

2012 CREDIT OUTLOOK:

Issuers' finances begin to stabilize, but lower quality issuers continue to struggle. Expect municipal insolvency reforms.

December 2011

The municipal market enters 2012 on a note of cautious optimism. Municipal defaults remained extremely rare in 2011, and credit fundamentals have stabilized for many state and local governments. Most issuers continue to prioritize bondholders while restructuring employee benefits and other government functions.

However, weak issuers remain pressured. They are vulnerable to continued economic stagnation, impending pension-accounting rule changes, legal challenges to pension reforms, and issuers' decreased willingness to honor non-essential, "problem" debts.

The pressure on lower quality issuers suggests additional municipal defaults and ratings downgrades over the next several years. It also portends municipal insolvency reforms to clarify whether – and how – severely distressed issuers can restructure bonded debts.

In this *Special Commentary*, we highlight the generalized improvement in municipal credit fundamentals, and note the risks ahead for weaker issuers. We also discuss the variety of ways states may seek to unwind chronically distressed governments.

STABLE CREDIT ENVIRONMENT

State and local credit fundamentals were stable entering 2012.

Payment defaults fell in 2011 to \$2.1 billion from \$2.8 billion in 2010.¹

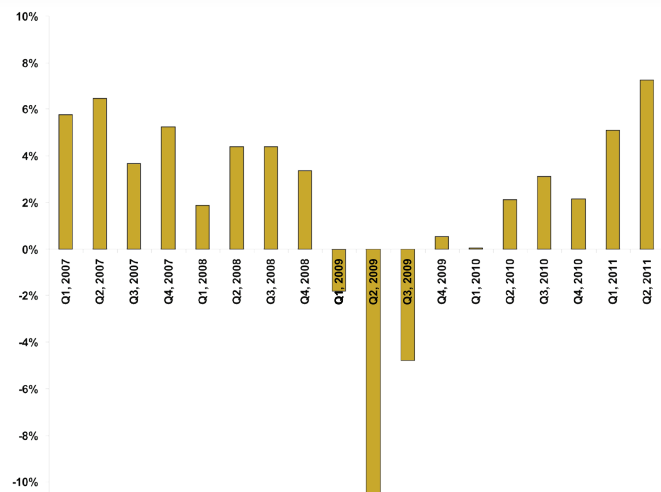
State and local tax collections continue to recover (see graph at right), and city finance officers report improved ability to meet financial obligations.²

State and local debt levels continue to drop, including outstanding short-term debt. This suggests that municipal governments continue to avoid "rolling over" debt to finance operating deficits.³

Tax aversion also appears to be waning. Washington State lawmakers are considering a sales tax increase.⁴ New York State recently passed a tax reform that increases annual revenue by \$1.9 billion,⁵ and California voters support the Governor's proposal to increase sales and income taxes.⁶

STATE & LOCAL TAX REVENUES ARE RECOVERING

Source: U.S. Census Bureau, December 2011



Pension reform is now ubiquitous. In 2011, 18 states increased employee-contribution requirements for pension benefits, 15 increased the age and service requirements to become eligible to receive a pension, and 12 reduced the cost-of-living increases built into pension benefits.⁷ Changes at the local level have also been commonplace.⁸ These changes are in *addition* to reforms enacted in 2009 and 2010.

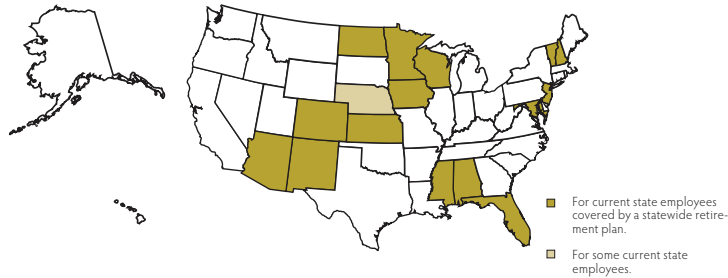
Importantly, states have prioritized bondholders while restructuring employee-related liabilities and other government programs. In Rhode Island, lawmakers granted bondholders a priority lien in municipal tax revenue while enacting broad-based pension reforms. In Michigan, a new state law designed to "protect the credit of the state and its political subdivisions" empowers state-appointed receivers to rewrite unsustainable collective bargaining agreements.⁹ In California, a new municipal bankruptcy process reduces the

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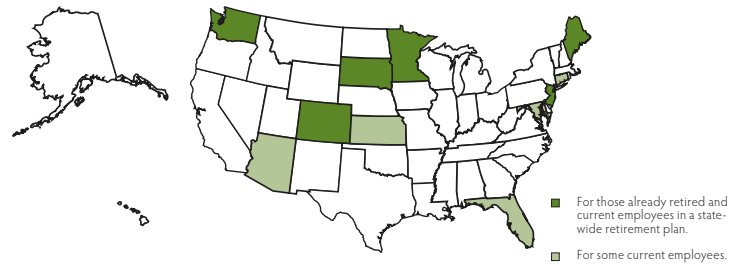
PENSION REFORM, 2011

Source: New York Times, December 6, 2011 based on data from National Conference of State Legislatures.

