

**Kroll Bond Rating Agency
Chapman Strategic Advisors LLC**

A Focus on Evolving Issues in Municipal Credit

A discussion of

Coming Attractions in State and Local Government Financial Distress and the Myth and Reality of Statutory Liens and Special Revenues Treatment in Chapter 9

Panelists

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Part I

QUESTION:

What are the coming attractions in state and local government financial distress and what are the key issues to be addressed and possible solutions?

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- A. The Promise of a Constructive Opportunity of PROMESA
1. How will PROMESA work?
 2. Does Title III and VI of PROMESA provide a vehicle to help the commonwealth, municipalities and public corporations of Puerto Rico?
 3. Does Title VI and use of creditor action process have any precedent where a two-thirds vote in favor of a restructuring proposal by a majority of the affected claims (bond/debt) can drag along the other non-consenting creditor with the same claim?
 4. Is Puerto Rico's moratorium of paying certain debt (bonds) scheduled payment on time consistent with PROMESA or the traditions of state and local debt financing?
 5. Can Title III adjustment of debt be used to resolve unresolved and potentially troublesome litigation by bondholders, business creditors or unhappy taxpayers or ratepayers?

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

6. Is it likely PROMESA is a successful recovery plan?

B. Atlantic City

1. Will the benefits of state oversight, assistance and refinancing of the past in New Jersey be extended to Atlantic City?

2. Has the lessons of the 1930's on diversity of tax sources confirm past problems and indicate the need for future action?

3. Is there light in the tunnel of financial distress?

C. Detroit Schools – Is the New School District and the Old School District Model a Blast from the Past or a View of the Future?

1. Does the Old School District with the old debt and the New School District with no old debt but with the operating assets have precedent?

– City of Duluth and Village of Duluth

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- The City of Mobile and the Port of Mobile
 - City of Memphis and Dueling Receivers
2. What have the courts said about leaving an “old municipality” with the old debt but with significantly reduced taxable property and very limited ability to pay
- *Brewis vs. City of Duluth and Village of Duluth*, 9 F. 747 (C.C.D. Minn. 1881)
 - *Port of Mobile vs. Watson*, 116 U.S. 289 (1986)
 - *Commissioner of Laramie County vs. Commissioner of Albany County*, 92 U.S. 307 (1875); *Broughton vs. Pensacola*, 93 U.S. 266 (1876)
3. The state may alter boundaries of an existing municipality so that there is a new municipality that arises from part of the old municipality’s territory so long as the old debt has ample resources to assure payment of that debt if there is limited or no liability of the new municipality to pay the old debt.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- D. Solving Financial Distress with Economic Development and Stimulus from Needed Infrastructure Improvements and Reinvestment in States and Municipalities?
1. We cannot avoid economic cycles but history of financial stability points the way. In the U.S.A., financial challenges and difficulties in balancing a government budget are not so much caused by the desire to spend more than tax revenues currently generate but rather by economic cycles such as panics, recessions and depressions. The cycles are exacerbated by unfunded pension obligations that are not sustainable and affordable as well as the adverse effects of failing to fund essential services and needed infrastructure at an acceptable level. The healthy economy of a state or local government goes hand in hand with full funding of essential services and needed infrastructure improvements and making sure all costs, including labor and pension obligations, are sustainable and affordable.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

2. Need to address the systemic problems of the past that caused financial distress. Other countries that have suffered the need for a debt restructuring have generally repeated the process numerous times with band aids rather than a permanent fix because they merely reduced debt without addressing the systemic problems that caused the financial distress. States and local government should always strive for the permanent fix as opposed to the band aid.
3. Balanced budgets require services and infrastructure at the level desired. The state and local governments in the U.S.A. have a long history of financial credibility having learned that quick fixes and failure to maintain governmental services and infrastructure at an acceptable and desired level result in a loss of businesses and individual taxpayers with the accompanying fiscal distress.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

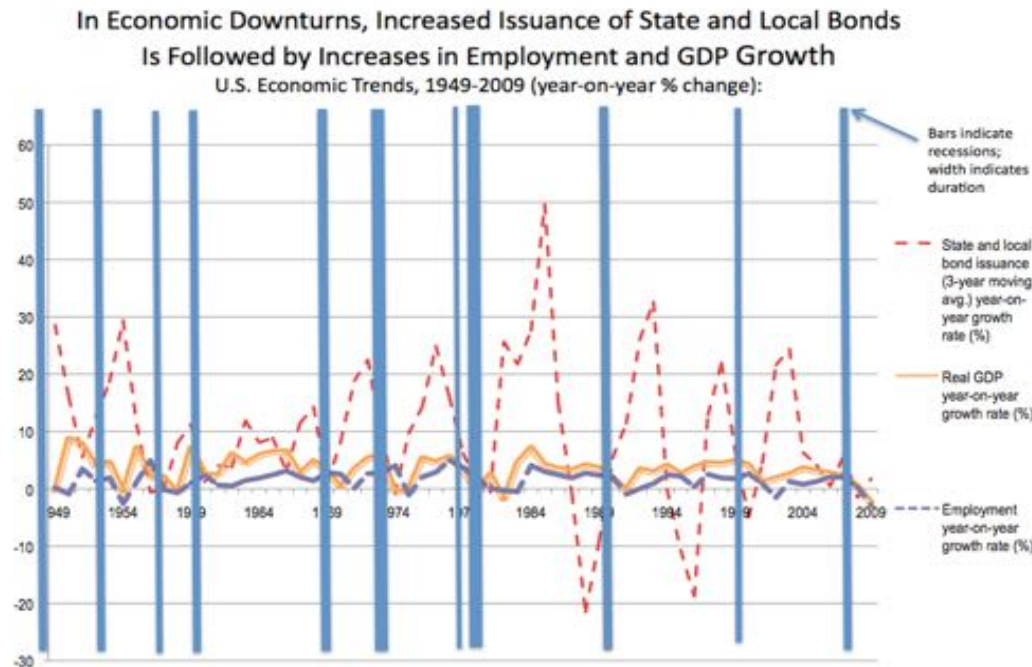
4. The state legislatures have assisted in balancing the budget with needed legislation. State legislatures have assisted in state and local governments by passing legislation that (i) limits debts and taxes, (ii) provides financial oversight and assistance to those who need it, (iii) assures and requires funding of needed services and infrastructure at the level desired, (iv) respects the principles of government financing and uses statutory liens and special revenues to reduce the cost of borrowing and reinvests in the state and local governments and (v) encourages reinvestment in the state and local governments and creation of new, good jobs and business development.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

5. The Need to Reinvest in State and Local Governments.

- a) The \$3.6 Trillion Price Tag and Cost of Delay. The American Society of Civil Engineers (“ASCE”), in its 2013 Report, estimates the cost to maintain infrastructure at a passable level will be \$3.6 trillion by 2020 or about 4 times the annual tax revenues for all state and local governments. In 2009, ASCE’s number for the next 5 years was \$2.2 trillion. Inattention has caused the number to increase by \$1.4 trillion in 5 years.
- b) Historically State and Local Government Increased Reinvestment After Economic Downturn. Continued borrowing is required to fund needed infrastructure and stimulate the economy as demonstrated by increased borrowing after each economic downturn since 1949, except the last one (2008).
- c) Economic Growth and Job Multiplier. Reinvestment in needed Infrastructure improvements creates increased GDP as studies have shown \$1.00 of hard infrastructure costs adds \$3.20 over 20 years to GDP growth. Further reinvestment in infrastructure translates into year to year growth of number employed workers and GDP growth given the economic stimulus and job multiplier (every new job creates service jobs that increase productivity indirectly this can range from 2 or 3 to 4 or more new jobs depending upon the industry it is created in).

