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Reducing Risk to Payment of State and Local Government Debt Obligations, Statutory Liens from Rhode Island to California SB222

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Government finance officers readily will admit that they consider assuring access to the capital markets at a low cost as part of their duties to their respective governmental bodies. The interest rates or the cost of borrowing is viewed generally as a reflection of the perceived risk in repayment of the debt. Recent history has shown that, when perception of risk of repayment is high, so is the annual interest rate or annual yield.

Greece, on March 2, 2012, had a ten year bond annual yield of 37.1% and, in July, 2015 after another bailout and austerity package being implemented, Greece's annual yield is still over 10.5%, with a 52 week range between 5.5% and 19.5%. Since 1826, Greece defaulted on its sovereign debt at least five times prior to its recent financial crisis (1826, 1843, 1860, 1894 and 1932). Brazil, a large developing economy, which defaulted or restructured its sovereign debt eleven times since 1826, the last time in 1990, has an average ten year bond annual yield between 2006 and 2015 of approximately 12.3% with an all-time high of 17.91% in October, 2008. Puerto Rico, given its recent financial distress, experienced yields on its ten year G.O. Bonds exceeding 10% in February, 2014 and also 10% in 2015. This is at the same time when other sovereigns experience unusually low 10 year bond annual yield of 2.27% for the U.S.A., 1.52% for Canada, .74% for Germany and 1.03% for France.

It is clear that perceived risk and lack of assurances of credit quality and structures where repayment will be assured have led either to increased interest costs or significant restriction or elimination of access to the capital markets. This always has been and always will be a significant issue for any sovereign or sub-sovereign because the necessity to borrow is inextricably intertwined with the need to provide capital improvements and the fact that the payment of tax revenues is sporadic and not usually timed to meet those capital improvement funding needs.

Use of Statutory Liens to Assure Payment of State and Local Debt and Lower the Cost

Because of this need to borrow, states and local governments in the United States have long sought various methods of attempting to provide assurances of repayment and good as gold structure in the public debt that is provided to creditors. The surprise bankruptcy of Orange County in 1994 revealed that statutory liens could not be rewritten or involuntarily compromised in a Chapter 9. Chapter 9 is a process of debt adjustment, but the bankruptcy court and the debtor municipality are limited to the process and cannot rewrite state law and mandated pledges of payments such as statutory liens.

Recently, when Rhode Island was confronted with the economic difficulties of the City of Central Falls and the looming financial questions surrounding Providence, its legislature, led by the Governor, passed a law granting a first statutory lien to all bonds and notes and, in essence, claimed that it was confirming the intended priority and assurance of payment to those obligations. This statutory lien, granted in 2011, allowed Central Falls to remove the bondholders from the fray of the Chapter 9 bankruptcy and the uncertainty of payment.

The Rhode Island legislation was intended, given the economic downturn of 2008, to provide assurances to the credit market so that municipalities would continue to have access to the market at the lowest cost possible in order to fund necessary services and infrastructure, recognizing that some municipalities, like Central Falls, were having financial hardships. No one wanted the contagion of financial distress for a municipality to be visited upon all municipalities in the state. For that reason, it has been recognized that there was no noticeable contagion to Rhode Island from the Chapter 9 bankruptcy of Central Falls or the restructuring that Providence implemented in 2011 and 2012, respectively. This statutory clarity meant that a municipality's access and borrowing costs would not be held hostage by a Chapter 9 of another municipality in the state. This legislation and its protection from the contagion of fiscal distress provided a beneficial result to all of the municipalities.

California Senate Bill 222 and the Cloud of the Detroit Bankruptcy

On July 13, 2015, California Governor Brown signed Senate Bill 222 (*"SB 222"*) into law making it effective as of January 1, 2016. This Bill was the result of the experience of California municipalities and school districts with regard to the cost of borrowing being greater than what their perceived credit quality would mandate due to concerns arising out of the Detroit bankruptcy.

As we all can recall, the original proposed treatment by the Emergency Manager in the Detroit bankruptcy was that the Unlimited Tax General Obligation Bonds (*"ULTGOs"*) of Detroit were unsecured despite voter approval of an unlimited levy of ad valorem taxes dedicated to the payment of the debt service on those specific ULTGOs. Ultimately, after extensive litigation and mediation, the matter was settled and incorporated in the plan of adjustment. The bond insurers received 74 cents on the dollar recovery and the bondholders, with the additional 26 cents from the bond insurers, received a 100 cents on a dollar recovery for payment in full. In addition, the settlement called for the ULTGOs to be treated as secured debt.

