Understanding and Avoiding Municipal Bankruptcy:

An Overview for Public Agencies

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PRESENTED BY

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Welcome and Introduction of Speakers



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Current State of Affairs

- Declining Tax Revenues
- Sacramento shifts spending burden to local levels
- Employee/Retirement Benefits
- Demise of Redevelopment Agencies
- Limited ability to enhance revenues

Alternatives To Chapter 9: Fiscal Emergency

- What is a “Fiscal Emergency”?
- Three types: Statutory and Non-Statutory
  - Constitutional, Statutory and Non-Statutory

Alternatives To Chapter 9: Fiscal Emergency

- Constitutional Fiscal Emergency
  - California Constitution Article XIII C § 2(b)
    - To impose, extend or increase any special or general tax
    - Requires unanimous vote of the governing body to place on next ballot
    - Expedite revenue enhancement ballot _____
- Non- Statutory Fiscal Emergency
  - (Lawsuit to modify Contracts)
    - Actual Emergency
    - Relief must be necessary to benefit public interest
    - Appropriately Tailored
    - Temporary
    - All criteria not necessarily required

Alternatives To Chapter 9: Fiscal Emergency

- Statutory AB 506 (Gov't Code § 53760.5)
  - Related to Chapter 9 Bankruptcy
    - Following a public hearing, issue a finding by the local governing board, that:
      - "…the financial state of the local public entity jeopardizes the health, safety, or well-being of the residents of the local public entity's jurisdiction or service area absent the protections of Chapter 9. " and
      - "… the public entity is or will be unable to pay its obligations within the next 60 days."

Alternatives To Chapter 9: AB 506

- Declaration of Fiscal Emergency Requirements
  - Public notice
    - Public hearing
    - Adopted declaration by a majority vote of the governing board
    - Participated in a “neutral evaluation process”

Alternatives To Chapter 9: AB 506

- "Neutral evaluation process" - Five Requirements :
  - Appointment of an third party "mediator"
    - Disinterested
    - Qualified
  - All creditors that hold or may have claims must be invited to participate:
    - Exceed $5 million
    - Constitute more than five percent of the total amount of the municipality's debt

Alternatives To Chapter 9: AB 506

- Neutral Evaluation Process (cont.)
  - Other "interested parties" may participate, such as:
    - Unions;
    - Retired Employees; and
    - CalPERS
  - Must be completed within 60 days unless extended
  - Strict confidentiality.

Alternatives To Chapter 9: AB 506

- "Neutral evaluation process" ends when:
  - The parties execute an agreement (may require approval of a bankruptcy court);
  - The 60-day period expires without reaching an agreement and the parties do not agree to extend; or
  - None of the parties invited by the local municipality to participate in the process agrees to do so.

Alternatives To Chapter 9: Threat of Chapter 9

- Negotiated resolution is best alternative
- Chapter 9 is not an ideal solution
  - Expensive
  - Outcome is uncertain for all parties

Alternatives To Chapter 9: Threat of Chapter 9

- Opportunities may exist for outsourcing, service consolidation, or alternative procurement
- Credit Market implications could be severe
  - Access to capital markets is more difficult
  - Borrowing costs may increase significantly
- Stakeholders now view bankruptcy as a serious option
- Stakeholder concessions may be feasible
  - Better achieved through negotiation
  - This takes political willpower
- Where negotiations fail, initiatives may find new support at the ballot box

Alternatives to Chapter 9: Reorganization

- Local Agency Formation Commission
  - Merger/consolidation
  - Dissolution

Chapter 9:
Basic Requirements

- When All Else has Failed
- Who is Eligible?
  - Federal
    - 11 U.S.C.§ 109 (c)
  - State
    - AB 506 (Gov't Code §§ 53760, et seq.)
    - Redevelopment Successor Agencies (Gov't code 53760.1(f) (AB 1484)

Chapter 9:
Basic Requirements

- Definition of Insolvency
  - (11 U.S.C. §§ 109(c)(3) & 101(32)(c))
  - Requirements:
    - Not paying its debts as they become due; or
    - Unable to pay its debts (prospective)

Chapter 9:
Planning Steps for Filing

- Build Public Agency Team:
  - Assess internal resources and identify administrative capabilities to support process
  - Retain Bankruptcy Counsel
  - Retain financial advisors to assist with analysis, case administration

Chapter 9:
Planning Steps for Filing

- Review Statutory Requirements:
  - Does statute authorize Chapter 9?
  - Have conditions of AB 506 been satisfied?
  - Determination of insolvency
  - qualification as debtor
  - Adopt Necessary Resolutions

Chapter 9:
Planning Steps for Filing

- Complete Internal Analysis
  - Complete analysis of General and Restricted Funds
  - Determine financial and operating plan for continuing services and required mandates
  - Determine objectives of bankruptcy and plan confirmation

Chapter 9:
Administrative Requirements for Filing

- First Day Motions
  - Filing of Petition seeking Stay and Relief under Chapter 9
  - Request for Automatic Stay
- Notice Requirements

