

How Safe Are General Obligation Bonds in Chapter 9?



MUNICIPAL BOND BUYERS CONFERENCE
FEBRUARY 24, 2014

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Chapter 9 Bankruptcy Filings are Relatively Rare

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- Chapter 9 bankruptcy filings are relatively rare (only 652 since 1937)
- There has been no tsunami of Chapter 9 filings since the Great Recession began (only 12 in 2012 and 8 in 2013)
- Mainly small special tax districts and municipal utilities, as opposed to general governments (e.g., cities and counties) that issue general obligation bonds
 - Only 53 of the 283 Chapter 9 filings since 1980 involved cities and counties and, of the 53, at least 24 (45%) never had a plan confirmed
 - Only 3 cities in 2012 and 1 city (Detroit) in 2013 filed Chapter 9 cases
- States cannot file a Chapter 9 bankruptcy case

Many States Do Not Permit, or Limit, Chapter 9 Filings

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- **12 states specifically authorize municipal bankruptcies**
 - (AL, AZ, AR, ID, MN, MO MT, NE, OK, SC, TX, WA)
- **12 states conditionally authorize municipal bankruptcies**
 - (CA, CT, FL, KY, LA, MI, NJ, NC, NY, OH, PA, RI)
- **3 states have limited authorization (CO, OR, IL)**
- **2 states prohibit filing (GA) but one (IA) has an exclusion**
- **21 states are either unclear or do not have specific authorization**
- **There have been five times more filings by municipalities in states that authorize Chapter 9 filings without any conditions than in states that had conditions to file**

Treatment of General Obligation Bonds in Bankruptcy

- **General obligation bonds may be treated as unsecured debt in Chapter 9 unless the pledge of the taxing power is supported by**
 - ✦ a statutory lien, or
 - ✦ “special revenues”
- **Prior to Jefferson County’s Chapter 9 filing in 2011, there had been no noted example of GO bonds from an issuer of size being “impaired” and not until Detroit’s filing were any GO bonds proposed to be significantly impaired**

Detroit Bankruptcy Case

- The City of Detroit commenced a Chapter 9 bankruptcy case in the United States Bankruptcy Court for the Eastern District of Michigan on July 18, 2013.
- The Emergency Manager has proposed that unlimited tax general obligation (“UTGO”) bonds be treated as unsecured debt.
- On October 1, 2013, the City defaulted on its obligation to make interest payments on the UTGO bonds.
- On November 8, 2013, two bond insurers (MBIA/National and Assured Guaranty) filed an adversary proceeding in the Bankruptcy Court against the City and four City officials (the Emergency Manager, the Finance Director, the Deputy Finance Director and the Treasurer).

Detroit Bankruptcy Case (Cont'd)

- The insurers allege that the City is unlawfully diverting voter-approved ad valorem taxes that the City must levy and collect for the sole purpose of paying principal and interest on the UTGO bonds.
- The insurers contend that Michigan law requires the City to:
 - Levy the full amount of ad valorem taxes, without limitation as to rate or amount, necessary to repay the UTGO bonds, which are in addition to other ad valorem taxes the City is authorized to levy,
 - Collect the proceeds of the ad valorem taxes levied for UTGO debt service and deposit such proceeds in segregated debt retirement funds (the “Debt Retirement Funds”), and
 - Use the proceeds of the ad valorem taxes only to pay principal and interest on the UTGO bonds.

Detroit Bankruptcy Case (Cont'd)

- The insurers also contend that any officer who willfully violates such payment restrictions is personally liable to bondholders for any loss arising from such failure.
- Ultimately, the insurers argue that the City has no legal or beneficial interest in the proceeds of the ad valorem taxes levied and pledged specifically to secure the repayment of the UTGO bonds (the “Restricted Funds”) and that
 - The defendants should be required to deposit the Restricted Funds into the Debt Retirement Funds as they are collected and segregate the Restricted Funds from other funds of the City, and
 - The defendants should be prohibited from using the Restricted Funds for any purpose other than repaying the holders of the UTGO bonds.

