GENERAL OBLIGATION BONDS: STATE LAW, BANKRUPTCY AND DISCLOSURE CONSIDERATIONS

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EXECUTIVE SUMMARY

General obligation bonds of state and local governments have long been viewed by investors and other participants in the municipal bond market as very safe investments, perhaps second only to United States Treasury securities. This perception is supported by the historically low default rate on general obligation bonds, particularly since the Great Depression.

Two general assumptions have historically informed considerations of general obligation bonds:

- All general obligation bonds are backed by:
  - A "pledge" of the "full faith and credit" of the issuer, and
  - A "pledge" of the taxing power of the issuer (e.g., *ad valorem* taxes); and
- Because of these "pledges," general obligation bonds will be treated as secured claims if the issuer were to become a debtor in a bankruptcy case under Chapter 9 of Title 11 of the United States Code (the "Bankruptcy Code").

Recent events, including the bankruptcy filings by Jefferson County, Alabama, and the City of Detroit, Michigan, have raised questions about the security of general obligation bonds and challenged the commonly held general assumptions described in the preceding paragraph. It has become apparent that all general obligations bonds do not enjoy the same security or the same remedies for enforcement of the promise to pay under state or local law. Further, the treatment of general obligation bonds in a Chapter 9 bankruptcy case is uncertain and will depend on the security provided by applicable state law.

The National Association of Bond Lawyers ("NABL") has prepared this paper to provide background about, and a basic framework for analyzing, general obligation bonds, which examines:

- Characteristics of general obligation bonds,
- State law remedies,
- Municipal bankruptcy, and
- Disclosure considerations.

Characteristics of General Obligation Bonds

The characteristics of any general obligation bond are determined by applicable state or local law. The precise source and security for payment of general obligation bonds varies considerably from issuer to issuer depending on such law; therefore, it is impossible to generally summarize characteristics of all general obligation bonds.

Contrary to the common assumption, general obligation bonds may be supported by a pledge of the issuer's full faith and credit *and/or* the issuer's taxing power. For example, general obligation bonds of California local governments are supported by a pledge of their taxing power, but not by their full faith and credit. In contrast, general obligation warrants of Alabama local governments are not supported by a pledge of their taxing power.

The concept of a full faith and credit obligation is consistently used among the states, but the specific attributes of any individual full faith and credit obligation will undoubtedly vary to some degree depending upon the law of the state in which the issuer is located. It may be difficult for an issuer to detail the attributes of its full faith and credit obligation, as constitutional, statutory, case law and other state law tends to recite the plain language of the term rather than provide a definition of the term.

Although it is difficult to attempt to fit all general obligation bonds into just a few conceptual boxes, it may be useful to think about general obligation bonds in three broad categories based on whether and to what extent the taxing power of the issuer is pledged:

- Unlimited tax general obligation bonds ("UTGOs"),
- Limited tax general obligation bonds ("LTGOs"), and
- General obligations payable from the issuer's general fund ("GFGOs").

State Law Remedies

The most common equitable remedy available to bondholders of general obligation bonds is a writ of mandamus directing a public official to perform an official duty such as payment of debt service when due. Because courts do not impose taxes directly due to principles of separation of powers, a mandamus action is the remedy to compel the imposition, collection and application of pledged taxes by a legislative authority or an official of local government.

There are legal limitations to a writ of mandamus. Generally, a writ of mandamus can be sought from a court of competent jurisdiction to compel a government official or legislative authority to perform only a non-discretionary, mandatory duty imposed by statute (*e.g.*, to impose or collect a tax, or perhaps to recognize a priority in the application of the collected funds). Depending on applicable state or local law, a court may conclude that the duty is discretionary.

There are also practical limitations to a writ of mandamus. For example, recalcitrant local officials can seek to frustrate enforcement of the writ by resigning from office. Moreover, a legislative or inherent priority of providing essential government services may result in a court being unwilling to issue the writ.

Municipal Bankruptcy

Unlike for-profit and nonprofit business entities, local governments cannot file a Chapter 9 bankruptcy case unless they are authorized to do so under applicable state law; therefore, before considering the potential impact of a Chapter 9 bankruptcy case on rights and remedies of general obligation bondholders, a threshold issue to consider is whether and under what conditions an issuer may file. For example, a Chapter 9 filing is currently prohibited or not specifically authorized in twenty-two states.

If the issuer is eligible to file a Chapter 9 proceeding, a fundamental issue is whether its general obligation bonds are secured or unsecured claims. Section 506 of the Bankruptcy Code provides that a "secured claim" is a claim "secured by a lien on property in which the [bankruptcy] estate has an interest," but only to the extent of the value of the creditor's interest in the estate's interest in such property. The Bankruptcy Code recognizes three types of liens: statutory liens (liens arising solely by force of a statute on specified circumstances or conditions), security interests (liens created by an agreement), and judicial liens (liens obtained by judgment, levy, sequestration or other legal or equitable process or proceeding). Section 552 of the Bankruptcy Code cuts off post-petition security interests, but not statutory liens, in property acquired by the debtor; therefore, general obligation bonds secured by a statutory lien may be treated as secured claims.

In Chapter 9, there is also an exception to Section 552 with respect to liens on "special revenues." Section 928 of the Bankruptcy Code, which was enacted in 1988 to protect the treatment of revenue bonds in bankruptcy, provides that special revenues acquired by the debtor after commencement of the case remain subject to any lien resulting from any security agreement entered into by the debtor before commencement of the case. To the extent that the security for a general obligation bond is classified as "special revenues," then such general obligation bond will enjoy the same protection.

Disclosure Considerations

Because the characteristics of any general obligation bond and the remedies available to bondholders are determined by applicable state or local law, it is not possible to prescribe one approach to the preparation of Official Statements for general obligations bonds. The disclosure must be tailored to each general obligation bond based on applicable state or local law. Topics that should be considered in preparing an Official Statement for an offering of general obligation bonds are described in this paper in "DISCLOSURE CONSIDERATIONS."

INTRODUCTION

General obligation bonds of state and local governments have long been viewed by investors and other participants in the municipal bond market as very safe investments, perhaps second only to United States Treasury securities. This is because the payment of the debt service on general obligation bonds is typically secured by a pledge of the full faith and credit of the issuer and/or by a pledge of its taxing power. In fact, the default rate on rated general obligation bonds continues to be very low even though defaults have increased as a result of the recession that began in 2008.

Recent events, including the bankruptcy filings by Jefferson County, Alabama, and the City of Detroit, Michigan, have raised questions about the precise nature of the security of general obligation bonds and shown that not all bonds with the "general obligation" moniker enjoy the same security or the same remedies under state or local law for enforcement of the promise to pay. Further, the treatment of general obligation bonds after the filing of a bankruptcy petition by the issuer under Chapter 9 of Title 11 the United States Code ("Chapter 9") is uncertain and depends on the security provided by state law.