INCREASED CONTRIBUTIONS: 18 STATES



REDUCED COST-OF-LIVING ADJUSTMENT: 12 STATES



risk of bond defaults and increases the likelihood that labor contracts are renegotiated outside of Chapter 9.¹⁰

Policymakers continue to prioritize bondholders because principal and interest costs remain modest and predictable and because bonds finance essential and popularly supported, jobs-producing infrastructure projects.¹¹ Politicians, taxpayers, public employees, and trade unions continue to benefit far more from maintaining vital market access than from defaulting on bonds.¹²

WEAK ISSUERS REMAIN VULNERABLE

The market's overall stability masks concentrated weaknesses in specific issuers. These issuers are disproportionately affected by still-declining home prices,

vulnerability to external shocks, changes to pension accounting rules, legal challenges to reforms, and a heightened unwillingness by some issuers to meet non-essential financial obligations.

CHRONICALLY STRUGGLING ISSUERS REMAIN RISKIER INVESTMENTS

The table below illustrates that there is justified concern that chronically distressed issuers may default. Today's distressed issuers are sufficiently similar to Depression-era defaulters to suggest an *uptick* in defaults and ratings downgrades. Distress among lower quality issuers also portends municipal insolvency reforms to clarify whether – and how – severely distressed issuers can restructure bonded debts.

FACTORS CONTRIBUTING TO DEFAULTS IN 1930'S ARE LESS PREVALENT TODAY EXCEPT AMONG SOME CHRONICALLY DISTRESSED LOCAL ISSUERS		GREAT DEPRESSION		GREAT RECESSION	
		Common for Issuer in Default	Chronically Distressed Issuer	High Investment - Grade Issuer	
Macroeconomic Factors					
	Significant declines in income and wealth	1	1	1	
	Numerous bank failures	1	2	2	
	Large, unexpected decline in revenues	1	1	1	
	Large, unexpected increase in municipal outlays for social services	1	4	4	
	Rampant tax delinquencies	1	3	4	
Management Practices					
	Ignoring real estate overdevelopment	1	1	1	
	Running operating deficits in prosperous years	1	2	3	
	Allowing debt service expenses to rise	1	2	3	
	Issuing debt with poor financial controls and disclosure	1	2	3	
	Slowly taking action to cut spending	1	2	4	
	Issuing short term debt to finance operating deficits	1	2	3	
	Strong legal protections for labor	3	1	2	
	Issuing debt under lax legal structure	1	4	4	
Financial Characteristics					
	High servicing costs	1	2	3	
	Large debt burden	1	2	3	
	Intergovernmental aid comprises significant portion of budget	4	1	2	

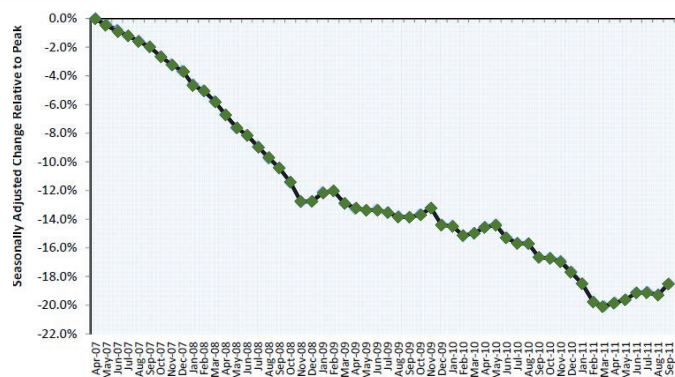
1 = Accurate description; 2 = Mostly accurate description; 3 = Describes some issuers; 4 = Inaccurate description

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DECLINING HOME PRICES

Chief among the challenges facing lower quality issuers is the still-deteriorating real estate market. Real estate assessments lag market prices by two years,¹³ and for many issuers, federal stimulus revenue has tempered local revenue declines until now. According to the latest Case-Shiller data, prices are still falling in most metropolitan areas.¹⁴

% CHANGE IN SINGLE FAMILY HOME PRICES (U.S.) Cumulative price change from peak, seasonally adjusted



EXTERNAL SHOCKS

Lower quality issuers also remain vulnerable to macroeconomic challenges. In the next 24 months, local governments might face another unexpected revenue drop as a result of federal budget cuts or events in Europe.

