State Oversight, Bankruptcies, and Recovery

Gregory Lipitz, Stephen Fehr, Thomas Neff, and William Kannel*

Fiscal stress continues to change the landscape of the municipal credit markets. The full impact of recent bankruptcies, work-out plans, and court rulings is ongoing. This paper explores state oversight of local governments, specifics of Chapter 9 filings, and recovery. It considers the recent Detroit, Jefferson County, and Harrisburg sagas and implications for bonds secured by special tax pledges and statutory liens. It discusses possible concessions to bondholders and other creditors in detail as well as other examples and scenarios.

INTRODUCTION: GREGORY LIPITZ

Our panel will be discussing state oversight and bankruptcy. I will begin by briefly introducing myself and our panelists. I have been with Moody's for about 11 years and am currently on the California team rating local governments there. I also chair our municipal bankruptcy task force. We have a great bunch of panelists. Stephen Fehr is a senior officer with Pew Charitable Trusts. Pew published a comprehensive review last year of state oversight of local governments entitled "The State Role in Local Government Financial Distress." Tom Neff is from New Jersey and is the director of the Division of Local Government Services for New Jersey's Department of Communal Affairs. Bill Kannel is from Mintz Levin, where he is a partner in their bankruptcy practice.

This is a remarkable time in our business and our careers, in what can only be described as a once-in-a-generation event. We have had, in a very short period, several bankruptcies and defaults of major local governments in the United States: Detroit, Jefferson County, San Bernardino, Stockton,

*Gregory Lipitz is vice president and senior credit officer at Moody's Investors Service. Stephen Fehr is project director at Pew Charitable Trusts. Thomas Neff is director of local government services for the State of New Jersey. William Kannel is a partner at Mintz Levin. This discussion is based on the authors' presentations in the panel on State Oversight, Bankruptcies, and Recovery at the Thirty-First Annual Conference of the National Federation of Municipal Analysts in Lake Buena Vista, Florida, May 6–9, 2014.

and some less big but no less important defaults and bankruptcies such as Central Falls, Rhode Island; Harrisburg, Pennsylvania; and Vallejo, California. At panels like this one, in meetings and credit discussions at ratings agencies like Moody's, in articles, commentaries, blogs, op-ed pieces, and, of course, in court pleadings, all of us—analysts, lawyers, investors—have tried to understand the ramifications of Chapter 9 bankruptcy, which was more or less unheard of until recently. What, for example, does a GO pledge mean, and what does it mean for an investor holding both a GO pledge and a revenue pledge of a city that is in bankruptcy? Which of those two pledges will get paid? What is the recovery rate of a GO pledge versus a revenue pledge? Also, does it matter if a state allows one of its local governments to file for bankruptcy, and does a particular state even care if one of its local governments is teetering on the precipice of a major financial meltdown? These are the questions all of us are thinking about, or should be thinking about, and the goal of this panel today is to address some of these questions and perhaps to shed light on some of the answers or some of the current thinking.

This will be an interactive panel. Stephen and Tom will talk about state oversight. Bill will then talk about bankruptcy. I will ask some questions, and at the end, we will open up the discussion to questions from the audience. I will start by asking: "Why do states get involved with oversight in the first place?"

WHY STATES GET INVOLVED WITH OVERSIGHT: STEPHEN FEHR

The topic of state oversight is extremely timely right now. From April 1 to May 6, starting, say, in Vermont, we see that the state legislature is immersed in a debate right now about how to help its school districts, how to help them consolidate, because they have considerable duplication. Moving down to New York State, we see that last Friday, the state comptroller, who monitors local governments, put out a report saying that he had now been able to monitor 2,300 local governments and had found 142 that are in some kind of distress. In Pennsylvania, the city of Shamokin has $800,000 of unpaid bills—the gas company cut off the gas to City Hall at one point—and the city council, since April 1, has voted to ask the state to put the city in Pennsylvania's Act 47 intervention program, which would make Shamokin the 28th city in that program. Last month in Harrisburg, there was a hearing in which the legislature considered tinkering with that intervention program, strengthening it. Moving over to Michigan, the governor declared the city of Lincoln Park in distress; they will now decide whether there will be an emergency manager there, as with Detroit. Going down to Missouri, the state legislature is bailing out a school district outside of St. Louis because it cannot pay its bills. And going west, to North Las Vegas, we see where the governor of Nevada met with union leaders in that community to try to get them to make some concessions to help Las Vegas stay afloat. All this happened in the month from April 1 to May 6, 2014.