Recent Legislation Calling for Statutory Lien

At the end of 2014, a Bill was introduced into Michigan's House of Representatives as HB 4495 providing and confirming that

ULTGOs would have a statutory first lien on all taxes subject to an unlimited tax pledge and that first statutory lien would apply to any ULTGO pledge made prior to or after the date of the enactment of the law. The Michigan House recently passed the Bill (HB 4495) that would confirm a statutory lien on any ULTGOs, and it is now pending in the Michigan Senate. Other states in 2014 introduced similar legislation for ULTGOs or bond debt that has been enacted into law, such as California's SB 222 noted and Nebraska's LB 67 that is still pending legislative action.

The Reasons for Recent Statutory Lien Legislation

There was noted by municipal market participants, during the later half of 2013 and 2014 after the Detroit Chapter 9 bankruptcy filing and the Emergency Manager threatening to treat ULTGOs as unsecured debt, that other municipalities in Michigan, including its school districts, experienced an approximately 100 basis point increase in the annual interest rate, the cost of borrowing, on ULTGOs due to the contagion from the Detroit bankruptcy with regard to ULTGOs. Likewise, the State of California recognized that its school districts and other municipalities also were experiencing an increase in the cost of borrowing purportedly due to that Detroit contagion of a 50-100 basis points increase in the annual interest rate.

Traditionally, the spread in the interest rate in the municipal market between the strongest credit (top investment grade) and significantly weaker credit (lower non-investment grade) was 200-300 basis points per year. To a state or local government, a spread of 200 basis points per year, or 2 percent more interest cost a year, on a 20 year bond would be 40% more of principal. For example, on a one billion dollar debt issue with a twenty year maturity and a bullet payment at maturity, a 2% additional interest cost per annum would be a present value at a 5% discount of about $250 million. That is $250 million dollar not available to the state or local government to pay for needed infrastructure improvements, public services, workers salaries, retiree benefits or tax relief to its residents. Those who claim "Wall Street" is being paid too much should readily embrace statutory liens or other methods to increase credibility and lower interest rates for state and local government debt.

The California Debt Investment Advisory Commission held a conference in San Francisco in March, 2014 to discuss the history of payment of ULTGOs in California and the California experience of ULTGOs in Chapter 9 proceedings. One of the take aways from the discussion with market participants was that confirmation of statutory lien status of the ULTGOs would help the market perception of the intended dedicated tax payment to the bondholders to the extent the ad valorem tax was collected. The issue then was then whether or not legislation should be drafted, as was done in Rhode Island, to confirm the intended treatment of ULTGOs having the first statutory lien on the pledged ad valorem tax revenues that could not be used for any other purpose as provided by California statutes and constitution. Ultimately, legislation was introduced as Senate Bill 222 which at first was to aid school districts and later was expanded to municipalities and special districts and was intended to confirm the statutory lien in the unlimited ad valorem tax pledge of the ULTGOs.

SB 222 Confirms What California Statutes Provide for ULTGOs for School Districts

This legislation may be viewed as creating new rights and benefits for ULTGOs. However, a review of past Chapter 9 cases and the treatment of ULTGOs in Chapter 9 proceedings in California by school districts and special districts, as well as careful reading of the state statutes, indicate that what the current legislation really does is confirm the intended treatment that prior courts have recognized. The legislation confirms that the unlimited ad valorem tax, as collected by the County Treasurer for the school district, municipality or special district, is to be paid, pursuant to the statute, into a special account (normally to the bond trustee directly by the County Treasurer) without ever being paid to the school district, municipality or special district. Under Section 1(b) Article XIIIA of the California Constitution, any new indebtedness to be repaid from an ad valorem tax levied against the real property must be approved by two-thirds of the qualified electors and such bonds may finance the acquisition or improvement of real property. Schools, municipalities and special districts (like healthcare districts), have used such legislation as permitted by the California Constitution to make improvements.

It is clear from the existing law with regard to the school districts, Cal. Ed. Code §§ 15250, 15252 and 15254, that the County Board of Supervisors, having jurisdiction over the school district, has the power and obligation to levy annually the ad valorem taxes upon all parties subject to taxation by the district without limitation on amount for payment of principal and interest on the ULTGO bonds of the district so authorized by a two-thirds vote of the electorate. The levy is to be dedicated and sufficient to pay the debt service on those ULTGO bonds and, as collected, the ad valorem taxes levied to pay those ULTGOs are to be paid by the County Treasurer to a segregated account for the interest and sinking fund (or to the bond trustee for the Debt Service Reserve Fund) for the payment of principal and interest on the G.O. bonds and cannot be used for any other purpose (Cal. Ed. Code § 15251). Accordingly, by the plain language of the statute, there is a mandated levy of ad valorem tax separate from any other levies that is dedicated to pay the ULTGOs in full where the payment of the tax revenues is to be collected and intercepted by the County Treasurer and paid into a special (trust) account (usually to the bond trustee) for the payment of debt services on the ULTGO and those tax revenues so pledged cannot be used for any other purpose. It should be clear, given not only the recent enactment of SB 222, but the prior existing case law and language of the existing statute, that there was a statutory lien created under the California Education Code for the benefit of the bondholders.