The National Association of Bond Lawyers ("NABL") has prepared this paper to assist its members and other public finance market participants in identifying and evaluating various issues involving general obligation bonds. This paper will discuss the common security characteristics of general obligation bonds, the remedies generally available under state or local law to enforce the payment of general obligation bonds, issues related to the treatment of general obligation bonds under Chapter 9, and matters that issuers, lawyers and other professionals involved in preparing a preliminary and final official statement (the "Official Statement") may wish to consider in connection with the offering of general obligation bonds to investors.

For additional reading see:

Moody's Investors Service, US Municipal Bond Defaults and Recoveries, 1970-2013, May 7, 2014;

Standard & Poor's Ratings Services, 2012 U.S. Public Finance Defaults and Rating Transition Data: Defaults Increase, But Sector Remains Stable Overall, March 28, 2013 and *U.S. Public Finance Defaults and Rating Transition Data; 2013 Update*, March 31, 2014;

Kroll Bond Ratings, Not All G.O. Bonds are Created Equal, April 18, 2013; and

Fitch Ratings, Rating to Bondholder Security After Detroit, May 1, 2014.

CHARACTERISTICS OF GENERAL OBLIGATION BONDS

The precise source and priority of payment for general obligation bonds may vary considerably from issuer to issuer depending on applicable state or local law. Most general obligation bonds expressly state that the full faith and credit (and in many cases the taxing power) of the issuer is pledged or have been interpreted by the courts as a pledge of the full faith and credit of the issuer. General obligation bonds issued by local governments often are payable from (and in some cases solely from) the issuer's *ad valorem* taxes, while general obligation bonds issued by states often are payable from appropriations made by the state legislature or certain specified taxes or revenues.

Although general obligation bonds are frequently secured by a pledge of the issuer's full faith and credit, this concept is rarely addressed by any constitutional or statutory provision, or in case law. However, the Supreme Court of Florida said in *State ex rel. Babson v. Sebring,* 155 So. 669, 672 *(Fla. 1934)* (emphasis in original):

> A provision in a municipal bond that "for the prompt payment hereof, both principal and interest as the same become due and payable, the full faith, credit and resources of the" named city "are hereby irrevocably pledged" is in legal effect an express undertaking by the municipality that it is obligated to in good faith use its resources *as may be authorized or required by law* for the prompt payment of the principal and interest of the bond as it becomes due and payable under its terms.

In the context of the New York City financial crisis in the mid-1970s, the New York Court of Appeals addressed the meaning of a pledge of an issuer's full faith and credit and said:

> A pledge of the city's faith and credit is both a commitment to pay and a commitment of the city's revenue generating powers to produce the funds to pay. Hence, an obligation containing a pledge of the city's "faith and credit" is secured by a promise both to pay and to use in good faith the city's general revenue powers to produce sufficient funds to pay the principal and interest of the obligation as it becomes due. That is why both words, "faith" and "credit", are used and they are not tautological. That is what the words say and that is what courts have held they mean when rare occasion has suggested comment. As stated by the Supreme Court of Florida in *State v. County of Citrus:* "[T]he effect of such pledge of 'full faith and credit' is not to create a general or special lien or charge upon the unspecified revenues, moneys or income of the obligor not therein specifically obligated to the payment of such bonds, but is to acknowledge an indebtedness for the amount of money received as a consideration for the bonds, which indebtedness will become enforceable in an ordinary action, should the special contractual obligation as embraced in the bond itself, fail."
>
> A "faith and credit" obligation is, therefore, entirely different from a "revenue" obligation, which is limited to a pledge of revenues from a designated source or fund. It is also in contrast to a "moral" obligation, which is backed not by a legally enforceable promise to pay but only by a "moral" commitment.

Flushing Nat'l Bank v. Mun. Assistance Corp., 40 N.Y.2d 731, 735 (1976) (citations omitted).

The general concept of a full faith and credit obligation is consistently used by issuers of general obligation bonds, but the specific attributes of any individual full faith and credit obligation will undoubtedly vary to some degree among different states. It may be difficult for an issuer to detail the characteristics of its full faith and credit obligation, as constitutional, statutory, case law and other state law tends to recite the plain language of the term rather than provide a definition of the term.

There are three general categories of general obligation bonds: unlimited tax general obligation bonds ("UTGOs"), limited tax general obligation bonds ("LTGOs") and general obligation bonds payable from the issuer's general fund ("GFGOs"). In some states, it is also possible that a general obligation bond may be issued as a "double-barreled bond" which is also secured by another defined source of revenues (*e.g.*, water or sewer revenues or excise taxes).

In broad terms, the characteristics of UTGOs, LTGOs, and GFGOs are set forth in the table on page 4. Market participants should consult state and local laws as there are many variations on these concepts. The characteristics of a particular bond issue will depend upon applicable state or local law or the express terms of the bond documents.

	UTGO	LTGO	GFGO
Full Faith and Credit	May be secured by full faith and credit of the issuer.	May be secured by full faith and credit of the issuer.	May be secured by full faith and credit of the issuer.
Taxing Power	May be secured by a promise to levy *ad valorem* property taxes, unlimited as to rate or amount, levied by an issuer on all taxable property within its territorial limits. In many states, this is a separately identified mill levy (levied solely to pay debt service) and the tax revenues from the levy are sometimes segregated from other issuer revenues.	May be secured by a limited *ad valorem* property tax. The tax may be limited as to rate or amount. The issuer cannot be compelled to levy in excess of the rate or amount. In some states, this is not separated from the mill levy for the general fund but in some states it is a separately identified mill levy and the tax revenues are sometimes segregated from other issuer revenues.	No specific pledge of taxing power. The issuer cannot be compelled to increase taxes but may be required in good faith to use its general revenue-producing powers.
Voter Approval	Voter approval often required.	Voter approval is often not required.	Voter approval is often not required.
Statutory Obligation to Repay	May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.	May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.	May be accompanied by an affirmative statutory requirement to provide for maturing debt service in the annual budget.

STATE LAW REMEDIES

Nature of General Obligation Bond Security

For general obligation bonds supported by the issuer's full faith and credit, courts have recited or relied on the plain language of the phrase to conclude that a full faith and credit obligation is just that: a dual obligation of an issuer to pay debt service when due and to use, in good faith, its full credit and resources to generate the revenues necessary to enable it pay such debt service when due. Depending on state and local law, issuers of UTGO or LTGO bonds may be more specifically obligated by promising certain procedural protections or by promising to levy specific taxes. These promises may be unconditional or conditioned upon certain actions or subject to certain limitations as described more fully herein.

Procedural Components of the Promise. A general obligation bond issuer is obligated to take the procedural steps necessary to pay debt service when due from legally available funds. These procedural steps provide a framework for the remedies available to bondholders, including a mandamus action, as later described in this paper. To understand the applicability and practical availability of potential remedies, it is important to understand each procedural step an issuer takes in connection with budgeting, imposing or increasing taxes, collection, custody and appropriation of funds, and applying amounts to payment of debt service, and whether any of these steps is specifically required by statute, is discretionary or conditional, or involves action by another governmental entity. It is also important to understand the timing of each step in relation to the timing of debt service payment dates.