Why do states exercise oversight? First of all, not every state intervenes. In our study, we found that 19 states have laws on the books that allow them to intervene, but that does not mean they have a very active intervention program; there are only a few that are aggressively involved. But why do they do it? If you go back to the genesis of the Municipal Assistance Corporation in New York City, a big part of the motivation was the worry that if the city went under, there would be an issue with protecting health and safety. So that is one basic reason. Another reason is that states may want to avoid the stigma of having one of their cities in distress. Vallejo, in the Bay Area, is a good example of that stigma; Vallejo was one of the few cities that did not grow while all the other communities in that area were thriving. States may also want to avoid the idea that if one of their cities is in distress, it could hurt other neighboring cities and it could hurt the state's credit rating as well. That was a clear motivation in Rhode Island, in Central Falls, where the state jumped in, from the governor on down. They went to the legislature and they strengthened their intervention program, because they have many similarly positioned cities in Rhode Island, and they were worried about more bankruptcies. And finally, there is Michigan. Governor Snyder, when asked: "Why do you do this?" said: "The goal is not to take them over, it is to help them get back on their feet." But he also made the strong point that in the case of Detroit, he has tried to reinvent his state, which struggled even before the recession. He is trying to help the state bounce back, and he has succeeded in many ways, but he said: "I can't succeed at this unless I have my biggest city economically secure." So another motive is to make sure that your biggest cities are strong so that they lift the entire state.

Gregory Lipitz: In terms of effectiveness, how effective are states at overseeing their local governments? With what we are seeing with the surge of bankruptcies, do you see any policy changes by states to address that?

Stephen Fehr: The first thing to understand about the states that are heavily involved in intervention is that the practices vary widely by state. They even vary within a state. Michigan has an emergency manager running things in Detroit. Rhode Island had a receiver in Central Falls. New York State likes control boards and has had a degree of success with those. Pennsylvania has varying practices; it has the Act 47 program, which includes 27 cities, but for Philadelphia, the state decided to have a control board, and for Harrisburg, a receiver. Some states, such as California and Alabama, have, in the case of municipal governments (but not school districts), taken a hands-off approach. The results of intervention have been very mixed. You could make a case that Central Falls was successful because the bankruptcy lasted only 13 months. They did many things right: they were very transparent with the community; they brought all the stakeholders in; everybody was involved, reducing the tension. Who can argue with a practice like that? But if you live in that community after the agreement, you are going to have to pay four years of increased taxes, and if you are a pensioner in that town, your pension benefits have been cut. So is that a success? If you live there, you might not think it is successful, but if you are in the industry, you might.

William Kannel: Let me interject that it is also a lot easier to do something like that in a city that is one square mile than it would be in Detroit. In fact, in Detroit, I don't think you could bring everybody together within a square mile.

Stephen Fehr: Part of the problem with Detroit is that it is a huge land area. One of the biggest challenges with Detroit is its size. By contrast, Washington, DC, where I live, had an effective intervention. The control board in DC righted things, but it took more than five years to do it. And the city always has this hammer over its head that if certain conditions are not met, the control board will be reinstated. If you live in DC, you might not think that the way it was done was the most democratic. There was considerable opposition to the control board. It was effective in turning things around, but it left a lot of bad feelings. You could argue that the Philadelphia control board has been very successful in stabilizing Philadelphia's finances—they are not clear by any means, but it has largely worked. But then you have examples in Pennsylvania of cities that have been in the Act 47 program since its inception in the late 1980s—they have never climbed out of it. This was part of the motivation for a hearing I attended last month, because the legislature wants to put a five- to eight-year limit on the amount of time a city can be in the program. The problem about Act 47 is, as the governor notes, that once you are in it, you don't know if you are ever going to climb out, so they are trying to resolve that.

You can look within a state, and in New York State, you could argue that control boards have stabilized Buffalo, Erie, and Nassau County, and that their credit ratings have gone up. And you could then say that in California, many cities' ratings have gone down. You might say that the lesson is that control boards work in New York, but if you live in one of those cities, you may not think that having that oversight is the most democratic way; you might feel that your own elected officials should do that. So there are mixed results. Michigan has several examples where an emergency manager has helped stabilize a city's finances or a school district's finances, but then what about Detroit? Michigan has a monitoring system where it detects distress in local governments. So why did Detroit happen?

Gregory Lipitz: How would you compare a state like Michigan, which has an institutionalized oversight mechanism and history, with a state like California? And what about New Jersey and North Carolina and other states with programs?

Stephen Fehr: That is a good question, because something we set out to understand when we did this research was why Alabama would not help Jefferson County, its largest county, and why California would not help its cities. The answer is that in both states, there has been a history of hands-off policies regarding cities. In the case of Alabama, a state senator from Huntsville told me: "We are doing fine. We can borrow; we are a thriving area. Why should we get involved in Jefferson County? The state doesn't need to intervene there." And it is just sort of an ethic there that they do not want to do that. In California, it goes back to the 1800s, when the state had strong pueblo governments that were independent of each other, and when California became a state, there was a long tradition of leaving the cities alone. Counties are different, because they have revenue implications, and school districts. California is very involved in school districts because the state gives the school districts state aid. This is also true in Alabama, where the state is very strong in school districts. And what I was trying to get from the governor of Michigan when I interviewed him was: "What is it about being from Michigan that makes you want to help your cities?" That is a good question for Tom, because New Jersey does this; it is huge. They even back it up with (now) modest amounts of state money—very few states are willing to put money into it. But there is this ethic in New Jersey of, let's help out a city in trouble, whereas in California, you did not see Jerry Brown going to Stockton or San Bernardino, and nobody expected him to.