Past Treatment of California ULTGOs in Bankruptcy is Consistent with the Mandate of State Law

Even before the 1988 Amendments, which have recognized the use of special revenues, namely a tax source dedicated to the payment of revenue bonds that was to be unimpaired and timely paid in a Chapter 9, there was the case of the *San Jose School District* which went into a Chapter 9 proceeding on July 1, 1983. The District also had a ULTGO bond payment due on July 1, 1983 and, given the actions required by the then and currently existing California law, the County Treasurer was duty bound and made the payment from pledged ad valorem tax revenues as scheduled and each payment thereafter without an interruption during the Chapter 9 proceeding. The specific ad valorem tax so collected by the County Treasurer cannot be used for any other purpose.

A statutory lien in a Chapter 9 is a lien that arises from the statute without any need for further action by the municipality. A statutory lien arises from the specific language whether or not the statute specifically uses the words "statutory lien". It is clear that the language for ULTGOs for California school districts, special healthcare districts, cities and counties could be interpreted and was interpreted without the need for the use of the words "statutory lien" in SB 222. Further, the levy of the ad valorem taxes for the District's ULTGO bonds is in addition to any other levies for other purposes and is dedicated by the state statute to the payment of the ULTGO bonds and no other purpose.

The Pledge of Ad Valorem Tax Revenues is Entitled to and was Intended to be Subject to Special Revenue Treatment

in a Chapter 9

The ULTGOs can be treated as secured by special revenues under Section 902(2)(e) of the Bankruptcy Code since the ad valorem taxes are not general property taxes to be used for general purposes but can only be used by the mandate of state statutes to pay debt services on the ULTGOs. In fact, the legislative history of the 1988 Amendments specifically identifies the *San Jose School District* case and the payment of the ULTGOs pledged ad valorem taxes as mandated to be paid under the state law.

In a Chapter 9, while the municipality and court must follow the procedure of the Chapter 9 process for debt adjustment, the municipality must act consistent with state law. The County Treasurer must follow the mandate of state law and cannot act other than to pay the ULTGO pledged revenues for payment of the debt service on a timely basis. The Bankruptcy Court should not interfere with this payment since this state statutory mandate is a limitation on the expenditure of these pledge funds that Chapter 9 specifically recognizes should be honored in Section 903 of the Bankruptcy Code. The municipality in Chapter 9 must act consistent with state law and the limitations placed on it by the state as to the municipality's political or governmental powers, including expenditures for such exercise. The municipality as a debtor in Chapter 9 cannot under Section 904 consent to a court's interference with such a state statutorily mandated payment because that would be contrary to state law limiting the power of the municipality to otherwise act.

The Senate Report on the 1988 Amendments specifically noted that the Amendments to Chapter 9 of the Bankruptcy Code providing for special revenues were consistent with the mandated payment of the ULTGO pledged revenues even in Chapter 9 as was done in the *San Jose* case. The Report noted:

> "The application of Section 552 in a Chapter 9 bankruptcy proceeding may also defy practical reality and state law mandates. As in the case of the San Jose School District, *In re San Jose Unified School District*, No. 5-83-02387-A-9, (B.C.N.D. Cal. 1983), the continued payment of interest to bondholders not only helped ensure the debtor's continued access to credit markets but also helps fulfill the requirement of state law that such collected funds be used to pay bondholders. Cal. Educ. Code Ann. 15251.
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> Accordingly, as a practical matter, even though Section 552 of the Bankruptcy Code provides that the pledge is terminated, given the mandate of the law and the practical reality of municipal finance, a municipality might well attempt to ignore that provision and continue to pay the bondholders as originally promised. Municipalities, prior to and after the enactment of the Bankruptcy Code, have so acted, such as the San Jose School District ... .
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> In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenues granted pursuant to state statutory or constitutional provision to bondholders can be terminated by the filing of a chapter 9 case. Likewise, under the contract clause of the Constitution (article I, section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a chapter 9 proceeding." S. Rep. No. 100-506 at 6 (1988).