Detroit Bankruptcy Case (Cont'd)

- The insurers are not seeking declaratory relief regarding the ultimate disposition of the Restricted Funds in the adversary proceeding, but are only seeking to ensure that the Restricted Funds remain restricted during the pendency of the Chapter 9 case.
- The insurers acknowledge that issues as to whether the Restricted Funds are impressed with a statutory lien as defined in Section 101(53) of the Bankruptcy Code and constitute “special revenues” as defined in Section 902 of the Bankruptcy Code will likely need to be determined at a later time following necessary and appropriate fact and expert discovery.

Reviewing General Obligation Bonds

- In reviewing a general obligation bond of a local government, the first question that should be asked is whether the bond is:
 - An unlimited tax general obligation bond, supported by ad valorem property taxes, unlimited as to rate or amount, levied by an issuer on all property within its territorial limits and taxable by it.
 - A limited tax general obligation bond, supported by ad valorem property taxes, levied by an issuer on all property within its territorial limits and taxable by it, subject to a limitation on the tax rate, or the aggregate tax that can be levied.
 - Supported only by a general fund pledge, not any ad valorem taxing power.

Reviewing General Obligation Bonds (Cont'd)

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- **General obligation bonds may be supported by**
 - A “full faith and credit” pledge and/or
 - A pledge of a taxing power.
- **Full Faith and Credit**
 - MSRB Glossary defines this as a term normally used in connection with general obligation bonds to express the commitment of the issuer to repay the bonds from all legally funds, including a good faith commitment to use its legal powers to raise revenues to pay the bonds.
 - If a GO bond is backed by the issuer’s full faith and credit, which funds (e.g., the general fund, or only unrestricted funds) are pledged?
 - Is there a statutory first budget priority or mandatory set aside or appropriations to pay debt service?

Reviewing General Obligation Bonds (Cont'd)

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- **Pledge of a taxing power**
 - Which taxes are pledged for repayment?
 - Are there limits as to rate or amount of the pledged taxes?
 - ✦ If so, consider whether the current rates or amounts imposed are at or close to the cap.
 - Are additional taxes being specifically levied for the payment of the debt service on the bonds being reviewed?
 - ✦ If so, was voter approval or other approval needed for such additional taxes and, if needed, was such approval obtained?
 - ✦ Were the additional taxes levied at rates or amounts in excess of otherwise applicable limits?

Reviewing General Obligation Bonds (Cont'd)

- **Pledge of a taxing power (Cont'd)**
 - If additional taxes may need to be levied in the future to pay debt service on the bonds being reviewed, is the issuer's power to raise taxes conditioned upon the approval of another governmental entity?
 - Are tax collections for debt services required to be segregated from other general fund revenues and used only to pay debt service?
 - Is there a statutory lien on certain revenue?
 - Is there a contractual security interest in certain revenue? Is this security interest perfected by status or are UCC methods of perfection (e.g., filing, possession) required?
 - Is the pledge of the taxing power a pledge of "special revenues" or is there a separate pledge of "special revenues"?

Reviewing General Obligation Bonds (Cont'd)

- **Remedies: Under applicable state law, what remedies are available to enforce a tax pledge?**
 - Writ of mandamus
 - Appointment of receiver
 - State intercept program (What is the trigger and who decides?)
- **Chapter 9 bankruptcy**
 - Is the issuer authorized to file a Chapter 9 bankruptcy case?
 - If the authorization to file is subject to certain conditions, what are those conditions?

Conclusions/Cautions

- In reviewing local government GO bonds, be cautious about focusing too much on bankruptcy issues (e.g., whether the issuer is authorized to file Chapter 9, whether the GO bonds are supported by a statutory lien or special revenues), because
 - Issuers and bond counsel may not be able to provide clear answers to these questions in connection with the primary offering
 - Any answers provided in connection with the primary offering (clear or not) are subject to change over the life (e.g., 30 years) of the GO bonds (see, e.g., the Central Falls, RI bankruptcy case in which the state imposed a statutory lien for the benefit of bondholders shortly before the filing)
- States cannot file Chapter 9, so investors are accepting “sovereign” credit risk when purchasing their GO bonds; however, states have not defaulted on their GO debt since the 1800s (except Arkansas in 1933, which was promptly refinanced)

Questions?

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