Gregory Lipitz: Tom, why don't you talk a little about New Jersey's experience with oversight of local governments?

NEW JERSEY'S OVERSIGHT OF LOCAL GOVERNMENTS: THOMAS NEFF

New Jersey does some things better than others; we are very good at oversight of local governments, and we are proud about it. It is a long tradition rooted in the Depression. When the Depression hit, and there were some bankruptcies and defaults, New Jersey took a position that we were not going to let it happen again to municipalities. And there has not been a substantive default or a bankruptcy in New Jersey in the last 80 years. In order to allow for a bankruptcy in New Jersey, you would need the approval of the Local Finance Board, which I chair and where I wear a different hat. The board is an independent body. If a municipality wants to declare bankruptcy, it goes to that board and asks for it, and the board has never approved it. It would be unlikely to ever approve it in the future, as well, because in New Jersey we have an attitude that cuts across political ideologies that if a municipality has made promises, whether it is to unions or to bondholders or whomever, it needs to live up to them.

In addition, our statutory framework for oversight in New Jersey is quite distinctive. We have a division of state government that I run, called the Division of Local Government Services, and we have 40 staff members. We are engaged in a number of activities that generally regulate our municipal governments, our authorities, fire districts, about 1,000 entities that we oversee. And we require them all, on several levels, to take steps to be financially solvent. In the first instance, we license five different municipal officials who are required to be present in all municipalities. We license their chief financial officer; we license their city clerk; we license their tax collector and their procurement official and their public works manager, because all five of those positions are critical to their revenues and the financial health of those municipalities. Moreover, our licensing of them is not routine either. They are required to take courses in their field; they are required to take a test and pass it. It is a test that only about 50% of the applicants pass. We get many complaints about that, but it allows for a level of competence in our municipal offices that I think is perhaps more solid and dependable than in other states where they do not license officials.

Another thing we do in New Jersey is that once every three years, every municipality is required to come to the state, have their budget for that year reviewed before they adopt it, and if, when we review their budget, they have not appropriated funds for debt service, for their pension payment, or for some other sort of obligation—whatever it is that is legal—we tell them that they have to go back and amend their budget and cover those payments. And we look at their revenues, and if their revenues seem out of whack for what they are estimating for the year, we make them go back and reduce their revenues; we don't let them fudge the revenues. So at the front end, we don't have a lot of municipalities in New Jersey that reach the level of financial distress that occurs in some other states. Of course, every now and then, you are going to get a municipality that hits a level of financial distress. In New Jersey, a municipality is not permitted to borrow for operating expenses, generally, and it is required to have conforming maturity schedules where it pays down the principal in equal amounts over a period of time; it cannot have wildly back-loaded debt payments. But every now and then, if a municipality runs into trouble and needs to restructure its debt, maybe kick its payments out in the current year into later years while it is otherwise taking steps to recover financially, it can come to the Local Finance Board and ask for permission to do that, and sometimes we will give approval, but we will condition it. We may require the municipality to get our approval before it hires more staff, or we may make it take other steps as a condition for approval.

If it really starts running into a wall and has problems with its finances, New Jersey will assist. Over many, many years, in a bipartisan manner, with the state's most conservative governor, as we have today, and with liberal governors in the past, the state has always agreed it will be there for our cities or our rural or small towns if they have problems. We have in our budget this year $125 million to set aside in the event that we need to help bail out a municipality that needs financial assistance. It is discretionarily available if a municipality wants it; all the municipality has to do is admit it has a problem and come and apply for help. It is a standard application; we review the application, and if the municipality truly needs the money, we will help it. But there is a condition on the receipt of the funds. It is a two-way street, and we assign a monitor to the municipality, just as Michigan does. Our monitors have very broad control: there are no hires; there are no professional service contracts; there are no raises; there are no promotions; there are no exemptions from taxes and pilots in lieu of taxes, unless the monitor approves that. And we have professional monitors who have many, many years of experience in their field who look over those municipalities to make sure that they are taking steps to right their situation. And as a note of success, four years ago we had 22 municipalities that had some level of distress and that were receiving state funds. Today we have 10, and that has occurred over the same period of time that many states and municipalities have had trouble with their budgets.

Our monitors take a fairly hardline position with the municipalities to get them back on the right footing. In the case of the city of Camden, which is much smaller than Detroit but which has all the same problems Detroit has—contracts that were unsustainable, declining ratable base in its communities, and just dysfunction—we have been working with the mayor and have taken a number of steps over the last four years to improve the situation. Camden has a record surplus this year; it has completely eliminated its police force and replaced it with a much cheaper police force that is conducted at the county level and that can serve as a regional police force to gain efficiencies. The new police force has 400 police officers, as opposed to the approximately 270 that were in the old police force, and the amount of money that is spent on their salaries and benefits is the same amount today as it was several years ago. So through cooperative action with the state and the mayor working together, in addition to some financial assistance, the level of police services has improved and the price has stayed the same. The residents in Camden are getting better police protection services, and every major crime category in the city is down since the new police force was put in place. We have worked with the city to do things like outsource its old-debt collection. The courts had tens of millions of dollars in fees and fines that were owed by people, and the city was doing an awful job of collecting those old arrears, so we worked with the city to outsource their collection to a private company. The city gets 100 cents on every dollar for the fees and fines that they are owed that are collected, and the private vendor gets essentially a vig (charge) that is payable by the person who otherwise owes that fee and fine and has not been paying it.