Substantive Components of the Promise. In terms of the substance of an issuer's full faith and credit obligation to pay general obligation bonds, an issuer may have pledged certain funds (*e.g.*, amounts in the general fund or only unrestricted funds) to the payment of its general obligation bonds. A general obligation bond usually carries the pledge of the issuer's powers to produce revenues sufficient for the payment of the debt, and sometimes carries a pledge of specific taxing powers. Where an issuer has pledged specific taxing powers, the issuer is generally obligated (by constitutional, statutory or contractual requirement) to impose one or more lawfully authorized taxes at rates and amounts sufficient to generate revenue to pay debt service on the bonds.

> Specific Taxing Power. Depending on state and local laws, UTGO (and under certain circumstances, LTGO) bonds may be issued with a pledge by the issuer to levy additional taxes. These additional taxes may be authorized specifically and solely for the payment of debt service. There is considerable variation among states regarding whether the levy of such taxes requires voter approval and whether the taxes are unlimited as to rate and in an amount sufficient to pay debt service.
>
> To understand the practical availability of particular remedies, it is important to know, *with specificity*, which taxes are pledged, and whether such taxes are subject to legal limitations as to rate or amount. The effect of legal limitations as to rate or amount depends on whether the current rates or amounts imposed are at or close to the legal maximum. In many jurisdictions, the legal limitations as to rate and amount have been the focus of sustained initiatives, referenda and other taxpayer protection efforts,

resulting in more restrictive limits on tax rates and amounts. Consequently, it is important to understand not only the legal limitations, but also whether these limitations in fact are likely to operate in a manner that will constrain the issuer's ability to pay debt service when due on its general obligation bonds, and under what circumstances.

Rights in the Pledged Taxes. The nature of the security provided to bondholders may include specific promises to take certain procedural steps or a specific pledge of certain funds or taxing powers. The nature of the security in the event of a default varies among the states, depending on whether (i) state law creates an effective statutory lien on certain funds or taxes, (ii) a security agreement properly creates and perfects a security interest under state law, (iii) a separate imposition of millage solely for debt service would be recognized and enforced under state law, (iv) there was in fact a statutory or other security interest created and perfected (either self-executing or by proper documentation, notice and/or possession), and (v) there is an effective property interest conveyed in the security which would be recognized in a Chapter 9 proceeding.[1]

Custody and Segregation of Funds. An issuer may be permitted or required to segregate or earmark certain funds for payment of debt service under state law. To understand whether an issuer has effectively segregated or earmarked funds for payment of debt service, it is important to understand whether tax collections or other amounts are subject to segregated custody and control, when any segregation occurs, and whether the taxes are levied, collected or held by (or diverted to) a different governmental entity or third-party custodial agent, perhaps subject to a deposit account control agreement in favor of the bondholders. Often, taxes are not segregated into a separately held and invested fund, but rather are commingled and simply accounted for separately. Further confusing the chain of custody and respect for segregation, even separately held funds may be loaned to another fund (which is not pledged to bond repayment), depending on whether and under what circumstances interfund transfers are permitted under state law.

Continuation or Expiration of Rights. Generally, an obligation to pay debt service will carry over to ensuing fiscal years to the extent the amount has not been paid when due. In some states, however, an issuer's obligation to pay debt service on LTGOs or GFGOs may not carry over past the end of the fiscal year in which a payment was missed and the unpaid obligation may be extinguished or lose certain security protections at the end of such fiscal year.

Legally Available Remedies

The remedies available to bondholders are informed by the procedural steps an issuer has promised to undertake to ensure payment of debt service on its general obligation bonds, whether certain funds or specific taxes are pledged, and whether pledged funds are subject to a statutory or other lien. The specific remedies that are available may be based upon provisions of state constitutions, statutes and codes, charters, ordinances or contracts.

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[1] As noted by *The Report of the National Association of Bond Lawyers Opinions and Documents Committee Re: Revised Article 9 of the Uniform Commercial Code, July 17, 2000*, there is some variation among states regarding the treatment of security interests created by a government or governmental subdivision or agency.

Writ of Mandamus. A common equitable remedy available to bondholders of general obligation bonds is to compel specific performance by writ of mandamus directing a public official to perform an official duty, such as the payment of debt service when due. Because courts do not impose taxes directly due to principles of separation of powers, a mandamus action is the proper remedy to compel the imposition, collection and application of pledged taxes by a recalcitrant official or legislative authority of local government. Generally, such a writ can be sought from a court of competent jurisdiction to compel a government official or authority to perform only a non-discretionary, mandatory duty of office imposed by statute (*e.g.*, to impose or collect a tax, or perhaps to even recognize a priority in the application of the collected funds).

Because a writ of mandamus is typically available to compel performance of non-discretionary or ministerial duties, it is important to understand whether each procedural step necessary to the payment of debt service on the bonds is, by statute or other state or local law, nondiscretionary or discretionary, conditional or unconditional. For example, a writ of mandamus to compel performance of a promise to apply funds to the payment of debt service after due consideration of the operating requirements of the issuer (in a circumstance where there is not a clear first priority for debt service) may not be available under a state's laws, whereas a writ of mandamus may be available to compel imposition of taxes to be imposed without limitation as is required for payment of debt service. Note that some procedural steps may be required to be undertaken by governmental officers of entities other than the issuer (for example, state statutes may provide for a state's or other entity's intercept of funds in certain circumstances[2]). If a writ of mandamus is issued to compel performance of a nondiscretionary duty, performance may be enforced by threat of being held in contempt of court, and by the powers of the court to address such contempt.

Appointment of Receiver. In many states, the power to appoint a receiver to undertake budgetary or other issuer functions of governmental finance may be available as a remedy under statute (legislative appointment) or compelled by a court (judicial appointment). The powers available to a receiver will vary by state and may depend upon the source of the power of appointment. In some states appointment of a receiver may interfere with powers that have been legally delegated to elected or appointed officials. Depending on the powers granted to the receiver, the receiver may effectively supplant all or certain powers, functions and responsibilities of some or all elected officials of the issuer. Typically, the receiver will have a limited role providing oversight (*e.g.*, budgetary approval) of issuer actions. In some circumstances, however, a receiver may be granted powers that go beyond those exercised by elected local officials.

Asset Seizure. In most states, the seizure of public property is not likely to be an available remedy to the owners of general obligation bonds.[3] A creditor generally has little or no recourse to the assets of a state or local government debtor. A state or local government owns property as a means of accomplishing governmental functions, so private parties, including the

[2] *See* Va. Code § 15.2-2659 (2012).

[3] McQuillin, *Law on Municipal Corporations* §§ 49.45, 49.47 (3d ed. 1995); McQuillin, *Law on Municipal Corporations* §28.73 (3d ed. 1995); *Bradford v. Brennan,* 631 A.2d 1165 (Conn. Super. Ct. 1992); and *City of Westminster v. Brannan Sand & Gravel Co.,* 940 P.2d 393 (Colo. 1997).

holders of general obligation bonds, generally do not have the power to impede those functions by seizing property. It may be possible to compel the sale of property held by the government in a proprietary capacity or property not considered essential to the proper functioning of the government, but these are narrow exceptions to the general prohibition on seizure of public assets.