Accordingly, the ULTGO pledge of ad valorem tax revenues for the timely payment of the ULTGO debt service was not interfered with in the *San Jose School District* case and is not to be interfered with under Chapter 9 as the legislative history for special revenue treatment so provides.

ULTGOs in California for Special Districts and Cities and Counties are Intended to Have the Same Treatment in Chapter 9 as School Districts

Also, municipalities and special districts are authorized under California state law to issue ULTGOs for that city, county and special district, secured by the levy of an ad valorem tax authorized by the constitution and the required two-thirds vote of its voters (Cal. Gov. Code §53506). Likewise, California statutes for special districts such as healthcare districts again specifically provide for the authorization to issue bonds with the voter approval of two-thirds vote for the issuance of bonds secured by an unlimited ad valorem tax pledged to the payment of the ULTGOs. (Cal. Health & Safety Code §32301-2.) Again, just like the school districts, the County Board of Supervisors is required to levy and collect the specific unlimited ad valorem tax annually until the bonds outstanding are paid or until there are sums from the collection of the tax in the treasury set apart sufficient to pay the interest on such bonds as they become due and also to constitute a sinking fund for the payment of principal at maturity. (Cal. Health & Safety Code §32312). In addition, the levy of the ad valorem taxes for the specific payment of those healthcare district ULTGOs shall be in addition to any other taxes levied for the district and shall be placed in a bond interest and sinking fund of the healthcare district (which is held by the bond trustee or the county) and, until all principal and interest on the bonds are paid, the money in that fund is not to be used for another purpose other than the payment of the bonds and the accrued interest thereon.

In the case of the *Sierra Kings Healthcare District*, a Chapter 9 filed in 2009 in the Bankruptcy Court for the Eastern District of California, the court approved a reaffirmation agreement that resolved issues raised as to the treatment of healthcare district ULTGOs which provided that the bonds were secured by special revenue and subject to a statutory lien that could not be impaired during the case or in a plan of debt adjustment and all payments were made as required by the terms of the documents.

Accordingly, the passage and enactment into law of SB 222 is clearly a confirmation and possibly, in some minds, a clarification of what already was specifically provided by California law and by the treatment of ULTGOs in Chapter 9 proceedings in bankruptcy. Neither the *Vallejo*, *Stockton* or *San Bernardino* cases and the decisions that have been made in those cases, have altered or would impair that treatment. Cities and counties' ULTGOs have the same state statutorily mandated right to payment of the unlimited ad valorem tax pledged to the payment of such ULTGOs by a two-thirds vote of the electorate. City and county ULTGOs require the County to levy ad valorem taxes sufficient to pay in full all debt due on the ULTGOs. Such ad valorem tax revenues are dedicated and pledged to the payment of the ULTGOs and cannot be used by any one for any other purpose until the ULTGOs are paid. The tax levy for ULTGOs for cities and counties is in addition to all other tax levied and is to be set apart for the sole purpose of paying debt service (Cal. Gov. Code § 29922-4 (counties) and §§ 43632-4 (cities). SB 222 confirms that the ULTGOs' unlimited ad valorem taxes pledge is a statutory lien, and for the same reasons as the School District ULTGOs, the taxes are intended to be unimpaired as special revenues in the collection and payment thereof as mandated by California state law.

Question Raised About Timely Payment of California ULTGOs in a Chapter 9

Since the passage and enactment of SB 222, some have raised the question as to whether such statutory liens provide any real

assurance that payment will be made and default will be avoided and whether or not payment in a Chapter 9 of the pledged unlimited ad valorem tax revenues can be delayed or interfered with. In the case of *Orange County* in 1994, a question was raised as to whether or not the secured notes issued by Orange County were subject to a statutory lien under such Section 53852 and 53856 of the California Government Code. The Bankruptcy Court considered the language of the statute and decided it was not a statutory lien but, on appeal, the District Court reversed and noted that the statute itself imposed the pledge without further action of the county, which met the basic definition in the Bankruptcy Code of a statutory lien. Because of the reversal of the Bankruptcy Court's position, there was a delay in the payment of the statutory lien debt which ultimately was refinanced and paid in full in the plan of debt adjustment.

Some have suggested that in a Chapter 9 proceeding, the payment of the pledged revenues covered by the statutory liens could be interfered with by having the payment delayed as in *Orange County* or otherwise used by the municipality and adequate protection provided for the use of the collected tax revenues for another purpose. This perceived problem is in reality a non-problem.

First, in the cases that have been cited, *San Jose School District* and *Sierra Kings Healthcare District*, that was not the case and timely payment was made as scheduled.