We have done things in municipalities like Paterson where we have required them to raise their taxes or to increase their sewer fees or water fees so that they have self-liquidating utilities within their budgets. Those are the sorts of things we do in New Jersey both on the front-end regulation for municipalities, and on stepping up to help when municipalities really need help. Of course, we have, from time to time, a municipality that wants to put its head in the sand, not admit to having a problem, and not come in and apply for the help that is available. That usually happens in municipalities where the leadership is concerned about somebody looking over their shoulder for a variety of reasons, none of which are usually good. I had a mayor of Trenton, our state capital, who used to routinely yell at me every year and tell me we should not be looking over his shoulder and that he should be allowed out of oversight, and ultimately he went to jail. There are other municipalities that have not asked for oversight, and we do have the authority in New Jersey to forcibly place a municipality under supervision. It is something we do only as a last resort. Right now we only have one municipality that is under forcible supervision and that is Atlantic City, although they have a new mayor there who is working very well with us and trying to make improvements there. But in the future, we expect that there will be several more municipalities that come under supervision when they don't ask for help and just dig their hole deeper and deeper. And our interest is not just purely for the residents there, or for the bondholders, because we don't believe that is appropriate. We do it out of our own self-interest at the state level, because at the end of the day, we don't let our municipalities go bankrupt or default, and we don't want to have to step up at the plate with an astronomical bailout. If we can get our hands around a problem sooner rather than later, it minimizes our exposure as well as the exposure of bondholders and vendors and employees who have to worry about their pensions and benefits otherwise being cut. We think it is a benefit to all of our municipalities when we bail out the few that really need the help that our municipalities sometimes need.

Gregory Lipitz: Can you talk a little bit about Newark?

Thomas Neff: Newark is a municipality that from time to time has come to the state and has asked for assistance, and the state will give the city assistance and some oversight for a year or two. Then the city will not ask for assistance one year and they are released from oversight, and they go right back to the ways that got them into problems in the first place, and it becomes a never-ending cycle. And Newark right now is talked about in some places as being potentially the next Detroit. It won't be because we don't allow our municipalities to go bankrupt or walk away from their obligations, but it is a municipality with enormous problems. It has a $60 million structural annual budget problem and only a $200 million tax levy and a $600 million budget with all its sources of revenue. Newark also ended last year with a $30 million cash deficit on its books. So it has real problems. Unfortunately, Newark is one of those cities in New Jersey that has refused to come to the table under the new mayor, who has been there for about six months. They have been pretending for months and months that they don't have a problem with their budget. The mayor and others in the city tell us that everything is fine, that they don't need to ask for help, that we don't need to look over their shoulders or see what they are doing, that we don't need to work with them, they will be okay. But you really cannot lie when you are going to issue debt. So last week, they had to issue their offering statement, on which they have to tell you things materially that you would expect to know as bondholders. That offering statement admits to the $60 million hole in their budget; it admits to the $30 million deficit last year. So they have now hit a point where they have to acknowledge the extent of their problems. My guess is that at the end of the day, we will not forcibly place Newark under supervision, because they have finally "fessed up" to their problems and they know that they have no way out at this point. Next week, a new mayor will be elected in Newark, and my guess is that whoever that mayor is will come and ask for the state's assistance. The state will be happy to provide it, and again, it comes with the strings of some state oversight and working to make things better with them. We really do try and work with our municipalities and we have a very good relationship with them. I think the mayor of Camden, who is under our oversight and perhaps as closely as any municipality is, would tell you not that we have a hostile relationship, as perhaps exists in some places where there is oversight, but that it is a two-way street of providing assistance but also giving guidance and assistance to make sure they are adopting best practices to get their budgets back in shape, because at the end of the day, it is good for their residents, it is good for their local governing body, it is good for the State of New Jersey, and it is certainly good for its bondholders.

William Kannel: As a bankruptcy lawyer, I have two follow-up questions. We know that states control access to Chapter 9, and until 10, 15 years ago, there were either states that had statutes—said you could file Chapter 9—or states that were silent. And now we increasingly have what I call "gatekeeping statutes," where you have to run the gauntlet of this or that receiver or control board. Do those prevent bankruptcies or do they channel municipalities to bankruptcies?