In most states, repayment of a general obligation bond is not a personal obligation of private property owners; however, non-payment of lawfully imposed taxes (which may in turn be pledged to the payment of general obligation bonds) will generally result in a lien on the property subject to the property tax. Therefore, the property interest of a delinquent taxpayer is indirectly available for the payment of debt service through the threat of a tax lien sale. It is important to understand the often detailed statutory or judicial notice, timing and other protections afforded to delinquent taxpayers to evaluate the security provided by a tax lien. It is also important to understand the value of the property subject to the lien, and the ability of the foreclosure and sale process to effectively realize that value. Note that if tax sale proceeds are insufficient to pay the tax lien, there is typically no right to seek a deficiency judgment against property owners to augment the insufficient sale proceeds.

Acceleration. Because the taxes and other revenues pledged to pay debt service cannot be accelerated, general obligation bonds are generally not themselves subject to acceleration. Bondholders will ordinarily not be able to direct an acceleration of the payment date upon a default or seek payment of accelerated principal. In the event of successive defaults in payment of principal or interest, bondholders may need to bring a separate mandamus or other enforcement action for each such payment not made.

For additional reading on remedies see:

David M. Eisenberg, *Creditor's Remedies in Municipal Default*, 1976 Duke L.J. 1363 (1976);

Jeff B. Fordham, *Methods of Enforcing Satisfaction of Obligations of Public Corporations*, 33 Colum. L. Rev. 28 (1933);

John Martinez, *Bondholder Remedies–General Obligation Securities*, 4 Local Government Law § 25:24 (October 2013);

Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 Fordham Urb. L.J. 787 (2012); and

Richard C. Schragger, *Citizens Versus Bondholders*, 39 Fordham Urb. L.J. 639 (2012).

<u>Affirmative Defenses</u>

Certain affirmative defenses may be available to issuers of general obligation bonds confronting litigation to compel payment of debt service. In most states, however, the availability of these defenses has eroded over time. Today, an affirmative defense of sovereign immunity is generally not applicable to liabilities arising out of governmental contracts based upon an implied waiver theory. Vestiges of the traditional sovereign immunity defense may still be perceived, however, in the general prohibition on seizure of governmental assets to enforce a judgment lien.

Other affirmative defenses may have continued applicability. Defenses to a writ of mandamus may include the insolvency of the issuer or the ineffectiveness of compelled action. Insolvency may be difficult to define because a state or local government has wide control over its revenues and expenses. In evaluating the potential effectiveness of an insolvency defense to a mandamus action, one should consider whether a court would be willing to second-guess an issuer's view regarding the necessity of paying operating expenses and/or the practical ability to raise taxes. As noted above, the remedy of mandamus is effective in compelling performance of nondiscretionary duties. The remedy of mandamus may not be available for a full faith and credit obligation that promises a broad range of legally available revenues which also are to be applied to meet other governmental obligations.

Depending on the legal limitations applicable to a pledge of a specific taxing power, an issuer may be constrained from imposing or increasing the pledged taxes. An issuer may resist imposing or increasing the pledged tax by asserting that such imposition or increase would be *ultra vires* or invalid due to a constitutional or statutory debt cap or the absence of other necessary authorization.

In certain extreme cases, an issuer may assert a defense to repayment by seeking a judicial declaration that the underlying obligation is invalid, typically due to a procedural defect in the authorization or validation of its incurrence, or based upon other legal theories including fraud.[4] Because invalidation of municipal debt will often result in the draconian outcome for investors of negating the debtor's entire repayment obligation, a local government invoking such a defensive tactic will likely find itself confronted with a broad array of equitable defenses (*e.g.*, estoppel, unjust enrichment, laches, unclean hands) and counterclaims for fraud in the offering and sale of the debt.

<u>Practical Limitations on Availability of Remedies</u>

In addition to the legal limitations on the availability of general obligation bond remedies, there are likely to be practical limitations to consider. The practical limitations on remedies were observed by the Supreme Court in *Faitoute Iron & Steel Co. v. City of Asbury Park, 316 U.S. 502 (1942)*. According to the Court:

> The principal asset of a municipality is its taxing power, and that, unlike an asset of a private corporation, cannot be available for distribution. An unsecured municipal security is therefore merely a draft on the good faith of a municipality in exercising its taxing power. The notion that a city has unlimited taxing power is, of course, an illusion. A city cannot be taken over and operated for the benefit of its creditors, nor can its creditors take over the taxing power. Indeed, so far as the federal Constitution is concerned, the taxing power of a municipality is not even within its own control -- it is wholly subordinate to the unrestrained power

[4] The City of Detroit has asserted in its Chapter 9 proceeding that certain of its Taxable Certificates of Participation issued to fund pension obligations are invalid.

> of the state over political subdivisions of its own creation. … The only remedy for the enforcement of such a claim is a mandamus to compel the levying of authorized taxes. The experience of the two modern periods of municipal defaults, after the depressions of [1873] and [1893], shows that the right to enforce claims against the city through mandamus is the empty right to litigate.

Id. at 509-10 (citations omitted). Further, the Court observed:

> How, then, can claims against a financially embarrassed city be enforced? Experience shows that three conditions are essential if the municipality is to be kept going as a political community, and, at the same time, the utmost for the benefit of the creditors is to be realized: impartial, outside control over the finances of the city, concerted action by all the creditors to avoid destructive action by individuals, and ratable distribution. In short, what is needed is a temporary scheme of public receivership over a subdivision of the state. A policy of every man for himself is destructive of the potential resources upon which rests the taxing power which, in actual fact, constitutes the security for unsecured obligations outstanding against a city. To deny a state the means of giving substance to the taxing power which alone gives meaning to unsecured municipal obligations is to hold, in effect, that the right to pursue a sterile litigation is an "obligation" protected by the Constitution of the United States. For there is no remedy when resort is had to "devices and contrivances" to nullify the taxing power which can be carried out only through authorized officials.

Id. at 510-11.

To assess whether there is any risk of nonpayment and any access to effective remedies in the event of a default, the following factors should be considered, which may or may not be material depending on both legal and factual circumstances:

Competing Governmental Priorities. Is there a legislative or inherent priority of providing essential governmental services? Consider that a state or local government's primary obligation is to provide for the health, safety and welfare of its citizens.[5] Some states expressly provide a priority for application of limited resources to essential governmental services prior to payment of debt service. Other states provide a first priority for payment of debt service. Relevant questions include the following:

- Has the issuer over-extended its obligations beyond its capacity to fund essential services and to service its debt and other obligations?
- Will bondholders bear the burden to prove certain operating expenses are not critical to the effective provision of essential governmental services in order to

[5] For a discussion of the interplay between the police power of states and local governments and the Contracts Clause of the U.S. Constitution, see *U.S. Trust Co. of New York v. New Jersey,* 431 U.S. 1 (1977), *reh'g denied*, 431 U.S. 975 (1977).

overcome the deference that may be given by courts to expenditure decisions by local officials?