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions



- American Society of Civil Engineers estimates that by 2020, \$3.6 trillion of infrastructure improvements must be made to keep U.S. infrastructure acceptable
- For every dollar of hard cost of infrastructure improvement, \$3.21 of economic activity is generated over the course of 20 years
- At least \$1 trillion of the \$3.6 trillion needs future financing
- For every new job created due to infrastructure improvements or economic development, there are at least 2 to 5 jobs produced indirectly in supplier industries and induced in local servicing industries

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- E. The Need to Successfully Address Legacy Cost So That Funding of Essential Services and Needed Infrastructure Improvements is a Solution
 - 1. State and Local Government Pension Fund's Status: There are approximately 4,000 public sector retirement systems for state and local governments in the United States with \$3.8 trillion in assets, 14.4 million current employees, 9 million retirees and annual aggregate benefit distributions of \$228.5 billion. The estimated amount of pension underfunding for states and local governments is estimated to exceed \$1 trillion. This unfunded liability for pensions of over \$1 trillion can be compared to the estimated FY2016 revenue of \$3.3 trillion for state and local governments.
 - 2. Many State and Local Governments Have No Current Pension Fund Problem or Have Resolved It: It should be noted that the vast majority of states and local governments have or will successfully address public pension issues without extensive prolonged disputes or litigation.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

3. The Aging Population and Possible Future Economic Downturn are Reasons to be Vigilant No Matter the Current Conditions of the Pension Fund: Those over 65 years of age in the United States constitute an increasing percent of the population, namely 14.8% of the 2015 population, which is expected to grow to 20.9% by 2050. Likewise, the working years of 18-64 of age is expected to be reduced as a percent of population, namely from 62.2% in 2015 to 57.6% in 2050. This results in about 40 million more people over 65 as potential retirees.

While the USA percentage of population over 65 in 2050 (20.9%) is lower than many other developed countries, such as Europe at 26%, China at 24% and Japan at 33%, it is still a concern. Likewise there have been 11 economic downturns since 1949, about one every 7 to 10 years, so we now are facing the probability of an economic downturn in the next few years since the last downturn was 2008. Economic downturns result in losses on pension fund investments and less revenues available to state and local governments to address the issues.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

4. Recent Pension Reform and Litigation: Between 2010 and 2014, over 40 states have addressed pension reform. To date, since 2011, there have been over 18 major state court decisions dealing with pension reforms by state and local governments.
- Over 77% (14 out of 18) of those decisions affirmed the pension reform, which covered reduction of benefits, including COLA, or increase of employee contributions, as necessary, and many times cited the higher public purpose of assuring funds for essential governmental services and infrastructures.
 - Of the four states that did not approve the pension reform, two states, Oregon and Montana, cited the failure of the proponents of reform to prove a balancing of equities in favor of reform for a higher public purpose.
 - Another state, Arizona, included state court judges in the reform, which violated other constitutional provisions about improper influence over judicial officers during service. Recently firefighters recognized a sustainable and affordable pension fund and their government employers best interest agreed to pension adjustments with a one time constitutional amendment to best support and document the reform there is now consideration of similar reforms for public workers with accompanying constitutional amendment.
 - The recent Illinois Supreme Court rulings appear to stand singularly against pension reform for a higher public purpose or as a reasonable effort to save an insolvent pension system.

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- F. Need for Timely and Complete Continuing Disclosure on Material Events During Financial Distress of State and Local Government
 - 1. The panic of financial distress can be reduced or eliminated by full and prompt disclosure of the financial situation and the evolving situation:
 - a) Disclosure should not be overly optimistic or pessimistic as to the situation
 - b) Delayed disclosure of material events in the hope that there soon will be good news to offset the bad is not helpful
 - 2. Tell one tell all is the best practice:
 - a) While everyone will be inquiring, it is always better to publicly tell all investors
 - b) If strategically certain information is sensitive then consider, for those investors who desire it, non-disclosure confidentiality agreement with recognition of the restriction on trading that is required by the law

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

3. Disclosure may be the workout or resolution's best friend:
 - a) Disclosure allows all to understand the situation including those who would constructively help if they knew the accurate situation
 - b) The state and others who have an interest in the long term financial survival of the local government cannot offer help or solutions if they do not know the full accurate financial situation
4. Checklist of disclosures to maximize market acceptance in evaluating repayment of bond debt and helps bondholders and trustees in asserting their rights and interests:
 - a) Authorized to file Chapter 9? Can the issuer file for Chapter 9, if not, then right to enforce obligation in state court by mandamus and other remedies without a required restructuring?

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- b) What is source of payment? Is the general obligation debt a “naked” full faith and credit promise or does it have a pledge of special revenues or statutory lien pledging and dedicating a specific and adequate tax revenue source for payment. (Alexander Hamilton in the 1790s said the secret of making public credit “immortal” is that whenever public debt is increased, it ought to be accompanied by a sufficient tax increase dedicated to its payment. (Syrett, The Papers of Alexander Hamilton, Vol. 6, p. 106 and Vol. 18, p. 103))

- c) Is there a lack of diversification of tax sources and limits on taxes that could realistically be triggered? Are sources of tax revenues too limited or are there tax limits and debt limits close to being triggered that may prevent the raising of taxes to pay the obligation?

I. Update on Developing Financial Distress Coming Attractions and Key Issues that Need to be Addressed and Possible Solutions

- d) Are there required priorities, set asides or appropriations to support payment? Do state constitutions or statutes provide for a priority of payment for general obligation debt or mandatory set aside of revenues or appropriations for payment of the debt? (Can plan of debt adjustment be confirmed if it is not in compliance with state law by not permitting mandatory priority of payment, set asides or appropriations? Could be a real obstacle to confirming a plan).
- e) Are there effective remedies available if there is a default? Do the state statutes and case law provide effective remedies (mandamus, intercept, constitutional or statutorily, required set asides, priority of payment, or appropriation) and does state court effectively enforce them?
- f) Is effective state oversight and assistance available to prevent defaults or aid a financially troubled municipality? Does the state provide by statute or practice the ability to monitor and oversee a financially challenged municipality, provide financial guidance and support to bridge the economic downturn and avoid litigation meltdown and Chapter 9.