Stephen Fehr: They are designed to prevent them. The one I would highlight is the one that they just set up in Rhode Island. I mentioned the receiver they had in Central Falls, where they appointed the receiver because they had a dire emergency. But in this new program, they have three levels, starting with a fiscal overseer. First they monitor the city, they appoint a fiscal overseer to try to get things back on track. If that does not work, they do a five-member budget commission to do essentially the same thing. If all else fails, then they appoint a receiver. The whole goal of that is to prevent bankruptcy, which is the ultimate stigma, and nobody wants to do that. Pennsylvania fought very hard to avoid that in Harrisburg. Michigan, aside from Detroit, has tried to avoid it in its other cities.

Thomas Neff: I would add that it would depend on who is exercising the oversight in a particular state. In New Jersey, we have a long tradition of believing bankruptcy is inappropriate, and although I am a lawyer, the first thing I tell a municipality when they come to us and start making noise about bankruptcy is: “Go fire your bankruptcy advisors and attorneys, because we are not going to let you do it and you are wasting your money.” In New Jersey, we don’t get to a point where we have a level of fiscal distress that reaches a crisis level, but it may be appropriate in other states where perhaps they let the level of fiscal distress get to a point where bankruptcy might sadly be the only option. I guess it would depend on how effective the state is in heading off the need for bankruptcy and what its inclination is. In New Jersey, there is just no appetite for it at all.

Gregory Lipitz: At Moody’s, we did a survey of the states with oversight. It was around the time that Detroit declared bankruptcy, and we had to reevaluate Michigan, which had both an institutional statutory framework for dealing with local governments in distress and a very long history. And when Detroit went bankrupt, we ultimately had to reassess our opinion about Michigan. The takeaway lesson for us was that even states with the strongest levels of oversight, with long histories of preventing bankruptcies, can stumble, and there is no guarantee of a default or of bankruptcy, but some states are better than others at effectively managing their oversight.

William Kannel: Another version of one of these gatekeeping statutes is AB 506 in California, which, like the bankruptcy code itself, requires some period of pre-filing negotiation. Apart from causing a bunch of bankruptcy lawyers to sit around a conference table, which I have less of a problem with than Tom has, is something like that a good idea, does that achieve anything?

Stephen Fehr: You are talking about the mediator. I have read that that accelerates bankruptcy, but we have not studied it to really comment one way or the other. I do want to say, though, that the Moody’s report on state intervention that Greg references, which came out in September, is a terrific, very exhaustive report. I would also say we have not talked much about North Carolina, which like New Jersey also has a very strong monitoring system. But the state just had a stumble, as Greg pointed out to me, in a town called Salisbury, where it was an enterprise situation with a fiber optic network. Salisbury just got a downgrade, although the whole goal in North Carolina is to avoid those kinds of downgrades. Generally speaking, though, North Carolina municipalities are rated higher than other states, and they often credit this strong state oversight as the reason.

Thomas Neff: I would add that if, at the end of the day, the entity that is at the table facilitating discussions has a "hammer," it certainly makes those discussions a lot more productive and makes it less likely that you are going to move toward bankruptcy. In New Jersey, I can tell you that we have been having weekly discussions with the professional staff in the city of Newark, and we have been warning them every step of the way. We ask them what they are doing to correct their problems, and what we can do to help. And at the end of the day, they have heard very clearly from the state that if they don't move forward and fix their problems, they will be placed under supervision. And those same people who are at the table in those discussions are the people who, if they do not perform, could be the ones who are terminated by the state. So there is an incentive to fix things when they are at the table having these discussions, and gradually they do come around. I don't have personal experience in other states, but I would suspect that where you have discussions at a table and there is no hammer, no threat at the end of the day, maybe bankruptcy is the threat or hammer, so if those discussions go poorly, maybe that is the realistic solution. But that is not our case; we do have the ability to exercise other alternatives.

Gregory Lipitz: I want to talk about AB 506 for a second because I think the intention of the statute was not to facilitate bankruptcy; getting into bankruptcy is hard enough, and one of the criteria is that you have to have good faith negotiations with all of your creditors. An unintended consequence of the requirement that people have to negotiate in good faith—and if you have done that and there is no outcome because the hammer is bankruptcy and you have intransigent parties on both sides—is that you have already checked off one of the major criteria on the list, and in effect you could facilitate more bankruptcies. We have not seen that. The city of San Bernardino declared bankruptcy soon after Stockton, but it went right into fiscal emergency and declared bankruptcy, which was subsequently upheld. I don't know if that is a commentary on the other California credits, but we have seen so far only two that have gone into bankruptcy since Stockton.

I want to switch gears a little here and talk about bankruptcy. And one of the big issues for investors is the meaning of a GO pledge. And so I will just ask: Is a GO pledge secured or unsecured?