Tepid stock market growth may also harm weak issuers, which often manage pension plans that assume 8% annualized returns. Each year of less-than-8% returns requires higher pension contributions in future budgets.

BURDENSOME PENSION ACCOUNTING RULES & LEGAL CHALLENGES

New pension-accounting rules will disproportionately squeeze weak local governments. Beginning in July 2013, the Government Accounting Standards Board (GASB) will require more conservative measurement of unfunded pension liabilities.¹⁵ The change will increase recommended pension contributions for governments with poorly funded plans.

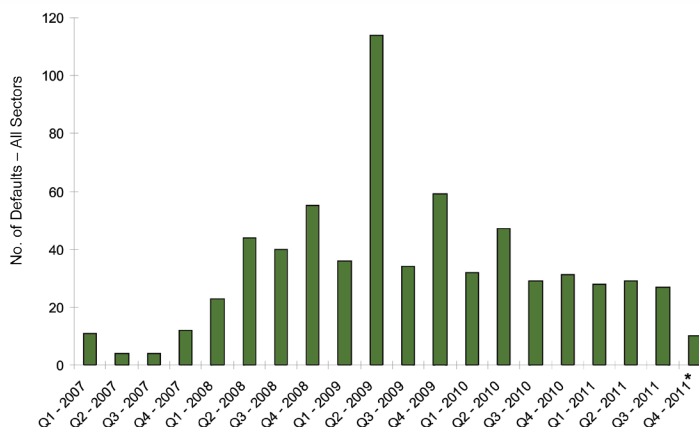
Legal impediments to pension reforms may also negatively impact weak issuers. Reform laws have been challenged in Rhode Island, New Jersey, Florida, New York, and Illinois, among other states.¹⁶ Many local issuers face similar lawsuits.¹⁷

REDUCED WILLINGNESS TO PAY FOR "PROBLEM" DEBT

Perhaps the most important market trend is a slight but noticeable change in issuers' willingness to meet non-essential financial obligations. During 2011, there was a modest uptick in non-monetary defaults,¹⁸ and a handful of issuers refused to honor poorly secured bonds for non-essential projects. These include Harrisburg, PA, Menasha, WI, Moberly, MO, and Wenatchee, WA, among others.

MUNICIPAL DEFAULTS REMAIN RARE BUT ARE MORE FREQUENT THAN PRIOR TO THE RECESSION

Source: Distressed Debt Securities Newsletter, November 2011



* Through November 21, 2011. Figures include "technical defaults" which occur when timely principal and interest payments are made but the issuer breaches other indenture covenants.

In each case, there was at least an implied pledge to pay bondholders if a designated revenue stream proved insufficient to cover principal and interest payments. However, tight budgets made payment unpalatable to taxpayers, especially since the bonds financed speculative projects that were unessential to the government's core functions.¹⁹

Breckinridge has always avoided these kinds of bonds precisely because of their non-essentiality and weak security. The uptick in issuers' unwillingness to honor these debts is consistent with past recessions.

Still, any increase in unwillingness-to-pay is an unwelcome development that warrants monitoring. Though very unlikely, issuers' unwillingness to pay poorly secured, non-essential debts could transform into an unwillingness to pay more essential obligations. Such a transformation will manifest itself in lower-quality issuers first.

REORGANIZING CHRONICALLY DISTRESSED ISSUERS

The stable credit outlook for most municipal issuers, combined with the shakier financial status of lower quality issuers, tight state budgets, and the recent uptick in issuers' unwillingness to pay non-essential debts, creates incentives for states to clarify and revise municipal distress and insolvency laws. Municipal investors remain uncertain how their bonds will be treated when local governments fail. Some even believe solvent governments will fail to pay their debts. Clearer rules can enhance investor confidence and ensure that creditworthy issuers retain access to affordable capital.

Below we briefly summarize the rules governing municipal insolvency and debt impairment, highlight insolvency reform approaches from previous recessions, and describe possible reforms for future years.