General Overview of a 50 State Survey of Rights and Remedies Provided by States to Investors Relating to Government Bond Debt and State Oversight and Supervision of Financial Emergencies and Authorization to File Chapter 9 Bankruptcy (See Second Edition of Municipalities in Distress? How Investors and States Deal with Local Government Financial Emergencies)

State	Municipal Bankruptcy Authorization	Debt Limitation	Municipal Restructuring Mechanisms	Revenue	Refunding Bonds	Other Default Remedies/Resolves	Accounting	Transparency	Reporting	Monitoring	Other Remedies	Special Revenue Bonds	Statutory - Jan 15, 2017	Statutory - Jan 15, 2017	Statutory - Jan 15, 2017
ALABAMA	§ Specifically authorized	§		§	§			§	§	§		§	§		
ALASKA	§				§	§ (during term; appointment of trustee)		§		§		§		§	
ARIZONA	§	§	§ (State Debt Restructuring)	§	§	§ (only action necessary for funding)		§		§	§ (only action necessary)	§			
ARIZONA	§	§		§	§	§ (during term; appointment of an agent)				§		§		§	
CALIFORNIA	Conditional or a measure authorized or declaration of technological	§	§ (California Debt and Investment Advisory Commission)	§	§	§ (negotiations, without default budget requirements)	§	§	§	§	§ (beneficial action and any other action and special law bond)	§	§		
COLORADO	Unlimited	§		§	§		§		§	§	§ (beneficial action)	§	§		
CONNECTICUT	Conditional	§	§ (all New State Interventions)	§	§	§ (appointment of a trustee; without call bonds)			§	§	§ (beneficial action and contractual remedies)	§		§	
DELAWARE	§	§			§					§		§			
DISTRICT OF COLUMBIA	§	§	§ (District of Columbia Financial Responsibility and Management Assistance Authority)		§		§		§	§	§ (effect of bonds due and payable)	§			
FLORIDA	Conditional		§ (State Financial Emergencies Act and Division of Bond Finance and Local Government Financial Technical Assistance Program)	§	§		§		§	§		§	§		
GEORGIA	§ Specifically authorized	§	§ (Georgia Local Government Financial Monitoring)	§	§	§ (only completed)				§	§ (only action to enforce collection)	§			

- * The language of the statute appears to strongly support a determination that it is a statutory lien
- ** While the language of the statute may appear to create a statutory lien further clarification would be helpful to reaffirm the intent to create a statutory lien
- *** While the language of the statute may appear to create a statutory lien it is insufficient and additional language is required to clarify the intent and to create a statutory lien. The language could be read as just providing for perfection of a pledge or lien without the intent and effect to create a statutory lien

General Overview of a 50 State Survey of Rights and Remedies Provided by States to Investors Relating to Government Bond Debt and State Oversight and Supervision of Financial Emergencies and Authorization to File Chapter 9 Bankruptcy (See Second Edition of Municipalities in Distress? How Investors and States Deal with Local Government Financial Emergencies)

HAWAII	N	X		X	X		X	X		X	X (bondholder action)	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	X	
INDIANA	N	X	X (Distressed Political Subdivision and Township Protections)	X	X	X (redemption bonds)	X	X	X	X		X	X	X	
IOWA	N, with exception	X		X	X	X (moratorium)				X		X	X	X	
KANSAS	N	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	X	
LOUISIANA	Conditional	X	X (appointment of Fiscal Administrator)	X	X	X (state taxing authority)		X		X		X		X	
MAINE	N	X	X (Board of Emergency Municipal Finance)	X	X	X (earmarking)		X		X	X (attachment and any action necessary)	X			X
MARYLAND	N	X		X	X					X		X		X	
MASSACHUSETTS	N	X	X (ad hoc state intervention)	X	X	X (state bond payment intervention)				X		X			X
MICHIGAN	Conditional	X	X (Emergency Financial Management and Local Government and School District Fiscal Accountability Act)	X	X					X		X	X	X	
MINNESOTA	Y	X	X (Back-Up Payment Procedures for Municipalities and School Districts)		X	X (school district expenditure limitations)				X	X (appropriate remedies to enforce bondholder rights)	X		X	
MISSISSIPPI	N	X		X	X	X (municipal borrowing)	X	X	X	X	X (other appropriate remedies)	X		X	
MISSOURI	Y	X		X	X		X	X		X	X (other appropriate remedies)	X			

General Overview of a 50 State Survey of Rights and Remedies Provided by States to Investors Relating to Government Bond Debt and State Oversight and Supervision of Financial Emergencies and Authorization to File Chapter 9 Bankruptcy (See Second Edition of Municipalities in Distress? How Investors and States Deal with Local Government Financial Emergencies)

MONTANA	Y, but not 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 and Audit Enforcement Act)	X	X	X (third-party agreements)	X	X	X	X		X			X
NEW HAMPSHIRE	N	X	X (Emergency Financial Assistance)	X	X					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 (school district fiscal monitor and Casino Tax Property Stabilization Act)	X	X		X		X		X	
NEW MEXICO	N	X	X (financial auditing and emergency loans)	X	X	X (emergency loans from state)				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 (local government commission)		X		X		X			X
NORTH DAKOTA	N	X		X	X		X			X		X			X
OHIO	Conditional	X	X (state auditor's fiscal caution and fiscal watch; fiscal emergencies; 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			

General Overview of a 50 State Survey of Rights and Remedies Provided by States to Investors Relating to Government Bond Debt and State Oversight and Supervision of Financial Emergencies and Authorization to File Chapter 9 Bankruptcy (See Second Edition of Municipalities in Distress? How Investors and States Deal with Local Government Financial Emergencies)

OKLAHOMA	Y	X		X	X	X (settlement of debt)	X			X		X			
OREGON	Limited	X	X (County Public Safety Emergency and Fiscal Control Board; Municipal Debt Advisory Commission)	X	X	X (refunding bond cram-down)		X		X		X			X
PENNSYLVANIA	Conditional	X	X (Financially Distressed Municipalities Act; Intergovernmental Cooperation Act)	X	X	X (appointment of a trustee)	X			X		X	X		
PUERTO RICO	N	X	X (Puerto Rico Oversight, Management and Economic Stability Act)	X	X	X (first lien provisions)	X			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	X		
SOUTH CAROLINA	Y	X		X	X	X (state treasurer withhold of state appropriation)	X	X		X		X (any appropriate action)	X	X	
SOUTH DAKOTA	N	X		X	X					X		X		X	
TENNESSEE	N		X (financially distressed municipalities procedures)	X	X	X (emergency financial aid to local governments)	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		X
VERMONT	N	X		X	X			X		X		X			X
VIRGINIA	N	X	X (bond payment guarantee provisions)	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			
WISCONSIN	N	X	X (Deficiency Protection for Public Improvement Bonds)		X			X		X		X			
WYOMING	N	X		X	X		X	X	X	X		X			
Total		49	30	47	52	29	24	28	15	52	18	52	16	15	10

Part II

II. Significance of Statutory Liens and Special Revenue Protections

The rise of statutory liens and special revenues.

- The increasing benefits of statutory liens and revenue bond financing have evolved from the recognized need to identify and dedicate sources of payment. The evolution began with the United States' experience of defaults in the 1800's and the 1930's and the advent of Chapter 9 in 1937.
- Because of these defaults, there was a growing recognition in the municipal market to identify the credible source of payment and what was available in revenues for payment and what was not.

QUESTION:

What is a statutory lien?

QUESTION:

Does a statute require the words “statutory lien” in those specific words?

III. Statutory Liens

The Bankruptcy Code includes three general types of “lien,” including consensual liens, statutory liens and judicial liens:

- The term “lien” means charge against or interest in property to secure payment of a debt or performance of an obligation. 11 U.S.C. § 101(37).

▪ Consensual Liens:

- The term “security agreement” means agreement that creates or provides for a security interest. 11 U.S.C. § 101(50)
 - The term “security interest” means lien created by an agreement. 11 U.S.C. § 101(51)

▪ Statutory Liens

- The term statutory lien means **lien arising solely by force of a statute on specified circumstances or conditions, or lien of** distress for rent, whether or not statutory, but does not include security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute. 11 U.S.C. § 101(53).