Second, the relevant statute specifically provides that the collected ad valorem tax as levied is in addition to all other tax levies and is not to be used for any other purpose but the state statutorily mandated payment of the debt service on the bonds as long as the bonds are outstanding. That is specific and clear from the state law as noted above and in the legislative history of the 1988 Amendment to the Bankruptcy Code regarding special revenues, the benefit of the bargain of which cannot be impaired and which must be paid by state law. The provisions of the Bankruptcy Code should not be interpreted as a legitimate basis to stay what is a state mandated payment. Further, there can be no diversion or other use of the pledged unlimited ad valorem tax revenues, even for payment of necessary operating expenses under Section 928 of the Bankruptcy Code, since state law mandates they must be used only for the payment of the ULTGO obligation as long as it is outstanding.

Third, the state of California has exercised its power as a sovereign over its sub-sovereigns, the municipalities, cities, counties, school districts and special districts with regard to the exercise of political or governmental power of such municipalities, in mandating the priority of payment (expenditures) that should be made from the pledged unlimited ad valorem taxes so levied and collected for those ULTGOs. Namely, such specifically levied and collected ad valorem taxes are to be used solely for the payment of ULTGO debt service and not for any other purpose. The municipality has no power to act contrary to that mandate of state law. The fact that a municipality may file for Chapter 9 does not allow the municipality to act contrary to that state law mandate as Section 903 of the Bankruptcy Code requires that state law be honored. Chapter 9 does not limit or impair the power of the state to control the municipality in the exercise of its political and governmental powers, including expenditures. The limitation on the court's jurisdiction under Section 904 with regard to political governmental powers, properties and revenues of the debtor as well as the debtor's use and enjoyment of income producing property means the municipality cannot consent to something that is contrary to the mandate of state law. California law mandates as to payment of such ULTGOs relates to the exercise of political and governmental power granted to the municipality by the state and not the procedures of the debt adjustment process.

Further, as the U.S. Supreme Court held in *United States vs. Bekins*, 304 U.S. 27 (1938) in ruling on the constitutionality of the then version of Chapter 9 (then known as Chapter IX), in implementing any plan of debt adjustment, the municipality must comply with state law, and clearly the municipality cannot in its implementation of its plan or in taking action in the Chapter 9 act contrary to state law. The purpose of Chapter 9 is to adjust contractual debt to the degree appropriate so that the municipality can be sustainable and the adjusted debt affordable, both in a fair and equitable manner and in the best interest of the creditors.

The desire to have continuing access to the market and the ability to borrow at the lowest cost achievable in the market has motivated states such as Rhode Island, California and others to develop mechanisms such as confirming or establishing statutory liens for the pledge of an unlimited ad valorem tax for payment of ULTGOs to assure the market that, in times of financial distress, the holders of such obligations should have no fear that collected tax revenues so pledged will not be timely paid to them. That assurance not only reduces the risk of repayment but also should lower the cost of borrowing for the benefit of all. To conclude otherwise would raise the issue of the unconstitutional interference of Chapter 9 with the sovereign power of a state over the political and governmental powers of its sub-sovereigns. The Supreme Court in *Ashton v. Cameron County Water Sup. District No. 1*, 298 U.S. 513 (1936) found the 1934 version of Chapter 9 unconstitutional because it interfered with the sovereign power of the states. Any effort to interpret Chapter 9 to interfere with the timely payment of the ULTGOs of school districts, special healthcare districts, cities and counties as mandated by California law should ultimately meet the same fate as *Ashton* pronounced.

Now is the time for government finance officers along with state, local governments as well as all municipal market participants to unite in the accurate assessment of the use of statutory liens, special revenues, statutory language mandating the payment of public debt and other repayment assurance structures so access to the municipal market can be increased and the cost of borrowing can be lowered (as reflected in the risk discernment of the market interest rate) for the benefit of all concerned. This appropriate determination of the attributes for repayment of debt should be pronounced by state and local governments and by market participants in the documents relating to the debt offering. If the documentation makes this pronouncement, all will know the debt is intended to have the benefit of a statutory lien, special revenue treatment, state law mandated payment assurances (including by statutory priority, appropriation or set aside) or other state statutory or constitutional assurances or debt structures (such as intercepts), which should be honored in a Chapter 9 proceeding It is anticipated that this proper evaluation should, as noted above, generate significant annual interest rate savings to state and local governments that could be used for needed infrastructure improvements, improved public services, payments to other creditors, salaries of public workers, retirement benefits or reduction of the tax burden of their citizens.

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