A VERY BRIEF REVIEW OF THE RULES

Municipal insolvency and debt impairment is governed by a mix of state and federal law. States control how municipal contracts may be impaired, including those for bonds.²⁰ Generally, impairment is accomplished in one of three ways: by empowering municipalities to file for Chapter 9 of the bankruptcy code, by taking advantage of pre-existing municipal distress procedures, or through emergency legislation.²¹

In all cases, impairment is permitted *only* in an extreme “financial emergency.” A municipality must face unanticipated, imminent financial collapse *and* no alternative to default.²²

The same insolvency and impairment rules apply to states, except that states cannot avail themselves of the bankruptcy court and no state has a formal, pre-existing procedure for restructuring itself.²³ A default by a state would likely be resolved through emergency legislation or federal intervention.

REFORMS REFLECT THE ISSUES OF THEIR TIME

Historically, municipal insolvency reform laws reflect immediate state needs. Approaches vary depending on whether municipal distress is systemic or concentrated. Reforms often seek to cordon off problem issuers from creditworthy issuers, and problem debts from manageable debts.

During the Great Depression, municipal distress was widespread and driven by overwhelming bonded debts. States lobbied Congress to create Chapter 9 of the bankruptcy code²⁴ because, at the time, it was believed impossible for states to restructure bond contracts outside of federal bankruptcy court.²⁵ A generalized, federal approach to unwinding distressed municipalities made sense.

In the 1970s, municipal distress was less widespread and its causes were multifaceted. Pension liabilities, labor contracts, and social insurance obligations also contributed to the era’s municipal calamities. During the 1970s, most municipalities restructured outside of Chapter 9.²⁶ Defaults in New York City and Cleveland, Ohio were cured by state intervention.

In the early 1990s, municipal distress was again concentrated. Several Northeastern manufacturing communities became economic backwaters. States like Connecticut and Massachusetts enacted municipal insolvency rules to resolve distress on a case-by-case basis.²⁷

Last year, three states (Michigan, Rhode Island, and California) enacted new municipal insolvency legislation and one (Indiana) considered it. The legislation generally reflected the character of each state’s municipal distress. For example, Michigan lawmakers created a process that puts collective bargaining agreements at risk and implies (though does not guarantee) that bonds are prioritized.²⁸ In Michigan, labor contracts are the prime reason for municipal distress but bonded debt is also high in some places. In contrast, Rhode Island’s new municipal insolvency law explicitly protects bondholders. There, debt levels are modest even among issuers with severely strained local budgets.²⁹

POSSIBLE REFORMS

Going forward, states’ municipal insolvency reforms are likely to fall into several categories: (1) statutory liens, (2) clarified “intercept protections,” (3) stronger

municipal monitoring, (4) the creation of “pension boards,” or (5) amendments to Chapter 9 of the bankruptcy code. We examine each below.

Statutory liens

Where municipal distress arises for a reason other than overwhelming bonded debts, statutory liens can help restore financial integrity. Statutory liens protect bonds from impairment inside or outside of bankruptcy.³⁰ They are exempt from the automatic stay in a Chapter 9.

Rhode Island lawmakers created a statutory lien in favor of bondholders prior to Central Falls’ August 2011 bankruptcy filing. Rhode Island’s municipalities exhibit modest debt burdens but enormous employee-related obligations. Placing a statutory lien on local issuers’ bonds preserved Rhode Island issuers’ ability to borrow for vital capital projects while forcing issuers to focus on their employee-related liabilities.

Clarified Intercept Programs

Another solution for states with widespread municipal distress but modest bonded debt burdens is to clarify that state intercept programs will be honored. State intercept programs guarantee, or partially guarantee, payment to bondholders in the event of financial distress. States promise to withhold state aid payments owed to a defaulting local government and redirect them to bondholders.

Presently, investors are unsure whether states will follow through on intercept pledges. Few intercept programs have been tested, and the Vallejo, CA bankruptcy case suggested that poorly designed programs might not be honored.³¹

Strengthened Municipal Monitoring

States that exhibit disseminated municipal distress may benefit from strengthening their municipal oversight regimes. Strong state oversight has been directly linked to lower borrowing costs by credit analysts.³² Michigan’s new Emergency Financial Manager law is a strong form of municipal oversight. Pennsylvania’s Act 47 program is a bit weaker. Most states have some sort of distress and oversight regime. Modest increases in program staff size and more frequent monitoring is likely to help prevent struggling issuers from becoming more distressed.