- Are other obligations of an issuer's general fund afforded enhanced constitutional, legal or political protections (*e.g.,* are there any extra protections afforded to vested pension obligations)?

- Are bondholders competing for the same limited dollars needed for more compelling obligations (either legally or politically)? Will issuer officials or a court recognize that the consequences of a bond default go beyond the legal consequences (such as credit ratings, access to and cost of capital, voter or constituent reaction, additional regulatory or legislative oversight or control), and therefore make bond repayment obligations a higher political priority among competing financial obligations?

Potential Changes in State Law. Subject to applicable constitutional provisions (such as the Contract Clause of the U.S. Constitution), a state legislature may approve changes to existing state law that may affect the nature and availability of remedies upon which bondholders may have relied. Changes may enhance or undercut the nature or availability of remedies[6], the failure to reauthorize a key taxing power that has lapsed or been struck down in court[7], the enabling of new taxing authority[8], providing a statutory lien for payment of debt service[9], or changes to state oversight, receivership or Chapter 9 authorizing laws.

Nature of Mandamus. As noted above, the principal remedy available to UTGO or LTGO bondholders may be a right to seek a writ of mandamus to compel performance of non-discretionary official action necessary to levy and collect sufficient taxes for the payment of debt service (up to the authorized tax limit in the case of an LTGO). The efficacy of the remedy is premised on the public official with the duty to undertake certain steps being willing to act in good faith without discretion in support of the local government's obligations (or at least being subject to compulsion by the court).

The following matters should be considered:

- Are state enabling laws explicit enough to provide the court with the ability to issue the writ? That is, is the statutory obligation to perform an official action

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[6] California – Cal. Gov't Code § 53760.3 (2012) (providing for mandatory mediation prior to the filing of a Chapter 9 proceeding in California).

[7] Alabama – *Jefferson County v. Jeffrey Weissman, D.D.S., et al.,* 69 So. 3d 827 (Ala. 2011).

[8] Pennsylvania – 53 P.S. § 11701.123(c) (providing additional taxing powers for certain distressed municipalities); Washington – RCW 82.14.048 (authorizing an additional sales and use tax pursuant to a legislative intent "to enable solutions for public facilities districts that are in default on bond anticipation notes or bonds" in response to a default).

[9] Rhode Island – R.I. Gen. Laws § 45-12-1 (2012).

clear, mandatory and non-discretionary? For example, in the absence of a mandatory statutory budgetary priority, could a writ be issued to compel the issuer to include debt service in its budget?

- In practical terms, will the issuer pay debt service from a pledged tax that can be enforced through a writ of mandamus or will the issuer pay debt service from discretionary funds that may be ill-suited to enforcement through mandamus?

The public official could refuse to comply with a writ, resign to avoid compliance, or be removed from office. The court may seek alternative avenues to compel performance (*e.g.*, by compelling performance by other officials or by appointing a receiver) in the event of a resignation or other official resistance.

Granting a writ may be discretionary or non-discretionary according to state law; but courts are given wide deference in the application of equitable remedies. A court may choose to withhold issuance of a mandatory writ in order to induce creditor negotiations or concessions, or could choose not to issue a writ without any explanation.

Ultimately, the efficacy of the mandamus remedy depends on the local government's possessing sufficient financial capacity (tax base) to render the compelled duty effective in actually producing enhanced revenue. It may be difficult for a court to assess whether a higher levy will generate more tax revenue, and a court may hesitate to compel an ineffective remedy.

Classification of Creditors. General obligation bonds represent "plain vanilla" municipal bonds, with broad appeal. The bonds may be bought by a large number of smaller (retail) holders. A bondholder group composed of many small creditors may complicate the process of directing remedies or reaching a compromise and settlement. The existence of a class of debt senior to the bonds in question may also be relevant as a senior debt class can make remedial actions by junior classes substantially more difficult or impossible.

State Fiscal Oversight Laws. Some states provide fiscal oversight to financially stressed local governments by statute. A state fiscal oversight law could serve to hinder or facilitate remedial outcomes. The existence of oversight or control boards, emergency management and/or receivership may avert an issuer default or may complicate the enforcement of remedies.

The foregoing are practical considerations that may affect the availability and efficacy of bondholder remedies to enforce payment of general obligation bonds. In light of these practical considerations, it is very likely that some form of negotiated settlement will be necessary absent resort to a Chapter 9 proceeding described later in this paper.[10] Settlements may involve a consensual refunding under court mediated guidance.

[10] The Supreme Court sustained the alteration of a municipal bond contract without the consent of all bondholders outside a bankruptcy case in *Faitoute Iron,* 316 U.S. at 516. *But see U.S. Trust*, 431 U.S. at 32 (striking down legislation allowing state to alter terms of bond obligations retroactively).

MUNICIPAL BANKRUPTCY

As discussed in the "INTRODUCTION", recent Chapter 9 bankruptcy cases filed by the City of Detroit, Michigan, Jefferson County, Alabama, the City of Central Falls, Rhode Island, and certain California cities have caused public finance market participants to focus on the characteristics of general obligation bonds and how they might be treated in a Chapter 9 case. In particular, the City of Detroit's initial proposal to treat its UTGOs as unsecured debt surprised many market participants by challenging the commonly held assumption that general obligation bonds supported by a voter-approved pledge of unlimited taxing power would be treated as secured claims in bankruptcy. (See the discussion in *City of Detroit Bankruptcy Case* below regarding the proposed settlement in connection with the Detroit UTGOs.)

A thorough review of Chapter 9 is beyond the scope of this paper; however, NABL has prepared a primer on Chapter 9 that readers can review to learn more.[11] More importantly, though, any attempt to summarize or examine in detail provisions of the Bankruptcy Code and relevant case law would not lead to general conclusions about the treatment of general obligation bonds in Chapter 9 for the following reasons:

- Chapter 9 proceedings have been relatively rare and the law is still developing,
- many of the reported decisions are at the trial court level and were not appealed and, therefore, may not be binding on other trial or appellate courts,
- disputes in bankruptcy (like civil litigation generally) are almost always settled before the issues are fully litigated, and
- most importantly, because the treatment of general obligation bonds in Chapter 9 will depend on the security provided by applicable state law, a decision regarding any particular general obligation bond is not likely to be determinative of the treatment of general obligation bonds issued in the other 49 states.

Although it is not possible to reach conclusions about the treatment of all general obligation bonds in Chapter 9, this paper will attempt to provide a framework for considering the possible impact of a Chapter 9 bankruptcy on general obligation bonds.

Because states (and territories such as Puerto Rico) are not eligible to file a Chapter 9 bankruptcy case, the discussion below regarding the possible impact of Chapter 9 bankruptcy on general obligation bonds is applicable only to general obligation bonds of "municipalities" (as that term is defined in the Bankruptcy Code).