III. Statutory Liens, continued

Basic Provisions for a Statutory Lien. Generally, the statute from which the statutory lien arises provides:

- The force and effect of the statute creates the interest in the dedicated revenues or proceeds to pay the debt without need of further action by the issuing governmental entity.
- May also provide for the priority of payment, a first lien or provision that the dedicated pledged revenues can only be used to pay the debt or in the order specified in the statute or authorizing documents.

III. Statutory Liens, continued

- May also provide an intercept or segregation of the revenues or require a governmental entity or officer to collect and pay over to a special account or to the bond trustee.
- Additionally, some states provide by statute that the state or local government, upon issuing debt pursuant to a specific state statute, automatically grants a lien (dedicated revenues or proceeds only to be used to pay the debt prior to any other use) on specified property, proceeds or tax revenue for the payment of the debt so incurred.
- The granting by a local government pursuant to a local ordinance, without more, is unlikely to give rise to a statutory lien.

QUESTION:

What are Special Revenues?

QUESTION:

Do you need the authorizing statute, resolution or indenture to say the pledged revenues are Special Revenues under § 902(2) of the Bankruptcy Code?

IV. Special Revenues

Section 902(2) of the Bankruptcy Code defines Special Revenues as:

(2) “special revenues” means—

- (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 purposes of the debtor;

IV. Special Revenues, continued

What is a Special Revenue?

- Every state provides for some form of special revenue bonds and, in certain cases, the special revenue pledge can be granted for general obligation debt.
- A special revenue pledge is one that promises to pay the debt from a pledge or dedication of revenues from a specific source or governmental enterprise, special excise taxes, incremental tax receipts for tax incremental financing, revenues derived from a particular governmental function, taxes levied to finance a project or system (except for general sales, property and income taxes levied for general purposes).

QUESTION:

What are the benefits of statutory lien?

QUESTION:

What are the benefits of special revenues?

V. The Benefits

What is the Purpose for Using Statutory Liens or Special Revenues Financings?

- These types of financings are intended to create predictable priorities in Chapter 9 so municipal bond market participants can be protected by a predictable result.
- Outside of a Chapter 9 proceeding, participants would be protected through enforcing payment by writ of mandamus or other remedies and the fact that a governmental officer must comply with the mandate of state law or suffer the penalties.

V. The Benefits, continued

What is the Purpose for Using Statutory Liens or Special Revenues Financings? continued

- In Chapter 9, there is intended to be established priority and assurance of payment so that governmental bodies suffering from temporary illiquidity would have access to the municipal bond market with a dedicated source of payment that would survive Chapter 9. (See legislative history of 1988 Amendment to the Bankruptcy Code regarding solving the dilemma of the City of Cleveland in 1978.)

QUESTION:

What is the treatment of special revenues in Chapter 9?

VI. Chapter 9 Treatment of Special Revenues

How are Special Revenues to be Treated in Chapter 9?

- A special revenue pledge is to be unaltered in a Chapter 9 proceeding, and the timely payment of the pledged revenues by the municipality is required by the Bankruptcy Code.
- Special revenues were intended by the 1988 Amendments to the Bankruptcy Code to be unimpaired in Chapter 9 and the debt holders to receive the benefit of the bargain.
- This unimpairment was respected in the Chapter 9 proceedings of the *Sierra Kings Health Care District* Chapter 9 (Eastern District of California), *Jefferson County, Alabama* (Northern District of Alabama) *Stockton, California*, and *Detroit, Michigan* (for those who continued to hold Water and Sewer Revenue Bonds, the case reaffirmed the unaltered status and timely payment of special revenue pledges in a Chapter 9 proceeding).

QUESTION:

What is the treatment of statutory lien in Chapter 9?

VII. Chapter 9 Treatment of Statutory Liens

How are Statutory Liens Treated in a Chapter 9?

- A statutory lien should remain unaltered in a Chapter 9 proceeding, and there is a continuing right to be timely paid after the filing of a Chapter 9.
- Such unimpairment was recognized in the Chapter 9 proceedings of *Orange County, California* in 1994 (delay in payment due to appeal and reversal of Bankruptcy Court as to effect of a statutory lien) and the *Sierra Kings Health Care District* Chapter 9 in 2009 (relating to General Obligation Bonds).
- A number of states have statutes containing statutory lien provisions. See e.g., Rhode Island, California, Colorado, Idaho, Louisiana and New Jersey (Municipal Qualified Bond Act). Statutory lien legislation is pending in Michigan (HB 4495), Nebraska (LB 67) and Illinois. See the 50 State Survey in the forthcoming new edition of “Municipalities in Distress?”). See also Appendix B.

Chapter 9 Priorities

Summary of Chapter 9 Priorities:

TYPE OF CLAIM	EXPLANATION
1. Obligations secured by a statutory lien to the extent of the Pledged Revenue collected. ^{ab}	Debt (Bonds, Warranties, Notes, Trans, Rans) issued pursuant to statute that itself imposes a pledge. (There should not be any delay in payments due to automatic stay since the Bankruptcy Court and municipality have no authority to do otherwise due to the mandate of state law to only use or expend revenues or proceeds for the designated purpose under § 903 of the Federal Bankruptcy Code and the municipality cannot act or consent differently since it is unable to do so under state law that controls under § 904 of the Federal Bankruptcy Code.)
2. Obligations secured by Special Revenues (subject to necessary operating expenses of such project or system) to the extent of the Pledged Revenue collected. ^{ab} These obligations are often non-recourse and, in the event of default, the bondholders have no claim against non-pledged assets. (Reaffirmed in Jefferson County Court Ruling and the ultimate treatment of Water and Sewer Revenue Bonds in Detroit.)	Special Revenue Bonds secured by any of the following: (A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems; (B) special excise taxes imposed on particular activities or transactions; (C) incremental tax receipts from the benefited area in the case of tax-increment financing; (D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or (E) taxes specially levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor. ^c There should be no delay in payment since automatic stay is lifted under Section 922(d). If the state statute also creates a statutory lien or mandate that the pledged tax revenues can only be used for payment of the debt obligations and for no other purposes before payment in full of the obligation then no reduction for necessary operating expenses – § 903 and 928 of the Federal Bankruptcy Code.

- a Chapter 9 incorporates § 506(c) of the Bankruptcy Code which imposes a surcharge for preserving or disposing of collateral. Since the municipality cannot mortgage city hall or the police headquarters, municipal securities tend to be secured by a pledge of a revenue stream. Hence, it is seldom a surcharge will be imposed. *But see* numbers 3 and 4.
- b Chapter 9 incorporates § 364(d) of the Bankruptcy Code, which permits a debtor to obtain post-petition credit secured by a senior or equal lien on property of the estate that is subject to a lien if the prior lien holder is adequately protected. However, if state law mandates the use of the pledge revenues solely or first to pay the statutory lien or special revenue debt that mandate of state law cannot be violated and no priming lien or other use of revenues can be authorized.
- c A pledge of revenues that is not a Statutory Lien or Special Revenue Pledge may be attached as not being a valid continuing Post-Petition Lien under § 552 of the Bankruptcy Code.