Pension Authorities

Where pension debts are drowning many municipal governments, states may have incentives to establish “pension authorities.” Pension authorities are the brainchild of an oft-cited municipal bankruptcy expert, James Spiotto.³³

Pension authorities could be created by state or federal law. They would serve as neutral arbiters to determine whether a government’s pension stress requires restructuring. To the extent restructuring was needed, the quasi-judicial panel would determine the size of the restructuring and any revenue enhancements.³⁴

Pension authorities might additionally authorize the use of pension fund assets to purchase the bonds of their host governments. Philadelphia’s pension funds purchased that city’s bonds during its 1991 financial crisis.³⁵ New York City’s pension funds did the same in 1975.³⁶ These investments can generate capital gains.³⁷

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Municipal Bankruptcy Amendments

If severe municipal financial distress metastasizes over the next several years, there may be interest in reforming Chapter 9 of the bankruptcy code. This scenario is unlikely insofar as today's politicians, taxpayers, and unions appear inclined to address their fiscal problems without the assistance of unaccountable federal judges. Still, possible reforms include:

- **More protection for GOs.** Given the modest bonded debt levels in the states, the most likely Chapter 9 reform would be to make explicit the seniority of the general obligation bonds in bankruptcy. This would comport with long-standing market expectations that general obligation bonds are the gold standard investment in municipal finance and with the law in several states. The National Bankruptcy Review Commission supported such an approach as recently as 1997.³⁸
- **Clarify revenue bond treatment.** Congress might also seek to clarify the seniority of revenue bonds in Chapter 9. The Jefferson County, Alabama filing unsettled some observers because the County sought to remove a court-appointed receiver and interrupt payments to sewer warrant holders. The market had long believed that receivers rights would be honored in Chapter 9 and that revenue bond payments were unaffected by municipal bankruptcy.³⁹
- **Enhanced protections for municipal employees.** If a wave of municipal bankruptcies ensued and public employees' retirement benefits and salaries

were systematically reduced across the country, Congress and voters might seek to enact new Chapter 9 protections for public pensions and labor contracts. Presently, it is easier to abrogate labor contracts in Chapter 9 than in Chapter 11.⁴⁰

- **Empower Chapter 9 judges.** Under Chapter 9, judges have limited power to impose higher taxes, spending cuts, or asset sales on municipalities. The Constitution generally prohibits the federal government (including its bankruptcy courts) from interfering with state and local fiscal decisions.⁴¹

However, the federal governments' authority to circumscribe states and local fiscal autonomy has grown since the 1930s. Modern Constitutional law likely permits more powerful Chapter 9 judges.⁴²

CONCLUSION

Brekinridge continues to anticipate a modest uptick in municipal defaults in 2012 and beyond. While the overwhelming majority of high investment grade credits exhibit stable credit fundamentals entering 2012, lower quality credits continue to struggle. Chronically distressed issuers are more vulnerable to economic downturns, impending accounting rule changes, and horizontal movement in the stock market. States may seek to address the needs of severely distressed issuers through new municipal insolvency laws.

¹ See "Municipal Defaults May Surpass Record in 2011, Lehmann Says," Bloomberg Businessweek, December 7, 2011. Available at: <http://www.businessweek.com/news/2011-12-07/municipal-defaults-may-surpass-record-in-2011-lehmann-says.html>.

² See City Fiscal Conditions in 2011, National League of Cities, p. 2, September 2011.

³ See Federal Reserve Flow of Funds data, Table L. 211, December 8, 2011. State and local debt fell from over 20% of GDP in 2010 to roughly 19% in 2011. Outstanding state and local debt declined by \$64 billion between Q4 2010 and Q3 2011. Short-term debt fell from 1.7% of the market in 2009 to 1.3% in 2011.

⁴ See William Yardley, "Washington State Democrats Hope voters Have New Attitude on Taxes," New York Times, p. 1, December 2, 2011.

⁵ See "Tax Code Changes Halve New York State's Budget Gap, a Credit Positive," Moody's Investors Service, December 12, 2011.

⁶ 60% of Californians support Governor Brown's November 2012 ballot proposal to raise \$7 billion by increasing sales taxes by ½% and raising income tax rates on upper-income filers. See Public Policy Institute of California, Statewide Survey, p. 13, December 2011.

⁷ See "Pensions and Retirement Plan Enactments in 2011 State Legislatures," National Conference of State Legislatures, September 29, 2011 and New York Times, December 6, 2011.

⁸ For example, Hollywood, FL voters enacted several reforms (including reducing cost-of-living adjustments) via referendum in September 2011, and San Francisco voters passed a November 2011 referendum that reduced benefits, tightened eligibility requirements, and hiked employee contributions.

⁹ See Sec. 3 of Act No. 4 of the Public Acts of Michigan, 2011.