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[11] *See NABL's 2012 Report – Municipal Bankruptcy: A Guide for Public Finance Attorneys* available at: www.nabl.org/uploads/cms/documents/Municipal_Bankruptcy_A_Guide_for_Public_Finance_Attorneys_June_2012.pdf.

Chapter 9 Bankruptcy Cases are Rarely Filed, and Even More Rarely Filed by the General Purpose Governments That are Most Likely to Issue General Obligation Bonds

In assessing the risk posed by Chapter 9 to the treatment of general obligation bonds, it is important to consider the likelihood that the issuer will file a Chapter 9 bankruptcy case while the bonds remain outstanding. Chapter 9 cases are relatively rare. There have been only 664 filings since 1937 and only 20 in 2012 and 9 in 2013.[12] Moreover, these filings have been mainly by small special districts and municipal utilities as opposed to general purpose governments that are most likely to issue general obligation bonds.[13]

An Issuer May or May Not Be Authorized to File a Chapter 9 Bankruptcy Case

Chapter 9 cannot pose a risk to the treatment of general obligation bonds unless the issuer is eligible to file a Chapter 9 case. Section 109(c)(1) of the Bankruptcy Code provides that only a "municipality" may be a debtor under Chapter 9. The term "municipality" is defined in the Bankruptcy Code to mean a "political subdivision or public agency or instrumentality of a State."[14] As a result of these provisions, states and territories are not permitted to file a Chapter 9 case.

Section 109(c)(2) of the Bankruptcy Code provides that a municipality may file a Chapter 9 case if and only if such entity "is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter . . . ." As a result, one of the first issues frequently contested in a Chapter 9 case is whether the issuer is authorized to file the case under applicable state law. Currently, twenty-two states either prohibit or do not specifically authorize a Chapter 9 filing and the balance of the states specifically authorize municipal bankruptcies or do so with conditions or only with respect to a limited category of local governments.[15]

Classification of Claims in Bankruptcy as Secured or Unsecured; Treatment of Secured Claims versus Unsecured Claims in Bankruptcy

The threat to general obligation bonds posed by Chapter 9 is that they will be treated as partially or wholly unsecured claims that may be repaid at a potentially steep discount. To better understand this threat, it is useful to first understand the provisions of the Bankruptcy Code

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[12] *See* http://www.abiworld.org/statcharts/Ch9Filings1980-Current.pdf, http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2012/1212_f2.pdf, and http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/1213_f2.pdf.

[13] James E. Spiotto, *The Myth and Reality of State and Local Governments Debt Financing in the U.S.A. in Times of Financial Emergency*, Address Before the Securities and Exchange Commission (July 25, 2011).

[14] 11 U.S.C. § 101(40) (2012). *See In re Las Vegas Monorail Company*, 429 B.R. 770 (Bankr. D. Nev. 2010) (holding that the debtor was not a municipality).

[15] *Moody's Investors Service, All GO Pledges Are Not Created Equal: Detroit Case Unlikely to Set National Precedent*, March 11, 2014. For a state by state summary of whether or not bankruptcy is authorized for local governments, see James E. Spiotto*, Primer on Municipal Debt Adjustment, Chapter 9: The Last Resort for Financially Distressed Municipalities*, First Edition 2012.

regarding the classification of claims as secured or unsecured and the treatment of secured claims.

The first step is determining whether the claims of the holders of the general obligation bonds are allowed under Section 502 of the Bankruptcy Code. The term "claim" is defined in the Bankruptcy Code to mean a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured . . . ."[16] Section 502(a) of the Bankruptcy Code provides that a "claim . . ., proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest . . . objects." Section 502(b) of the Bankruptcy Code provides that, if an objection is made, the bankruptcy court, after notice and a hearing, must determine the allowed amount of the claim. Because general obligation bonds clearly involve a right to payment, claims filed by the holders of the bonds will be allowed unless a party in interest objects. An issuer, for example, could object if it believed that the bonds had been invalidly issued.

Determination of secured status is then made pursuant to Section 506 of the Bankruptcy Code. Section 506(a)(1) provides that:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

The term "lien" is defined in the Bankruptcy Code as a "charge against or interest in property to secure payment of a debt or performance of an obligation."[17] The Bankruptcy Code recognizes three types of liens:

- statutory liens – a "lien arising solely by force of a statute on specified circumstances or conditions, or lien of distress for rent, whether or not statutory, but does not include [a] security interest or judicial lien, whether or not such interest or lien is provided by or is dependent on a statute and whether or not such interest or lien is made fully effective by statute."[18]

- security interests – a "lien created by an agreement."[19]

- judicial liens – a "lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding."[20]

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[16] 11 U.S.C. § 101(5) (2012).

[17] *Id.* § 101(37).

[18] *Id.* § 101(53).

[19] *Id.* § 101(51).

[20] *Id.* § 101(36).

If a claim is secured by a lien on property in which the bankruptcy estate has an interest, the amount of the secured claim will be determined by the value of the creditor's interest in the estate's interest in the collateral. If the value of the collateral exceeds the allowed amount of the claim (which is referred to as being "fully secured" or "oversecured"), then the entire allowed claim of the creditor will be treated as a secured claim. If the value of the collateral is less than the allowed amount of the claim (which is referred to as being "undersecured"), then the creditor will have two claims: a secured claim in an amount equal to the value of the collateral and an unsecured claim for the deficiency.

This determination is important because of the protection afforded secured claims in bankruptcy. This protection is ultimately grounded in the takings clause of the Fifth Amendment.[21] A Chapter 9 plan of adjustment must meet the confirmation requirements incorporated from Section 1129 of the Bankruptcy Code, including the minimum required treatment of secured claims and unsecured claims specified in Section 1129(b) if the plan is to be confirmed over the objection of one or more classes of impaired claims ("crammed down").[22] If the claims of general obligation bondholders are determined to be secured, then they would be most likely to receive cash payments over time with a present value equal to the allowed amount of their secured claims (probably according to the original principal amortization schedule and at the original interest rates).[23] In contrast, if the claims of general obligation bondholders are determined to be unsecured, then their claims are not required to be paid in full.[24]

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[21] *See Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment."); *U.S. v. Security Indus. Bank*, 459 U.S. 70, 75 (1982) ("The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation." (citing *Radford*, 295 U.S. at 589)); *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992).

[22] *See* 11 U.S.C. § 901 (2012). A Chapter 9 plan of adjustment also must meet the additional confirmation requirements set forth in Section 943.

[23] 11 U.S.C. § 1129(b)(2)(A) (2012) provides that, with respect to a class of secured claims, a plan must provide:

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such claims is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

[24] *Id.* § 1129(b)(2)(B).

Means of Determining that General Obligation Bonds are Secured Claims

General obligation bonds may be treated as secured debt if they are secured by a statutory lien or a lien on "special revenues."