BANKRUPTCY, THE GO PLEDGE, AND PENSIONS: WILLIAM KANNEL

Asking if a GO pledge is secured or unsecured is like asking if a loan is secured or unsecured. You have to work through the definitions. The bankruptcy code defines a secured claim as an allowed claim of a creditor, secured by a lien on property in which the bankruptcy estate (although in Chapter 9, there really isn't a bankruptcy estate) has an interest. Then you have to look at the definition of lien in the bankruptcy code, which is "a charge against or interest in property to secure payment of the debt or performance of an obligation." For the most part, people know that when they see it; there is surprisingly little case law on when there is a lien and when there is not. There is a lot of case law on the value of a lien, whether a lien is properly perfected, what assets a lien may attach to, and the relative priority of different secured creditors in the same assets, but as to whether something is a lien or not, there is actually very little case law out there. I think that is for the most part because it is like that famous Justice Potter Stewart definition of pornography: "You know it when you see it." If you think about what a lien is, it is if I lend Greg money, he promises to pay it back, and if he doesn't, I can go sell his house. That is a lien. And things that are different from that start to confuse bankruptcy lawyers and bankruptcy judges, because they do not fit into the category they typically see in Chapter 11.

Gregory Lipitz: What about the full faith and credit pledge?

William Kannel: What would most bankruptcy lawyers think about a full faith and credit pledge? Well, the glib answer is that it depends on whom they are representing, but the honest answer is that it is a pledge in and of itself, which is not a lien, which is not an interest in property, it is just a promise to pay. I am a Chapter 11 debtor, I buy paperclips, I promise to pay for them in net 30 days—that is an unsecured claim. If I promise to raise taxes sufficient to pay for them, that is—for most bankruptcy lawyers and bankruptcy judges—an unadorned full faith and credit pledge without a specific interest in property, probably an unsecured claim. Where it starts to get confusing and to be something more than that is where you have property that has been raised and is only there to pay you and cannot be used for anything else. And then I think you start to get to an interest in property that secures the payment of a debt. Even if maybe you don't have the next step where you don't pay me, I get to liquidate it.

Gregory Lipitz: I want to switch gears a little but still stay within the bankruptcy realm, and ask about pensions, which are a very hot topic now, given what is happening in Stockton, where CalPERS is sort of being left aside in the plan of adjustment, and Detroit, where the court, in its decision to allow the city into bankruptcy, seems to have made very clear that pensions are a contract and contracts can be modified. What do you think most bankruptcy lawyers would say about pensions versus debt? Who has the senior priority in that situation?

William Kannel: Again, the glib answer is, it is whoever has the senior priority. But actually, there are very few flavors of debt in bankruptcy. There is secured debt; there is administrative debt; there is debt that the bankruptcy code otherwise gives some sort of priority to, regardless of when it arises; there is unsecured debt; and then there is equity, which really is not debt. Secured debt has the first right to the collateral in which it has a lien. To the extent there is a deficiency—and there are some exceptions to the rule—you have an unsecured claim. Unless there is a lien securing the pension debt, or unless there is a lien securing the bond debt, they are both unsecured debt in the eyes of a bankruptcy judge. That is basically the way bankruptcy lawyers and bankruptcy judges see the world. And the general rule is that unsecured debt should generally be treated the same in bankruptcy.

Gregory Lipitz: Eventually, this period in which Detroit and San Bernardino and Stockton are in bankruptcy, is going to end. We are going to move, we hope, to a more prosperous time, and we hope we will see fewer defaults and bankruptcies in the municipal space. But when all is said and done, we have had the benefit of hindsight. Do you think we can draw any broad conclusions about Chapter 9 and municipal bankruptcy, and if so, what would those broad conclusions be?

William Kannel: I think there are several conclusions we can draw right now. The first two are almost contradictory. What is unique about Chapter 9 is it really exists along a fulcrum that Chapter 11 does not. It seems to exist at the intersection of three constitutional provisions: the first is the supremacy of federal law; the second is the bankruptcy clause, which is that only the federal government makes bankruptcy law; and the third is the Tenth Amendment, which says if it is not a power that is given to the federal government, it is reserved by the state. As a result, we have Chapter 9, which has very specific limitations on what a federal bankruptcy judge can do with a municipality, starting with the fact that the bankruptcy option is available only for municipalities in a state that allows Chapter 9 to be available. There are also restrictions on the jurisdiction of the court, and restrictions on the extent to which the court or creditors can reach into and affect how the municipality spends its revenues. I have heard many bankruptcy judges and other bankruptcy professionals say that the court's only job in Chapter 9 is to determine at the beginning whether the debtor is eligible to file Chapter 9 and at the end whether there is a confirmable plan of adjustment. Despite that, these cases have been incredibly litigious, much more litigious than we would have thought, whether we are discussing Jefferson County, which was really just the water and sewer debt; Stockton, where there was a big eligibility battle; Detroit, where there was also an eligibility battle, although that was waged only by the pensions and labor—the capital markets stepped out of that battle—and we are yet to see the confirmation battles in Stockton, which start next week, and in Detroit, which start presumably at the end of July. I think the reason that has happened is that people are concerned about precedents that are going to be set and there are any number of huge players. We have been involved in the case since July, and I cannot tell you, because I cannot count that high, how many various retiree and labor groups there are at the table in Detroit. There are many parties, and things are very politically driven. And we are not dealing with a corporate debtor with a board of directors or a chief restructuring officer (CRO), which is bankruptcy—I know Kevin Orr exists, but the mayor is there, the city council is there, the labor unions are there, all of whom may have very different agendas and who are not pulling in the same direction. So it makes it a very complicated and multidimensional chess game at every level. At the end of the day, I think you are going to be able to draw the conclusions that these are very politically driven, and I think to the extent there is precedent that allows certain types of debt to be impaired, they will be an attractive target for other municipalities. That said, I don't think there is going to be a huge tidal wave of Chapter 9s. But I think it may be more surgically used in the future than it was in the past.