¹⁰ See Assembly Bill No. 506 (passed on October 9, 2011) which amended Section 537690 of the California Government Code. Commentators on this bill have generally assumed that it makes filing a municipal bankruptcy in California more difficult. However, the filing requirements remain quite permissive. Municipal labor unions had sought more restrictive language so as to make Chapter 9 filings more uncommon, but lawmakers enacted only modest changes. A municipality may now file for Chapter 9 when majority of the governing body votes to declare a "financial emergency." The change is unlikely to alter financial dynamics for California local governments. Most California general obligation bonds are exempt from the automatic stay in a Chapter 9 proceeding and must be paid, by law, outside of Chapter 9. The new law, then, does little to eliminate the pressure on local bargaining units to renegotiate existing labor contracts (whether inside or outside of court).

¹¹ Roughly 80% of Americans support spending additional money on the nation's infrastructure to "create jobs." American voters favor Infrastructure spending to "create jobs" over all other policy options. See New York Times / CBS News poll, October 25, 2011 (poll conducted between Oct. 19-24 and included 1,475 registered voters).

¹² As a general rule, it is highly disadvantageous for a government to default on its bonds when bonded debt is not the root cause of a municipality's financial problems. Defaults make it more difficult to capitalize pension funds, reduce healthcare costs, and keep teachers in the classroom. At the same time, defaults severely limit governments' ability to finance and repair ageing infrastructure.

¹³ See Mark Muro and Christopher Hoene, "Fiscal Challenges Facing Cities: Implications for Recovery," National League of Cities, p. 6, November 2009.

¹⁴ See S&P/Case-Shiller Home Price Indices, December 27, 2011. Prices declined by roughly 1% in the 20-state index.

¹⁵ See "GASB Proposes to Significantly Improve Pension Reporting," July 2011. Available at: http://www.gasb.org/cs/ContentServer?site=GASB&c=GASBContent_C&pagename=GASB%2FGASBContent_C%2FUsersArticlePage&id=1176158721550

¹⁶ Rhode Island's reform, which closes the existing pension fund and replaces it with a system of benefits that combines a 401k and pension plan, may be particularly vulnerable to legal attack. The plan is appropriate to the scale of Rhode Island's pension problems and carefully adjusts pension benefits for older employees more modestly than those for younger employees. Still, a lower court ruling in September 2011 suggests that changing benefits for employees with more than 10 years of service might prove challenging. See Rhode Island Council 94 v. Carcier, 2011 R.I. Super. LEXIS 120, September 13, 2011.

¹⁷ For example, Milwaukee County retirees have sued to prevent scheduled hikes to retiree health insurance premiums. See Bruce Vielmetti, "County retiree sues over rise in health care costs," The Journal Sentinel, December 28, 2011.

¹⁸ A non-monetary or "technical" default is one in which an issuer violates an indenture covenant but principal and interest continues to be paid on time. The Distressed Debt Securities newsletter notes that a few municipalities violated covenants in 2011 by using their "debt reserves as a kitty for making interest payments, thereby alleviating the necessity of budget cuts elsewhere. They are also leaning on their bond insurers and letter of credit guarantors to an unprecedented extent to achieve the same results." See Distressed Debt Securities Newsletter, November 2011.

¹⁹ In Harrisburg, officials refused to make good on a guarantee of incinerator bonds. In Menasha, the town backed debt issued to finance the conversion of an electric generating plant to supply steam to local paper manufacturers. When debt service costs spiraled and revenue failed to cover debt service payments, Menasha officials backed out of the deal. In Moberly, MO, officials refused to appropriate debt service on a \$39 million bond for a Chinese-American artificial sweetener manufacturer. The town pledged to appropriate payment if the manufacturer could not, but the company became insolvent even before the first payment. In Wenatchee, operators of a 4,300 seat arena cannot make payments on bonds that were payable from the arena's revenues. Lawmakers in the State of Washington failed to pass a bill that would have redeemed the bonds.

²⁰ Unless prohibited by federal law or a state constitution, states have complete control over municipal governments. In legal parlance, this is known as "Dillon's Rule," which states that "municipal corporations owe their origin to, and derive their powers and rights wholly from, the [state] legislature. It breathes into them the breath of life; without which they cannot exist. As it creates, so may it destroy. If it may destroy, it may abridge and control." See Clinton v. Cedar Rapids and the Missouri River Railroad, 24 Iowa 455 (1868). The rule has twice been affirmed by the Supreme Court of the United States, most recently in Hunter v. Pittsburgh, 207 U.S. 161 (1907).