Chapter 9 Priorities, continued

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
3. Secured Lien based on Bond Resolution or contractual provisions that does not meet test of Statutory Lien or Special Revenues to the extent perfected prepetition, subject to the value of prepetition property or proceeds thereof. ^c	Under language of Sections 552 and 928, liens on such collateral would not continue postpetition. After giving value to the prepetition lien on property or proceeds, there is an unsecured claim to the extent there is recourse to the municipality or Debtor. You may expect the creditor to argue that pursuant to Section 904, the Court cannot interfere with the property or revenues of the Debtor, and that includes the grant of security to such secured creditor.
4. Obligations secured by a municipal facility lease financing.	Under Section 929 of the Bankruptcy Code, even if the transaction is styled as a municipal lease, a financing lease will be treated as long-term debt and secured to the extent of the value of the facility.
5. Administrative Expenses (which would include expenses incurred in connection with the Chapter 9 case itself). ^d Chapter 9 incorporates Section 507(a)(2) which, by its terms, provides a priority for administrative expenses allowed under Section 503(b). These would include the expenses of a committee or indenture trustee making a substantial contribution in a Chapter 9 case.	Pursuant to Section 943, all amounts must be disclosed and be reasonable for a Plan of Adjustment to be confirmed.

^d These expenses strictly relate to the costs of the bankruptcy. Because the bankruptcy court cannot interfere with the government and affairs of the municipality, general operating expenses of the municipality after filing of the Chapter 9 are not within the control of the court (unless the municipality consents and is not otherwise prohibited under state law from interfering with the payment, are not discharged and will remain liabilities of the municipality after the confirmation of a plan or dismissal of the case.

Chapter 9 Priorities, continued

<u>TYPE OF CLAIM</u>	<u>EXPLANATION</u>
6. Unsecured Debt includes:	
A. Senior Unsecured Claims with benefit of subordination paid to the extent of available funds (without any obligation to raise taxes) which include any of B, C, D, or E below.	
B. General Obligation Bonds.	Secured by the “full faith and credit” of the issuing municipality. Postpetition, a court may treat general obligation bonds without a statutory lien or Special Revenues pledge as unsecured debt and order a restructuring of the bonds. Payment on the bonds during the bankruptcy proceeding likely will cease. ^e
C. Trade.	Vendors, suppliers, contracting parties for goods or services. Payment will likely cease for prepetition goods or services. ^f
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. ^g
E. Unsecured portion of secured indebtedness.	
F. Subordinated Unsecured Claims.	Any debt subordinated by statute or by contract to other debt would be appropriately subordinated and paid only to the extent senior claims are paid in full. Senior debt would receive <i>pro rata</i> distribution (taking unsecured claim and subordinated claim in aggregate) attributable to subordinated debt until paid.

^e However, if state law mandates specific appropriation, set aside or priority of payment of revenue collected the failure to honor state law may be an obstacle to confirming a plan of debt adjustment since the plan, court and municipality cannot go forward. See § 903 of Federal Bankruptcy Code.

^f 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.

^g Chapter 9 does not incorporate § 1113 of the Bankruptcy Code, which imposes special provisions for the rejection of collective bargaining agreements (making the standard less restrictive, *i.e.*, “impairs ability to rehabilitate”) or § 507(a)(4) and (5), which give a priority (before payment of unsecured claims) to wages, salaries, commissions, vacation, severance, sick leave or contribution to pension plans of currently \$12,475 per employee.

QUESTION:

In a Chapter 9 can a municipality act contrary to state law?

VIII. Application of State Law in a Chapter 9

11 U.S. Code § 903 – Reservation of State power to control municipalities

Section 903 provides:

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

- (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
- (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition.

VIII. Application of State Law in a Chapter 9

11 U.S. Code § 904 – Limitation on jurisdiction and powers of court

Section 904 provides:

Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with —

- (1) any of the political or governmental powers of the debtor;
- (2) any of the property or revenues of the debtor; or
- (3) the debtor's use or enjoyment of any income-producing property.

VIII. Application of State Law in a Chapter 9

Ashton v. Cameron County Water Improvement District Number 1, 298 U.S. 513 (1936)

The U.S. Supreme Court in *Ashton* found, in part:

▪Such being the separate and independent condition of the States in our complex system, as recognized by the Constitution . . . it would seem to follow . . . that the means and instrumentalities employed for carrying on the operations of their governments . . . should be left free and unimpaired, should not be liable to be crippled, much less defeated . . . Without this power, and the exercise of it, we risk nothing in saying that no one of the States under the form of government guaranteed by the Constitution could long preserve its existence.” *Id.* at 528- 9.

▪**If obligations of states or their political subdivisions may be subjected to the interference here attempted [in a Chapter 9], they are no longer free to manage their own affairs; the will of Congress prevails over them; although inhibited, the right to tax might be less sinister and really the sovereignty of the state, so often declared necessary to the federal system, does not exist.** *Id.* at 531 (emphasis added).

VIII. Application of State Law in a Chapter 9

Ashton v. Cameron County Water Improvement District Number 1, 298 U.S. 513 (1936)

The U.S. Supreme Court in *Ashton* additionally found, in part:

- Like any sovereignty, a state may voluntarily consent to be sued; may permit actions against her political subdivisions to enforce their obligations. Such proceedings against these subdivisions have often been entertained in federal courts. ***But nothing in this tends to support the view that the federal government, acting under the bankruptcy clause, may impose its will and impair state powers—pass laws inconsistent with the idea of sovereign*** 298 U.S. at 531 (emphasis added).

VIII. Application of State Law in a Chapter 9

United States v. Bekins, 304 U.S. 27 (1938)

Just two years after its decision in *Ashton*, the U.S. Supreme Court found:

- It should also be observed that Chapter X, § 83(e), provides as a condition of confirmation of a plan of composition that it must appear that the *petitioner "is authorized by law to take all action necessary to be taken by it to carry out the plan," and, if the judge is not satisfied on that point as well as on the others mentioned, he must enter an order dismissing the proceeding.* The phrase "authorized by law" manifestly refers to the law of the state." *Id.* at 49 (emphasis added).

VIII. Application of State Law in a Chapter 9

United States v. Bekins, 304 U.S. 27 (1938)

The U.S. Supreme Court in *Bekins* continued:

- In *Ashton v. Cameron County District* . . . the court considered that the provisions of chapter IX **authorizing the bankruptcy court to entertain proceedings for the “readjustment of the debts” of “political subdivisions” of a State “might materially restrict [its] control over its fiscal affairs,” and was therefore invalid;** that, if obligations of States or their political subdivisions might be subjected to the interference contemplated by chapter IX, they would no longer be “free to manage their own affair

VIII. Application of State Law in a Chapter 9

The U.S. Supreme Court in *Bekins* continued:

- In enacting Chapter X, the Congress was especially solicitous to afford no ground for this objection. In the report of the Committee on the Judiciary of the House of Representatives, [Footnote 2] which was adopted by the Senate Committee on the Judiciary, [Footnote 3] in dealing with the bill proposing to enact Chapter X, the subject was carefully considered. The Committee said:

. . . 'The bill here recommended for passage expressly avoids any restriction on the powers of the States or their arms of government in the exercise of their sovereign rights and duties. No interference with the fiscal or governmental affairs of a political subdivision is permitted. The taxing agency itself is the only instrumentality which can seek the benefits of the proposed legislation. No involuntary proceedings are allowable, and no control or jurisdiction over that property and those revenues of the petitioning agency necessary for essential governmental purposes is conferred by the bill.' . . ." 304 U.S. 49 – 51 (emphasis added).