Thomas Neff: It seems to me that bankruptcy is unnecessary when other alternatives are available. For municipalities that refuse to put those alternatives in place, I hope that people who are rating bonds, who are advising people on whose bonds to buy, look to places like New Jersey and give it some benefit of the doubt in terms of those ratings and interest rates that are charged, because there are ways to protect bondholders and the people who live and work in cities without resorting to something as volatile, unpredictable, and expensive as a bankruptcy.

William Kannel: If entities identify their problems early and monitor them aggressively, there is generally no need to have a bankruptcy proceeding. And the best bankruptcy proceedings, whether Chapter 11 or Chapter 9, are ones where the problems have been identified early and the solutions have been negotiated early. I don't think we are yet there in the context of Chapter 9, where you would see a pre-packaged Chapter 9.

Stephen Fehr: One of the things that stood out when we did our research was that most states react; they are not proactive, they react to crisis. The whole thrust of monitoring is to be proactive, to spot problems before they get worse. And what we mean by monitoring is that the municipality reports its fiscal condition to the state in some way, and the state looks at it and says: "You are headed for trouble, let's work on it"; and sometimes the state offers technical advice, but it tries to head off crisis. Strong monitoring is a way to proactively tackle this.

Gregory Lipitz: As part of our analysis, we found that the states we labeled as having strong oversight all had some form of monitoring.

QUESTIONS AND ANSWERS

Question: I Didn't Hear Illinois, Chicago, or Chicago Board of Education Mentioned in This Panel. What Is the Right Way to Think About a State with a Constitution That Is Protecting Both Types of Debt?

William Kannel: Most bankruptcy lawyers will tell you that the provision in the Michigan constitution that gave pensions the sanctity of a contract did not do much for those pensions. The bankruptcy law divides the world into property interests, the most common of which is a security interest or other lien, and contractual rights. Contractual rights can be impaired in bankruptcy. There would be very little purpose in filing for bankruptcy if you had to pay everybody what you owed them. I am not exceedingly familiar with the provisions in Illinois regarding pensions. If they actually create a property interest, then it is going to be tough to adjust those pensions in bankruptcy. If they create a contractual interest, they are just like any contractual claim, like the guy who sold you paperclips.

Question: Why Should a Municipality Be Protected from Its Mistakes? If Bankruptcy Is the Right Decision, Why Not Just Get to It and Resolve the Problem Quickly?

Thomas Neff: It is not just the people who live in that municipality and who perhaps foolishly allowed bad people to run their cities through the democratic process who are affected. You have public employees who work in these places who may not live there, and it may not have been their fault that some knucklehead was elected and let the place get run into the ground. And there are spillover effects. If a municipality goes down the tubes, the neighboring municipalities may have to deal with the impacts of that, whether it is a spillover of crime when the distressed municipality cannot pay for its police force, when areas become blighted and that blight spreads across political boundaries. And it affects other taxpayers as well who may be far away. I believe that when Detroit was allowed to declare bankruptcy, it sent a signal that perhaps there could be other municipalities in Michigan that would be allowed to go bankrupt, and maybe the bondholders there are not secure; perhaps there could be a default. And the next time another municipality in Michigan sells debt, it may pay a little bit more of a premium than it otherwise would pay to go to debt. So perhaps there is an interest in all the taxpayers in Michigan making sure Detroit does not otherwise affect their finances, and that would particularly be true of similarly situated challenged municipalities that may be doing everything they can to turn around a situation that may not be of their own making.

In New Jersey, we have Atlantic City. I would argue that the problems in Atlantic City are not so much the officials' faults who live in Atlantic City or the people who happen to reside there, it is just aggressive casino competition that otherwise drained resources out of the city that was relying on casino work. It happened relatively quickly, and it is not their fault. So the state has an obligation to be helpful to the extent it can be and to try and right things there. Because if it does not, the surrounding communities that are not encompassed within the city's political boundaries are going to feel the impacts of that as well. If Atlantic City has to go into bankruptcy, it will also affect people who don't live there; it will affect the surrounding communities. I share that gut reaction sometimes when I am dealing with a difficult mayor or a council, and I momentarily think they don't deserve the help, they don't deserve to be bailed out, they don't deserve the special treatment. But you have to keep that in check and take a deep breath and realize that if we let them suffer, other people are going to suffer as well.