²¹ Pre-existing state insolvency procedures must be properly drafted. The federal bankruptcy law prohibits states from creating their own bankruptcy codes. See 11 USC 903(l). State-based regimes typically require a finding of "financial emergency" before a municipality may abrogate a contract via a non-bankruptcy process. Even then, a state's declaration of "financial emergency" might be questioned.

²² This understanding stems from the U.S. Supreme Court's ruling in U.S. Trust v. New Jersey, 431 U.S. 1 (1977). In that case, the court established that a state can "impair" its own contract "if it is reasonable and necessary to serve and important public purpose." U.S. Trust, at 25. The term "reasonable" has been construed to mean there must be a "financial emergency" and the term "necessary" is, by definition, understood to mean there is no alternative but to impair the contract. These limitations are also reflected in Chapter 9 of the bankruptcy code. Among other things, a Chapter 9 debtor must be "insolvent" to access the courts. An "insolvent" municipality is one that is experiencing a "financial emergency" and cannot avoid the impairment of at least some contracts without threatening essential government services. See 11 USC 109(3). If a government has access to the capital markets, emergency state grants, sufficient cash-on-hand, or can reasonably tax more or cut more spending, it's highly unlikely to qualify as "insolvent." Moreover, the burden of proving "insolvency" rests with the destitute municipality. As one court has put it "Chapter

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⁹ offers a solution to chronic economic distress caused by costs and revenues spiraling in opposite directions, but Chapter 9 is not available to a city simply because it is financially distressed." See *In re Bridgeport*, 129 BR 332, (BC Conn 1991), at 336.