VIII. Application of State Law in a Chapter 9

The municipality in Chapter 9 cannot act contrary to mandates of state law:

- **Timely mandated payment without delay:** Some may argue that, under Section 904 of the Bankruptcy Code, the municipality in Chapter 9 may consent to the court enforcing the automatic stay, preventing or delaying the payment of revenues subject to a statutory lien. (The automatic stay is not applicable to special revenues under 922(d) of the Bankruptcy Code).
- If the municipality, however, is not authorized or able under state law to take such action then it is prohibited from so consenting or acting.
- The failure of a municipality to follow a state law mandate that revenues are to be used solely to pay the statutory lien debt could be fatal to the court's ability to approve any Plan of Debt Adjustment for the municipality and may mandate dismissal of the case.

VIII. Application of State Law in a Chapter 9

The municipality in Chapter 9 cannot act contrary to mandates of state law, continued:

- In *Bekins*, the U.S. Supreme Court recognized that as a condition of confirmation of a plan it must appear that the petitioner “is authorized by [state] law to take all action necessary to be taken to carry out the plan and if the judge is not satisfied on that point as well as others mentioned, he must enter an order dismissing the proceeding”. *Bekins*, 304 U.S. at 49.
- Further, Section 903 of the Bankruptcy Code prohibits the court from limiting or impairing the state’s control over state law mandated payments.

VIII. Application of State Law in a Chapter 9

No other use of revenues subject to statutory lien or special revenues are permitted:

No Diversion for DIP Financing of Special Revenues.

- Some may argue that “special revenues” can be subject to a senior lien for post-petition financing during the Chapter 9 at the request of the municipality, permitting the diversion of revenues subject to providing adequate protection under Section 364(d) of the Bankruptcy Code.
- To do so would be contrary to Sections 922(d) and 928 of the Bankruptcy Code and the legislative history of the 1988 Amendments thereto.

VIII. Application of State Law in a Chapter 9

No Delay in Payment of Special Revenues.

- Sections 902, 922(d) and 928 of the Bankruptcy Code, along with the legislation history of the 1988 Amendment. establish that there should be no payment delay with respect to debt secured by a pledge of special revenues.
 - The legislative history is clear that payment of debt secured by a pledge special revenues cannot be impaired in any way and must be as collected applied as set forth in the relevant documents governing the financings.
 - The Senate Report accompanying the special revenue provisions provides: “Finally, the amendment insures that revenue bondholders receive the benefit of the bargain with the municipal issuer, namely they have the unimpaired right to the project revenue pledged to them.” Senate Report 100-506 at 12.

VIII. Application of State Law in a Chapter 9

No Diversion for Post-Petition Financing of Revenues Subject to a Statutory Lien.

- A statutory lien cannot be subject to a priming lien or use in post-petition lending under Section 364(d) unless the trustee and bondholders consent.
- There can be no diversion or other use since the municipality is not permitted or able under state law to act contrary to and without the municipality's consent (which cannot be given under state law), and the Bankruptcy Court has no jurisdiction over revenues or governmental power under Section 904 of the Bankruptcy Code.
- Further, as Section 903 of the Bankruptcy Code provides, the Bankruptcy Court cannot impair or limit the state mandate under state law that revenues subject to a statutory lien cannot be delayed or diverted and must be timely paid as collected to the statutory lien debt as required by state.

QUESTION:

Does the Bankruptcy Code and its legislative history address how statutory liens and special revenues should be treated in Chapter 9?

IX. Legislative History

The legislative history of the 1988 Amendments supports the timely and unimpaired payments of revenue subject to statutory lien and special revenues.

- The 1988 Amendments incorporated the special revenue protections into Chapter 9.
- The Senate Report accompanying the 1988 Amendments provided that the special revenue provisions were consistent with the understanding at the time that mandated payment of pledged revenues created by a statutory lien or that were subject to state law mandated payment.
- Previous case had recognized that such debt should be unimpaired and timely paid, including the *San Jose School District* case (discussed in following slides).

IX. Legislative History

The Senate Report for the 1988 Amendments provides:

- “The application of Section 552 in a Chapter 9 bankruptcy proceeding may also defy practical reality and state law mandates. As in the case of the San Jose School District, *In re San Jose Unified School District*, No. 5-83-02387-A-9, (B.C.N.D. Cal. 1983), the continued payment of interest to bondholders not only helped ensure the debtor’s continued access to credit markets but also helps fulfill the requirement of state law that such collected funds be used to pay bondholders. Cal. Educ. Code Ann. 15251.
- Accordingly, as a practical matter, even though Section 552 of the Bankruptcy Code provides that the pledge is terminated, given the mandate of the law and the practical reality of municipal finance, a municipality might well attempt to ignore that provision and continue to pay the bondholders as originally promised. Municipalities, prior to and after the enactment of the Bankruptcy Code, have so acted, such as the San Jose School District

IX. Legislative History

The Senate Report for the 1988 Amendments continues:

- ***In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenues granted pursuant to state statutory or constitutional provision to bondholders can be terminated by the filing of a chapter 9 case.*** Likewise, under the contract clause of the Constitution (article I, section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a chapter 9 proceeding.” S. Rep. No. 100-506 at 6 (1988).
- Accordingly, the statutory lien pledge of ad valorem tax revenues for the timely payment of the Unlimited Tax General Obligations (“ULTGOs”) debt service was not interfered with in the *San Jose School District* case and is not to be interfered with under Chapter 9 as the legislative history for special revenue treatment so provides.

IX. Legislative History

- This legislative history noted the recognized principles that are embodied in Sections 903 and 904 of the Bankruptcy Code and the Tenth Amendment as recognized in the Supreme Court of the *Ashton and Bekins*:
 - That the statutory lien cannot be terminated nor the mandated payment impaired so that revenue subject to the statutory lien or special revenues must be paid timely as intended to the debt holders.

QUESTION:

Are the revenues of a municipality subject to statutory lien or special revenues required under the provisions of the Bankruptcy Code to be paid as collected to the debt it is pledged to?

X. Payment of Revenues – Statutory Provisions

11 U.S. Code § 922 – Automatic stay of enforcement of claims against the debtor

- (a) A petition filed under this chapter operates as a stay, in addition to the stay provided by section 362 of this title, applicable to all entities, of —
 - (1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against an officer or inhabitant of the debtor that seeks to enforce a claim against the debtor; and
 - (2) the enforcement of a lien on or arising out of taxes or assessments owed to the debtor. . . .
- (d) Notwithstanding section 362 of this title and subsection (a) of this section, ***a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 [928] of this title to payment of indebtedness secured by such revenues. (emphasis added)***

X. Payment of Revenues – Statutory Provisions

11 U.S. Code § 928 – Post-Petition Effect of Security Interest

- (a) Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, ***special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case.***
- (b) Any such lien on special revenues, other than municipal betterment assessments, derived from a project or system shall be subject to the necessary operating expenses of such project or system, as the case may be. (emphasis added).

X. Payment of Revenues – Statutory Provisions

11 U.S. Code § 903 – Reservation of State power to control municipalities

This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise, but—

- (1) a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition; and
- (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition. (Emphasis added.)

X. Payment of Revenues – Statutory Provisions

11 U.S. Code § 904 – Limitation on jurisdiction and powers of court

Notwithstanding any power of the court, *unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with —*

1. any of the *political or governmental powers* of the debtor;
2. any of the *property or revenues* of the debtor; or
3. the debtor's *use or enjoyment of any income-producing property*. (Emphasis Added.)

