning and Supervision)	X	X			X	X	X	X (appropriate relief)	X	X
INDIANA	N	X	X (Distressed Political Subdivision Protections)	X	X	X (redemption bonds)	X	X	X	X		X	X
IOWA	N, with exception	X		X	X	X (moratorium)				X		X	X
KANSAS	N	X		X	X		X	X		X		X	X
KENTUCKY	Conditional	X	X (county restructuring)	X	X	X (taxing limits; appointment of trustee)	X		X	X		X	X
LOUISIANA	Conditional	X		X	X			X		X		X	X
MAINE	N	X		X	X	X (earmarking)		X		X	X (attachment and any action necessary)	X	X
MARYLAND	N	X		X	X					X		X	X
MASSACHUSETTS	N	X	X (ad hoc state intervention)	X	X	X (state bond payment intervention)				X		X	X
MICHIGAN	Conditional	X	X (Emergency Financial Management and Local Government and School District Fiscal Accountability Act)	X	X					X		X	X
MINNESOTA	Y	X			X	X (back-up payment procedures for municipalities and school districts)				X	X (appropriate remedies to enforce bondholder rights)	X	

STATE	MUNICIPAL BANKRUPTUCY AUTHORIZATION	DEBT LIMITATION	MUNICIPAL RESTRUCTURING MECHANISM	RECEIVER	REFUNDING BONDS	OTHER DEFAULT RESOLUTION REMEDIES	ACCOUNTING	FORECLOSURE	INJUNCTION	MANDAMUS	OTHER REMEDIES	SPECIAL REVENUE BONDS	STATUTORY LIENS
MISSISSIPPI	N	X		X	X	X (municipal borrowing)	X	X	X	X	X (other appropriate remedies)	X	X
MISSOURI	Y	X		X	X		X	X		X	X (other appropriate remedies)	X	
MONTANA	Y, but no counties	X		X	X					X	X (limited remedy and interest penalty; suits in equity)	X	
NEBRASKA	Y	X		X	X	X (debt compromise)		X		X		X	
NEVADA	N	X	X (local government financial assistance; audit enforcement)	X	X	X (third-party agreements)	X	X	X	X		X	X
NEW HAMPSHIRE	N	X		X	X	X (emergency financial assistance)				X	X (contractual remedies)	X	
NEW JERSEY	Conditional	X	X (Local Government Supervision Act; Municipal Rehabilitation and Economic Recovery Act of 2002 and Special Municipal Aid Act	X	X		X	X		X		X	X
NEW MEXICO	N	X		X	X					X		X	
NEW YORK	Conditional	X	X (Emergency Financial Control Board, Municipal Assistance Corporation; New York Financial Control Board)	X	X	X (appointment of a trustee)	X	X		X		X	X
NORTH CAROLINA	Conditional	X	X (local government debt monitoring; local government fiscal management)	X	X			X		X		X	X
NORTH DAKOTA	N	X		X	X					X		X	X
OHIO	Conditional	X	X (fiscal watch; fiscal emergencies; and financial planning and supervision commission)	X	X		X	X	X	X	X (general remedies provision, including appointment of trustee and action to declare bonds not paid from property taxes immediately payable)	X	
OKLAHOMA	Y	X		X	X	X (settlement of debt)	X			X		X	
OREGON	Limited	X		X	X	X (Municipal Debt Advisory Commission & refunding bond cram-down)		X		X		X	
PENNSYLVANIA	Conditional	X	X Financially Distressed Municipalities Act; Intergovernmental Cooperation Act)	X	X	X (appointment of a trustee)	X			X		X	
PUERTO RICO	N	X		X	X	X (first lien provisions)	X			X		X	
RHODE ISLAND	Conditional	X	X (fiscal overseer; municipal receiver; budget commission)	X	X	X (bond issuance requirements; bond payment guarantee)	X	X		X		X	
SOUTH CAROLINA	Y	X		X	X		X	X		X	X (any appropriate action)	X	X
SOUTH DAKOTA	N	X		X	X					X		X	X
TENNESSEE	N			X	X		X			X		X	X
TEXAS	Y	X	X (municipal receivership)	X	X			X		X		X	X
UTAH	N	X		X	X					X	X (contractual remedies)	X	
VERMONT	N	X		X	X			X		X		X	X
VIRGINIA	N	X		X	X					X	X (any contractual remedy)	X	X
WASHINGTON	Y	X		X	X	X (designation of trustee)		X	X	X		X	
WEST VIRGINIA	N	X		X	X		X	X	X	X		X	X
WISCONSIN	N	X			X	X (deficiency protection)		X		X		X	
WYOMING	N	X		X	X		X	X	X	X		X	
TOTAL		49	17	47	52	24	23	28	15	52	17	52	30