- ²³ See 11 USC 109. The Commonwealth of Puerto Rico is also ineligible as it is not "a political subdivision, public agency, or instrumentality of a state." In early 2011, Congress exhibited short-lived interest in creating a bankruptcy code for states. Enactment of state bankruptcy legislation is highly unlikely and probably unworkable as a practical matter. As described in note 25 above, states retain the authority to restructure their debts when necessary. States have arguably used this authority recently to restructure their pension and retiree healthcare obligations, which are their most overwhelming form of debt. Also, no Governor or legislature seeks to be the first in the Nation's history to file for bankruptcy protection.
- ²⁴ The original municipal bankruptcy chapter was, in fact, Chapter 10, not Chapter 9. The 1976 bankruptcy amendments changed the Chapter number.
- ²⁵ The constitutionality of a federal bankruptcy chapter for states was upheld in *U.S. v. Bekins*, 304 U.S. 27 (1938). In that case, the Supreme Court essentially reversed the long-held rule that states and local governments cannot escape contractual obligations. They managed this feat by allowing states to authorize municipal access to the bankruptcy courts. Since *Bekins*, it is generally understood that states and local governments can restructure contracts in three ways: (1) through consent of the parties (which is not considered an "impairment" because it is a "consensual" renegotiation), (2) through the bankruptcy code, or (3) by declaring an unexpected financial emergency and establishing that there is no alternative remedy to the financial distress.
- ²⁶ This is just one reason that states avoided Chapter 9 during the 1970s. Chapter 9's provisions were also antiquated in the 1970s. At the time, the code was ill equipped to manage the bankruptcy of a large city. See Lawrence P. King, *Municipal Insolvency: The new Chapter IX of the Bankruptcy Act*, 1976 Duke L.J. 1157 (1976), at 1158.
- ²⁷ For example, Connecticut intervened to keep Bridgeport, CT out of federal bankruptcy court in 1991. Massachusetts placed the City of Chelsea into receivership in the same year. See "An Act Establishing a Receivership for the City of Chelsea," (Act Approved September 12, 1991), Chapter 200.
- ²⁸ See "Local Government and School District Fiscal Accountability Act," Act No. 4, Public Acts of 2011, MCL §§141.1501. The Act specifically authorizes emergency financial managers to "reject, modify, or terminate" terms of collective bargaining agreements. However, it is silent with respect to bond contracts. Still, its stated purpose is to "protect the credit of this state and its political subdivisions. See Sections 19(1)(j) of the Act and Section 3.
- ²⁹ For example, in Central Falls, annual debt service costs were less than 11% of governmental fund expenditures in Fiscal Year 2010 (and were not increasing), but annual required pension and retiree healthcare contributions were 34% - and rising. See Central Falls' Comprehensive Annual Financial Report (CAFR), 2010.
- ³⁰ In the context of municipal bonds, statutory liens give bondholders a first lien on municipal revenues. The lien survives a bankruptcy filing because it arises by force of state law as opposed to the agreement of parties or judicial action. The bankruptcy code is designed to honor creditors' state law rights as much as possible. Statutory liens that create priority rights in revenue streams for bondholders should be upheld by Chapter 9 courts. See *In re County of Orange*, 189 B. R. 499 (C.D. Cal. 1995).
- ³¹ In Vallejo, the City argued that it was entitled to intercepted funds earmarked for bondholders. Vallejo's argument relied on a quirk in California local government law that is likely inapplicable in other jurisdictions. Still, bankrupt issuers are likely to raise similar arguments in other states. Importantly, California's state controller filed a motion to ensure that intercepted funds be used to protect Vallejo's bondholders. See: Randall Jensen, "California Controller Seeks to Protect Use of Intercept Funds," *The Bond Buyer*, Wednesday, December 29, 2010. The City and National Public Finance Guarantee Corporation settled the issue before the court could rule on it.
- ³² For example, North Carolina's Local Government Commission has been linked to higher credit ratings by Fitch Ratings. See Omer Kimhi, "Reviving Cities: Legal Remedies to Municipal Financial Crises," 88 B.U.L. Rev. 633 (2008), at 680-681.
- ³³ Spiotto presented his ideas to Congress. See "The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter," Hearing before the Subcommittee on Courts, Commercial, and Administrative Law of the Committee on the Judiciary, 112th Congress, 1st Session, February 14, 2011. Serial No. 112-25, p. 54 - 95.
- ³⁴ See Spiotto's testimony. "The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility of a State Bankruptcy Chapter," Hearing before the Subcommittee on Courts, Commercial, and Administrative Law of the Committee on the Judiciary, 112th Congress, 1st Session, February 14, 2011. Serial No. 112-25, p. 54 - 95.
- ³⁵ See David L. Dubrow, "Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?" *The Urban Lawyer*, Vol. 24, No. 3 Summer 1992, at 541.
- ³⁶ New York City employees lent \$2.5 billion to the City's pension fund. See Eric Scorsone, "Local Government Financial Emergencies and Municipal Bankruptcy," Michigan Senate Fiscal Agency, p. 5 May 2010.
- ³⁷ These investments can generate capital gains only to the extent that interest rates remain stable.
- ³⁸ See the National Bankruptcy Review Commission's proposals to update Chapter 9. Available at: <http://govinfo.library.unt.edu/nbrcreport/22chapte.html>. The National Bankruptcy Review Commission was an independent commission established under the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106. The Commission was created to investigate the bankruptcy code and suggest proposals to improve it. It issued a report in October 1997 that, among other things, detailed findings, conclusions, and recommendations to Congress.
- ³⁹ Subsequent to this writing, Judge Thomas Bennett ruled on both of these issues. As to receiverships, the judge ruled that receivers appointed by state courts as a contractual remedy lose their "control" over debtor property in a Chapter 9 but retain limited powers over pledged revenues. Precisely what this power over pledged revenues means is vague. As to revenue bond payments, the judge ruled that they are exempt from the automatic stay imposed by Chapter 9. These payments, also known as "net revenues," comprise the money available to pay principal and interest costs after operating and maintenance costs have been paid. See "Memorandum Opinion," *In re Jefferson County, Alabama*, 11-05736-TBB9 (Filed 01/06/2012).
- ⁴⁰ For example, 11 USC 1113 is inapplicable in a Chapter 9. This section of the bankruptcy code requires Chapter 9 debtors to meet legal hurdles before rejecting executory collective bargaining agreements in bankruptcy. As such, a municipality may more easily restructure collective bargaining agreements in Chapter 9 than in Chapter 11. See *In re City of Vallejo*, 403 B.R. 72 (Bkrtcy. E.D. Cal. 2009).
- ⁴¹ This rule is codified in Chapter 9 of the bankruptcy code in sections 903 and 904. These sections (a) explicitly reiterate that states retain control of municipalities during the bankruptcy filing and (b) the court may not interfere with the municipality's "political or governmental powers," its "property or revenues," nor the "use or enjoyment" of its business-like enterprises (e.g. utilities).
- ⁴² The federal government may now exert far more control over state and municipal affairs. The limitation on federal interference with state affairs today is delimited only by the political process itself. If states seek federal regulation, they can establish it by electing lawmakers to federal office. See *Garcia v. San Antonio Metropolitan Transit Authority*, 496 U.S. 528 (1985). This suggests that at least some parts of sections 903 and 904 of the bankruptcy code could be revamped and Chapter 9 judges could have much more power over municipal affairs than at present. See also David L. Dubrow, "Chapter 9 of the Bankruptcy Code: A Viable Option for Municipalities in Fiscal Crisis?" *The Urban Lawyer*, Vol. 24, No. 3 Summer 1992.

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