Chapter 9:
Typical Players and Roles
In Municipal Bankruptcy

- Municipal Entity / Debtor
  - General Counsel
  - Elected Officials / Governing Authority
  - Key Operating Officials
  - Bankruptcy Counsel
  - Financial Advisor

Chapter 9:
Typical Players and Roles
In Municipal Bankruptcy

- Bankruptcy Court
  - Judge
  - Federal Trustee
  - Ombudsman (special obligation)

Chapter 9:
Typical Players and Roles
In Municipal Bankruptcy

- Primary Creditor Constituencies
  - Bondholders
  - Financial Guarantors
  - Pension Funds
  - Public Employee Unions
  - Appointed Official Committees

Chapter 9:
Limitations of the Bankruptcy Court

- The Bankruptcy Court does NOT have jurisdiction with respect to:
  - The governmental powers of the municipal debtor;
  - Scope of municipal services that are being provided as determined by the local governing body
  - The disposition of assets, the incurrence of additional indebtedness or the conduct of governmental affairs.

Chapter 9:
Various Classes of Claims

- Priorities:
  - Mortgage Bonds and collateralized obligations
    - secured by a statutory lien to the extent of the value of the assets so secured;
  - Revenue Bonds and other obligations
    - secured by defined revenues of a project or system subject to the operating expenses of the project or system.

Chapter 9:
Various Classes of Claims

- Secured liens associated with bond resolutions and/or contractual provisions that:
  - while not qualifying as a statutory liens or pledge of special revenues, have underlying collateral with measureable value, subject to the collateral value;
- Obligations subject to a municipal facility lease financing associated with real or tangible property;
  - Various
- Administrative Expenses
- Unsecured Obligations

Chapter 9:
Various Classes of Claims

- The following are not afforded priority claim status:
  - Pre-petition municipal bond / note payments
  - Unpaid pre-petition wages and benefits
  - Accrued vacation health care benefits

Chapter 9: Miscellaneous Provisions

- Only the municipal debtor
  - can file a case
  - can file and seek confirmation of a plan of adjustment
- No requirements for sharing information with employee representatives prior to rejection or modification of agreements
- No limitation of damages arising from the rejection of public real estate leases held by a trustee

Chapter 9:
Labor Collective Bargaining Agreements

- Major Issues:
  - Bankruptcy permits the rejection of “uneconomic” agreements and contracts.
  - Unfunded pension liabilities and other post employment benefits may be classified as unsecured claims.

Chapter 9:
Emerging from Bankruptcy

- Must timely file and confirm a Plan of Adjustment
- The Bankruptcy Court shall confirm a Plan of Adjustment if the requirements are satisfied.

Chapter 9:
Emerging from Bankruptcy

- Plan of Adjustment
  - Requirements for confirmation for the Plan of Adjustment:
    - Is accepted by the requisite holders of impaired classes of claims or, if not so accepted;
    - Is "fair and equitable";
    - Does not discriminate unfairly as to the non-accepting class;
    - Is in the "best interests" of each holder of a claim and each impaired class of creditor under the Plan of Adjustment;
    - Is feasible; and
    - Complies with the applicable provisions of the Bankruptcy Code.

Chapter 9:
Emerging from Bankruptcy

- Effective Date of the Plan of Adjustment
  - Confirmation of a Plan of Adjustment binds the municipal debtor and its creditors to the terms.
  - The municipal debtor must implement the Plan of Adjustment in accordance with its terms.

Chapter 9:
Emerging from Bankruptcy

- The Bankruptcy Court
  - Retain jurisdiction over the case for period of time as is necessary
  - Oversees implementation of the Plan of Adjustment.

Chapter 9:
Emerging from Bankruptcy

- Municipal Debtor must Restore its Credibility
  - Credit markets
  - Significant stakeholder groups
- Other forms of debt issuance may be feasible but will likely involve a bankruptcy-remote structure.

Bankruptcy Avoidance: Best Practices

- Spot Problems Early
- Need for continuous “Financial checkup”
- Integrity of Financial Statements
- Avoid Scandal

Bankruptcy Avoidance: Best Practices

- Avoid unreasonable budget projections
- Maintain integrity of Reserve Accounts
- Restricted funds and inter-fund borrowings:
  - Avoid interfund borrowing wherever possible
  - Ensure ability to retire interfund borrowings
  - Follow adopted policies

Bankruptcy Avoidance: Best Practices

- "Plan B" in event of further State fiscal crisis
  - Do not assume tax increases will pass
  - Have a back-up plan
- Recognize all Post Employment Obligations and anticipate funding them
  - Anticipate accruals under Retired Employees Association vs. Orange County decision.

Bankruptcy Avoidance: Best Practices

- Make Difficult Political Decisions
  - Cooperative approach to resolving issues
  - Hard decisions, made early

Recent Bankruptcies and Lessons Learned

- Prospective Insolvency
- Collective Bargaining Agreements
- AB 506
- Institutional Impacts
- Increased Transparency

Questions and Answers



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