William Kannel: If I am representing creditors, one of the fundamental decisions I make, and it can evolve over the course of a workout, is whether we go to remedies immediately or whether we "delay and pray." And the results can be different, depending on what you do. Sometimes hiring lawyers and pursuing remedies right away is the wrong thing to do. Sometimes entering into forbearance agreements with triggers is the right thing to do. Sometimes you will go through a year or two of doing that and then conclude that you just wasted a year or two. Your strategy evolves and you have to be flexible in your thinking. From the debtor's side, the obligor's side, there is nothing more painful—or expensive, frankly—than what is termed a "free-fall bankruptcy." You get a call from a client who says: "I may have trouble making payroll Thursday." You hate those calls, because there is not much you can do. While getting out in front of it for a period of time is generally helpful, you can end up coming to the conclusion that you should have pulled the plug a year ago. It is almost entirely fact-specific.

Question: Are the Detroit Unlimited Tax GO Bonds (UTGOs) That Are Voter Approved for Only That Purpose a Statutory Lien? Could That Stop the Plan from Being Confirmed on Appeal, Simply Because It Is in Violation of State Law?

William Kannel: I want to be careful about talking about Detroit in specifics, because we are involved in the case. Bankruptcy judges favor settlements. People generally know what their arguments are, even in an area that is not clear. For example, are these UTGOs secured or not secured?

My guess about what ultimately drove that settlement, and I am parroting what Kevin Orr has said publicly, is that the city would have risked losing the millage if they had treated the UTGOs as unsecured.

Question: Is the Provision of the Code, Section 903, That You Cannot Divert Revenues from Their Statutory Purposes and That You Cannot Violate Specific State Law?

William Kannel: I will give you a couple of different answers to that question. Section 903 basically says that the court cannot interfere with a state's ability to control its municipalities. That is different from saying state law in all instances trumps bankruptcy law. In Vallejo, the unions came in and said: "Hey, I know there's this provision in the bankruptcy code that allows you to reject my collective bargaining agreement, but to get out of collective bargaining agreements under California law you have to jump through all these hoops." And the court said, no. With regard to bankruptcy law and things that are typically driven by bankruptcy law, such as rejection of contracts, section 365 of the bankruptcy code, one of the Bankruptcy Code sections incorporated into Chapter 9, the bankruptcy law controls. You think about it in the context of Judge Rhodes' decisions on eligibility—I mean what better state law is there than the state constitution that says you cannot mess around with pension debt? But Judge Rhodes said, no, you can mess around with pension debt. So 903 does not provide that state law always trumps bankruptcy law. Bankruptcy law often incorporates state law, such as state definitions of what a lien is. That is incorporated into bankruptcy law. With regard to the distinction between property interests and contractual interests, bankruptcy honors state property interests, for the most part, because the Fifth Amendment protects property interests. So bankruptcy law generally protects state property interests as opposed to contractual interests.

Gregory Lipitz: One of the arguments that CalPERS is raising in Stockton is that 903 exempts them from bankruptcy court jurisdiction because they are an agent of the state. How do you think that dovetails with Judge Rhodes' decision in Detroit and Judge Klein's decision in Vallejo?

William Kannel: Let me put it this way, we had the trustee in Stockton. CalPERS has a lot of arguments that it thinks it has.

Question: How Does New Jersey Feel About the Size of the Bond Anticipation Note Market in the State and the Risk It Poses as a Market Access Instrument? Would the State Ever Step in If There Were a Large Number of Failed Bids?

Thomas Neff: The short answer is we are concerned about it. There are a lot of one-year notes that are issued in New Jersey, bond anticipation notes and tax anticipation notes as well—we know we are probably an outlier compared to other states. There are a couple of things we are doing in New Jersey. One is that the state has stepped in from time to time to help a municipality with a bond anticipation note (BAN) that they may have trouble rolling over. We had a municipality, Collingswood, with a relatively small $3 million BAN that was coming due, and the municipality had been downgraded to junk bond status for a particular reason, which made it difficult for them to get market access, and they did not otherwise have funds on hand to make good on the BAN when it came due without being able to roll it over. So the state stepped in and provided a short-term bridge loan for them of three or six months until they could permanently finance their BAN. In the interim, they entered a program we have in New Jersey called the Qualified Bond Act Program, where a municipality can pledge away the aid that it otherwise receives from the state to back its long-term debt. Collingswood entered that program while it was in the bridge loan period, and that gave the market confidence that if Collingswood had an issue, they would otherwise have access to the long-term market. They went to long-term debt and converted their BAN accordingly.

The other thing we are doing in New Jersey to try and address the issue is that because the state cannot always be the deep pocket to bail out a municipality if it has a BAN problem, we have gone to municipalities that otherwise have very severe restrictions on where they can invest and have allowed them to purchase the BANs or TANs of other municipalities if they have the funds. It gets them a better interest rate than if they put their money in a bank, and the municipalities whose BANs they purchase may get a lower interest rate than they would get from the marketplace. We don't encourage that all the time, but at the state level, we have been working with municipalities that are on the wealthier side, and we have been keeping track of who would like to purchase other municipalities' BANs. So when there is a problem with a BAN rollover, the state may step in to some extent, and other municipalities that have the funds to help may also make short-term loans to help bridge the time until permanent financing is available.