Statutory Lien. If applicable state law creates a statutory lien on property of the issuer to secure payment of general obligation bonds (that is not avoidable under Section 545 of the Bankruptcy Code[25]), then the bonds may be treated as secured debt.

Some of the limited case law related to the treatment of municipal bonds in Chapter 9 is related to the existence of a statutory lien. For example, in the Chapter 9 bankruptcy case of an irrigation district in the State of Washington, the United States Court of Appeals for the Ninth Circuit affirmed the holdings of the lower courts that the bondholders had an unavoidable lien on property owned by the district.[26] In the Chapter 9 bankruptcy case of Orange County, California, the United States District Court for Central District of California held on appeal from the bankruptcy court that the lien under California Government Code Section 53856 securing the appellants' 1994-95 tax and revenue anticipation notes was a statutory lien which survived the filing of the County's Chapter 9 petition.[27]

After a superior court judge appointed a receiver to oversee the deteriorating finances of the City of Central Falls, Rhode Island in May 2010, the State of Rhode Island quickly responded with a plan to scrap the state's limited intervention program and replace it with an expanded version that would allow Rhode Island to get involved with distressed cities earlier. In 2011, Rhode Island adopted a statutory lien to protect general obligation bondholders, R.I. Gen. Laws § 45-12-1, which is set forth in Appendix A. When the state-appointed receiver of Central Falls concluded that the city should file bankruptcy later in 2011, the city was able to emerge from bankruptcy in a little over a year, and the claims of the city's general obligation bondholders were treated as secured and paid in full.

Examples of statutory liens on revenues pledged to pay general obligation bonds in other states include Colorado, Colo. Rev. Stat. § 11-57-208; Nevada, Nev. Rev. Stat. Ann. § 350.662; and Louisiana, La. Rev. Stat. Ann. § 39:1430.

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[25] Section 545 permits a statutory lien to be avoided under certain circumstances, e.g., if the lien first becomes effective against the debtor when a bankruptcy case concerning the debtor is commenced, if the lien is not perfected or enforceable at the time of commencement of the case against a bond fide purchaser that purchases such property at the time of the commencement of the case.

[26] *See In re Badger Mountain Irrigation Dist.*, 885 F.2d 606 (9th Cir. 1989).

[27] *See Alliance Capital Mgmt. L.P. v. County of Orange (In re County of Orange)*, 189 B.R. 499 (Bankr. C.D. Cal. 1995). *See also In re Sierra Kings Health Care Dist.,* 2010 Bankr. LEXIS 6536 (Bankr. E.D. Cal. Sept. 13, 2010).

Special Revenues. In 1988, Chapter 9 of the Bankruptcy Code was amended to add provisions relating to "special revenues," which were intended to protect holders of municipal revenue bonds (the "1988 Amendments"). Although the 1988 Amendments were intended to resolve concerns about treatment of revenue bonds in Chapter 9, holders of general obligation bonds also may be able to take advantage of these provisions if the security pledged for their bonds constitutes "special revenues."

By way of background, after the adoption of the Bankruptcy Code in 1978, it became apparent that some of the provisions of Chapters 7 and 11 that applied to business bankruptcies would have unintended consequences when incorporated and applied in municipal cases under Chapter 9. For example, Section 552(a) of the Bankruptcy Code, which is applicable in a Chapter 9 case, terminates security interests in property acquired by the debtor or the estate post-petition.[28] Prior to the 1988 Amendments, the application of Section 552(a) could have eliminated the right of bondholders to the revenues that were intended to be their sole source of repayment. Conversely, there were concerns that Section 1111(b) of the Bankruptcy Code, which transforms nonrecourse debt into recourse debt for purposes of Chapter 11, would transform a revenue bond issue (with liability limited to specific revenues) into a general obligation of the issuer.

To resolve these problems, the 1988 Amendments added the following definition of "special revenues" to Section 902(2) of the Bankruptcy Code:

(A) receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services, including the proceeds of borrowings to finance the projects or systems;

(B) special excise taxes imposed on particular activities or transactions;

(C) incremental tax receipts from the benefited area in the case of tax-increment financing;

(D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or

(E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purposes of the debtor.

[28] Section 552(a) of the Bankruptcy Code provides: "Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." Although Section 552(a) cuts off security interests in property acquired post-petition, it does not apply to statutory liens in property acquired post-petition.

The 1988 Amendments also added Sections 927 and 928 to Chapter 9. Section 927 assures that bonds intended under applicable nonbankruptcy law to be limited obligations of an issuer payable solely from specified revenues remain limited obligations in bankruptcy.[29] Section 928(a) provides that Section 552(a) does not apply to special revenues acquired post-petition.[30] To ensure that revenue bonds would continue to be paid on a current basis during a Chapter 9 case, the 1988 Amendments also added Section 922(d) to Chapter 9, which provides an exception from the automatic stay for application of special revenues to payment of indebtedness secured by such revenues. Section 928(b), however, provides that "[a]ny lien on special revenues, other than municipal betterment assessments, derived from a project or system shall be subject to the necessary operating expenses of such project or system, as the case may be," effectively converting a gross revenue pledge into a net revenue pledge.

City of Detroit Bankruptcy Case

The City of Detroit commenced a Chapter 9 bankruptcy case in the United States Bankruptcy Court for the Eastern District of Michigan on July 18, 2013. Upon the filing of the petition to commence the case, the city's Emergency Manager proposed that the city's UTGOs be treated as unsecured debt. On October 1, 2013, the city defaulted on its obligation to make interest payments on its UTGOs.

On November 8, 2013, two bond insurers (MBIA/National and Assured Guaranty) filed an adversary proceeding in the Bankruptcy Court against the city and four city officials (the Emergency Manager, the Finance Director, the Deputy Finance Director and the Treasurer) relating to the UTGOs they insure. On November 8, 2014, a few hours after MBIA/National and Assured Guaranty filed suit, AMBAC filed its own adversary proceeding relating to the UTGOs it insures and some of the city's LTGOs it also insures.

On December 23, 2013, MBIA/National and Assured Guaranty filed a first amended complaint in their adversary proceeding. In this first amended complaint, the insurers allege that the city is unlawfully diverting voter-approved *ad valorem* taxes that the city must levy, collect and use for the sole purpose of paying principal and interest on the UTGOs. The insurers contend that Michigan law requires the city to:

- Levy *ad valorem* taxes for the exclusive purpose of repaying the UTGOs, without limitation as to rate or amount, and in the amount necessary to repay the UTGOs, which are separate from and in addition to other *ad valorem* taxes the city is authorized to levy (the "Unlimited Tax Levy"),

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[29] Section 927 of the Bankruptcy Code provides that: "The holder of a claim payable solely from special revenues of the debtor under applicable nonbankruptcy law shall not be treated as having recourse against the debtor on account of such claim pursuant to section 1111(b) of this title."

[30] Section 928(a) of the Bankruptcy Code provides that: "Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."

- Collect the *ad valorem* taxes levied for UTGO debt service and deposit such proceeds in segregated debt retirement funds (the "Debt Retirement Funds"), and

- Use the *ad valorem* taxes only to pay principal of and interest on the UTGOs.