QUESTION:

Does the case law support timely payment as collected of revenues subject to statutory lien and special revenues to their respective debt holders?

XI. Applicable Case Law

San Jose School District

- In 1983, the San Jose School District lost a labor arbitration and claimed to be unable to make the payments required with respect to that arbitration.
- On July 1, 1983, the School District filed for protection under Chapter 9. On that same date, the School District had a schedule debt due on its ULTGO debt.
- Despite the fact that the Special Revenue provisions had yet to be incorporated into the Bankruptcy Code, that payment was timely paid and continued to be paid through the Chapter 9.

XI. Applicable Case Law

San Jose School District, continued

- With respect to that debt, under California law, the County Treasurer was to levy a tax sufficient to pay debt service and the County Treasurer was to collect the specified levy of tax and pay it into a special account or directly to the bond trustee for payment on the ULTGO debt.
- California law specifically mandates that such pledged revenues could only be used to pay debt service on the ULTGO debt and no other purpose.
- Accordingly, the County Treasurer was required by state law to levy, collect and pay for the benefit of the ULTGO debt and could not take any different action. The School District had no right to the separately levied tax revenues that could not be paid to or used by the School District under state law. (Cal. Ed. Code § § 15250-254).

XI. Applicable Case Law

Sierra King Health Care District

- In the Fall of 2009, Sierra King Health Care District in California filed for Chapter 9 protection. In August 2009, shortly before its filing, the District had issued ULTGO bonds pursuant to Cal. Health & Safety Code § § 32300-312.
- The good faith issuance by the District was called into question given the timing of the Chapter 9 filing, and various securities law claims were considered.
- As discussed on the following slide, the District and bondholder entered into a settlement and reaffirmation that the ULTGO debt was secured both by a pledge of special revenues and by a statutory lien.

XI. Applicable Case Law

Sierra King Health Care District, continued

- With respect to the ULTGO debt, California law required after two-third approval of the electorate, which had occurred in the case of the District, that the debt service for payment of the ULTGO debt be levied by the County and, after collection, be paid to a special account or directly to the Bond Trustee (which was the practice).
- The revenues could only be used to pay the ULTGO debt and no other purpose. Additionally, any surplus was to be paid back to the taxpayers.
- Given the threat of securities fraud litigation, there was a settlement of those claims and a reaffirmation and ruling by the court that the revenues so levied and collected to pay the ULTGO debt were subject to a statutory lien and were special revenues not to be impaired during the Chapter 9 or as a part of the plan of reorganization, and were to be timely paid.

XI. Applicable Case Law

Heffernan Memorial Hospital District

- In 1995, the Heffernan Memorial Hospital District filed a Chapter 9 petition. As a part of its plan of adjustment, the hospital district agreed to transfer, assign and pledge a specific stream of sales tax revenues to the Calexico Special Financing Authority. The Authority, in turn, agreed to issue certain sales tax revenue bonds, for which the pledged sales tax stream would be used to secure and provide payment to the holders of the sales tax revenue bonds. The bankruptcy court found that these bonds were secured by a pledge of special revenues.
- As indicated in *San Jose School District*, *Heffernan Memorial Hospital District*, and *Sierra Kings Hospital District*, California and other jurisdictions have long recognized that a special tax or a portion of a general tax specifically levied to pay for a municipal financing and not for general purposes of a debtor should be treated as special revenues and such debt should be timely paid throughout a bankruptcy proceeding.

XI. Applicable Case Law

No Adverse Rulings in Jefferson County, Vallejo, Stockton and Detroit

- **Jefferson County:** The Court in *Jefferson County* recognized special revenue treatment for sewer debt and payment consistent with the terms of the documents. While the case authorized payment of special revenues to pay debtor counsel fees in part it was purportedly due to the language of the indenture being interpreted to allow such payment and ultimately settled. The ultimate plan treatment was a compromise or settlement. Accordingly, *Jefferson County* case does not stand for any impairment or delay in payment as collected other than as purportedly authorized by the documents or voluntarily agreed to.
- **Vallejo and Stockton:** In *Vallejo* and *Stockton* bankruptcies, there was recognition of the mandated payment and the timely payment of special revenue bond issues (even though there was a dispute over lease financing relating to extent of the collateral and payments with one major holder).

XI. Applicable Case Law

No Adverse Rulings in Jefferson County, Vallejo, Stockton and Detroit, continued

- ***Detroit Water and Sewer Bonds:*** In *Detroit* the special revenues of the water and sewer bonds were timely paid and if a holder did not accept Detroit's tender offer in the plan, those remaining holders were unimpaired (except for those who voluntarily settled and took the tender offer).
- ***Detroit's UTGO Debt:*** There was no adverse ruling in the *Detroit* case as to statutory liens and special revenues. There was a voluntary settlement approved by the court that, as agreed, provided less payments than state law would have required. The UTGO debt in Detroit were impaired and claimed by Detroit not to be subject to a statutory lien or special revenue treatment. Since this class claim was settled with the insurers receiving 74 cents on the dollar and the bondholders being paid 100 cents on the dollar by the insurers, there was only a voluntary impairment and no court ordered impairment.

XI. Applicable Case Law

No Adverse Rulings in Jefferson County, Vallejo, Stockton and Detroit, continued

- Detroit's unlimited tax general obligation ("UTGO") bonds had voter approval of additional tax revenue dedicated to payment of those bonds, which raises some fundamental government finance issues as noted above as to Sections 903 and 904 of the Bankruptcy Code.
- In fact, presently there is pending in the Michigan Senate legislation reconfirming a statutory lien on UTGOs in Michigan. This legislation has already passed the Michigan House (H.B. 4495).
- As discussed on the next slide, although the parties ultimately settled their issues with respect to the Detroit UTGO Debt, given Detroit's originally proposed impairment of such debt, several questions exist.

XI. Applicable Case Law

No Adverse Rulings in Jefferson County, Vallejo, Stockton and Detroit, continued

- Those questions include:
- What does it mean to have a tax revenue pledge approved by the voters and dedicated to pay the general obligation bonds?
- What does Article IX Section 25 of the Michigan Constitution mean that “The repayment of voter approved bonded indebtedness is guaranteed”?
- What consequences are there to the Municipal Bond Market if UTGO Bonds are ultimately treated as unsecured debt?
- Can the plan of debt adjustment be confirmed if it is not in compliance with state law and if the claimant does not consent to a settlement that provides for an impairment?

QUESTION:

Can a Bankruptcy Court confirm a Plan of Debt Adjustment that proposes action not authorized by state law?

XII. Plans of Adjustment

Federal Courts Have Ruled that the Bankruptcy Court Cannot Confirm a Plan that Violated the Mandates and Priorities of State Law

- In the case of *In the matter of Sanitary and Imp. Dist. No. 7*, 98 B.R. 970 (B.C.D. Neb. 1989) the court recognized where a plan proposes action not authorized by state law or without satisfying state law requirements, the plan cannot be confirmed.
- The issue was whether the state law priority of payment of bonds over warrants required the plan to provide for full payment of bonds as required by state law in order to be confirmed. While these were unsecured claims (not covered by a statutory lien or special revenues) which can be modified in a Chapter 9, the court noted mandated priorities under state law as well as state law provision for payment post confirmation should be honored in order for the court to confirm the plan. See also *Colorado Springs Creek General Imp. Dist.* 177 B.R. 684 (B.C.D. Colo. 1995).

QUESTION:

Does reduced borrowing cost actually benefit municipalities?

XIII. Borrowing Costs

Access to the Market at a Low Cost of Borrowing is Desired by All Government Borrowers

- *Access and the Cost of Borrowing is a Reflection of the Perceived Risk of the Government Credit*
 - Fiscal Distress for Government Begets Higher Cost of Borrowing and Even Loss of Access to the Market
 - These higher borrowing costs are indicated on the following slides

XIII. Borrowing Costs

Access to the Market at a Low Cost of Borrowing is Desired by All Government Borrowers, continued

- On March 2, 2012, Greece had a ten year bond annual yield of 37.1% and in July, 2015, after the third attempted bailout and austerity package being implemented, Greece annual yield is still over 10.5% with a 52 week range of 5.5% and 19.5%.
 - Greece has defaulted on its sovereign debt since 1826 at least five times prior to its recent financial crisis (1826, 1843, 1860, 1894 and 1932).
- Brazil, a large developing economy which defaulted or restructured its sovereign debt eleven times since 1826, the last time 1990, had an average ten year bond annual yield between 2006 and 2015 of approximately 12.3% with all time high of 17.91% in October, 2008.

XIII. Borrowing Costs

Access to the Market at a Low Cost of Borrowing is Desired by All Government Borrowers, continued

- Puerto Rico, given its recent financial distress experience, had yields on its ten year G.O. bonds exceeding 10% in February, 2014.
- At the same time, other sovereigns experienced usually low bond annual yields of 2.27% for U.S.A., 1.52% for Canada, .74% for Germany and 1.03% France.
- A review of selected sovereigns that have defaulted since 1998 demonstrates default does result in a time out or lack of access to the international bond market.

XIII. Borrowing Costs

Access to the Market at a Low Cost of Borrowing is Desired by All Government Borrowers, continued

Analysis of Recent Sovereign Restructurings 1998-2010					
Country	Default Date	Time to Competition (quarters)	Haircut (%)	First Issuance to International Bond Market (quarters after completion)	Participation (%)
Russia	08/1998	8	(40,75)	10	(75-99)
Pakistan	05/1999	11	(29,32)	18	99
Ukraine	08/1998	12	(5-5.92)	16	(82-100)
Ecuador	09/1999	5	(9-47)	24	98
Argentina	06/2001	12	(25-82)	19	(50-76)
Dominican Republic	12/2004	3	(1-2)	4	97
Serbia	12/2000	20	62	Not Yet	
Dominica	12/2003	2	50	-	78.5
Belize	12/2006	2	(1-28)	Not Yet	98
Grenada	01/2004	3	(40-50)	Not Yet	91
Jamaica	02/2010	-	20	4	99

(Federal Reserve Bank of Dallas, Global and Monetary Policy Institute Working Paper No. 143, Aitor Erce, April 2013)

XIII. Borrowing Costs

2. **In Detroit the Emergency Manager's Unjustified Attack on ULTGOs Raised the Perception of Risk and Increased Annual Interest Rates**
 - The filing of the Detroit Chapter 9 proceedings and the Emergency Manager's unwarranted attack on ULTGOs caused other municipalities in Michigan, like school districts, to experience approximately 100 basis points increase in the annual interest rate, the cost of borrowing, on ULTGOs due to the Detroit contagion.
 - In California, the Detroit fall out cost school districts a 50-100 basis point increase, which was historically unjustified given the Chapter 9 experience of *San Jose School District* and *Sierra King Health Care District* cases.
 - California response through the efforts of CDIAC was to attempt to clarify the intended low risk of California ULTGO by passing SB 222 to reconfirm that California state law provides a statutory lien intended to be unimpaired and paid in a Chapter 9.

XIII. Borrowing Costs

The Recent Use of Statutory Lien Legislation to Gain Market Access in Financially Distressed Times and to Lower the Cost of Borrowing for the Benefit of All

- **Rhode Island**
 - In 2011, in response to the threat of bankruptcy of the City of Central Falls and economic distress in other local governments, the legislature passed and Governor of Rhode Island signed into law legislation that provided outstanding notes and bonds of cities and towns shall be paid and shall have a first lien on all ad valorem taxes and general fund revenues by the power and force of a state statutory provision (RI Gen. § 45-12-1).
 - The expressed intention of this law was to assure market access at a lower borrowing cost especially in times of financial distress.

XIII. Borrowing Costs

- **California**

- As noted above, in response to the Detroit contagion due to the unjustified attack on UTGOs in its Chapter 9 case, California, through the efforts of CDIAC and California legislature proposed and had passed SB 222 which expressly provides and reconfirms a statutory lien on voter approved unlimited ad valorem tax specifically levied, collected and dedicated to pay those ULTGOs and under California law cannot be used for any other purpose by the local governments (See e.g. California Ed. Code § 15251 and California Gov. Code § 53515).

- **Michigan**

- In the exit financing for Detroit after confirmation of its Plan of Debt Adjustment, in order for the public market to accept such financing, it was necessary for the Michigan legislature to pass legislation providing that the financing was secured by a statutory lien on pledged revenues. At the end of 2014 and in 2015, the Michigan legislature has considered legislation reconfirming a statutory lien for UTGOs in Michigan. The Michigan House has passed HB 4495 and it is now pending before the Michigan Senate.

XIII. Borrowing Costs

- **Other States**
 - In Nebraska, legislation is pending granting statutory lien status to the bonds and notes issued by local government (NE LB 67).
 - Included in proposed legislation regarding authorizing Chapter 9 for certain local government in Illinois, is a proposed statutory lien for all bonds and notes with pledged revenues as the source of payment as a first lien (unless otherwise specified), senior to any other claims. (See Illinois Governor Rauner's Pension Proposal).
 - See additionally, statutes in California (Cal. Ed. Code § 15251 and Cal. Gov't Code § 53515), Rhode Island (R.I. Gen. Laws Chapter 45-12), Colorado (Colorado Rev. Stat. § 11-57-208), Idaho (Idaho Code § 57-234), *Compare: e.g.* Louisiana (LA Rev. Stat. § 39:14301), Oregon (OR Rev. Stat. § 287A.310), Texas (TX Govt. Code § 1202.006 and 1208.002) and Utah (UT Code. § 11-14-501).

XIII. Borrowing Costs

Reducing Risk with Statutory Liens and Special Revenues Can Benefit All In Lower Costs of Borrowing

- **The 200-300 Basis Point Spread Between Strong and Weak Credits.**
Traditionally the spread in the municipal market between strong credits (top investment grade) and significantly weak credit (lower non-investment grade) was 200-300 basis points.
- **Being Classified as a Weaker Credit Increases the Cost of the Borrowing By 25% or More of the Face Amount of Debt and Should be Avoided if Possible.**
To a state or local government, a 200 point per year or 2 percent more interest cost a year on a 20 year bond with a bullet maturity would be 40% more of the principal amount paid as interest over 20 years. Put another way, on a billion dollar debt issue with a twenty year maturity and a bullet payment of principal at maturity, a 2% additional interest cost per annum would be a present value at a 5% discount of about \$250 million or 25% of the face amount. That is \$250 million not available to state or local government to pay needed infrastructure improvements, public services, worker salaries, retiree benefits or tax relief to its citizens.

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