The insurers also contend that:

- Under Michigan law, the city has no equitable or beneficial property interest in the *ad valorem* taxes levied and pledged specifically to secure the repayment of the UTGOs,

- Those ad valorem taxes (the "Restricted Funds") are restricted by law and cannot be levied, collected or used by the city for any purpose other than satisfying the city's payment obligations with respect to the UTGOs, and

- The Restricted Funds are impressed with a "statutory lien" as defined in the Bankruptcy Code and constitute "special revenues" as defined in the Bankruptcy Code.

On February 19, 2014, the bankruptcy court held a hearing on the city's motions to dismiss both adversary proceedings brought by the insurers, during which the insurers argued that the bondholders have a statutory lien on the Restricted Funds and the city argued that the UTGOs are general unsecured claims.

On February 21, 2014, two days after the hearing, the city filed a proposed plan of adjustment pursuant to which it offered to pay 20 cents on the dollar to the holders of UTGOs. On March 31, 2014, the city filed another proposed plan of adjustment that would have reduced the payment on the UTGOs to 15 cents on the dollar. On April 9, 2014, the city and the insurers announced a settlement pursuant to which the insurers will vote in favor of a further revised plan of adjustment that will pay them 74 cents on the dollar. If a plan of adjustment is confirmed based on the settlement, then no final decision regarding the secured status of the UTGOs is likely to be rendered.

<u>Unresolved Issues under Chapter 9</u>

As the proposed settlement in the City of Detroit bankruptcy case illustrates, issues raised in a Chapter 9 bankruptcy case relating to the characterization and treatment of general obligation bonds may not be the subject of a final judicial resolution. Moreover, given the relative rarity of Chapter 9 filings, many issues relating to general obligation bonds have not yet been raised. Some of these unresolved issues include:

- Are all general obligation bonds the same, or does bankruptcy treatment depend upon the type of general obligation bond? Is an unlimited tax pledge approved by the debtor's taxpayers without limit as to rate or amount different than a limited tax pledge approved only by elected officials of the debtor (an arguably unilateral promise by the issuer to levy within an existing authorization)?

- If not all general obligation debt is treated the same, what is the basis for the different treatment? If 11 U.S.C. § 552 (2012) cuts off liens created by "security agreements," is there a difference if the pledge arises by operation of state law in addition to the bond indenture? In the case of liens imposed by state law, does it matter if these liens are automatic or not? If a lien is not automatic, but properly perfected under state law (under the UCC or otherwise), does that make a difference?

- How critical is uninterrupted custody and control of the pledged revenues? Does a statutory lien prevail in a Chapter 9 proceeding if custody and control is compromised?

- Regardless of lien treatment, are state law restrictions on the use of revenues or the power to tax preempted by the Bankruptcy Code? What is the critical factor in this determination: ballot language, state law restrictions, nature of the tax assessment, levy and collection by the debtor or a third party?

- Is the answer different if it is a double barrel bond? If the pledged special revenues are inadequate, does the obligation still benefit from the general obligation pledge or is the debt secured only to the extent of pledged special revenues and unsecured to the extent they are insufficient? *See* 11 U.S.C. § 927 (2012), which provides that special revenue bonds remain non-recourse obligations after the filing of a Chapter 9 proceeding.

- Is the answer different depending on when taxes are levied? May a debtor in a Chapter 9 case divert taxes assessed pre-petition but collected post-petition for other purposes? May a debtor in a Chapter 9 case levy additional taxes authorized solely for debt post-petition when it is diverting those taxes for other purposes such as operating expenses?

- Are there limits to the extension of federal authority to modify state statutory limits during pendency of a Chapter 9 proceeding? Does the Supremacy Clause mean that a bankruptcy court can modify state taxing authority or state spending authority? Are the automatic stay provisions a limit on this federal authority?

In addition to these questions, there are questions about payment of operating expenses that could impact treatment of general obligation bonds. Payment by an issuer of necessary operating expenses in a Chapter 9 case comes before payment of debt, secured or unsecured. Section 904 of the Bankruptcy Code recognizes the reality that municipalities need to function as such during the pendency of a bankruptcy proceeding. Section 928(b) of the Bankruptcy Code expressly acknowledges this right even for special revenue obligations. Municipalities, for instance, need to continue to provide police and fire services. The exact scope of necessary operating expenses is not defined by the Bankruptcy Code and may be contested by the creditors in a bankruptcy proceeding. For example, it is unclear whether the professional costs of administering a bankruptcy constitute necessary operating expenses.[31]

There are also questions about whether certain pledged revenues are property of the municipal debtor, which may not be entirely a function of the Bankruptcy Code. For instance, in some states municipalities pledge revenues to be received from the state under bond documents that provide for intercept of such monies for the benefit of bondholders before receipt by the municipalities. Are these funds revenues of the debtor?[32]

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[31] *See Bank of N.Y. Mellon v. Jefferson County, AL (In re Jefferson County)*, 2013 Bankr. LEXIS 2596 (Bankr. N.D. Ala. June 27, 2013).

[32] Amicus Curiae Brief in Support of Motion of Creditor National Public Finance Guarantee Corporation for an Order Declaring the Automatic Stay Inapplicable or, in the Alternative, Granting Relief from the Automatic Stay, *In re City of Vallejo, California*, 2009 Bankr. LEXIS 970 (Bankr. E.D. Cal. Sept. 16, 2010) (No. WS-002).

DISCLOSURE CONSIDERATIONS

Given the various types of general obligation bonds under state and local law, the differences in pledges, liens and remedies from state to state, and the uncertainties surrounding the treatment of general obligation bonds under Chapter 9, it is impractical to prescribe a single approach to the preparation of Official Statements for general obligation bonds. Issuers, with the assistance of lawyers and other professionals, make numerous judgments as to what information constitutes material information each time an Official Statement is prepared. With materiality as the guiding principle, the nature of the disclosure about the issuer's general obligation bonds in an Official Statement will vary from issuer to issuer. However the following are possible topics that should be considered by issuers, lawyers and other professionals involved in preparing an Official Statement in connection with the offering of general obligation bonds, if applicable in the jurisdiction and deemed to be material to investors:

- Has the issuer pledged its full faith and credit obligation to secure the bonds? If so, are there any applicable constitutional, statutory, local law or case law definitions of full faith and credit that are relevant to potential investors?

- Is the issue secured by a pledge of *ad valorem* property taxes? If so, is the pledge limited or unlimited as to rate or amount? If limited, is the current levy at or near the maximum legal amount? What actions, including an election or approval by another government, are necessary to increase taxes? What other procedures must be followed to increase taxes?

- Are pledged taxes limited in use to payment of debt service on general obligation bonds or may they be used for other purposes?

- Are any other taxes or revenues pledged to the payment of the general obligation bonds? If so, describe such taxes or revenues and any limitations on the use of those funds to pay debt service.

- Are taxes or revenues which are pledged to the payment of debt service segregated at all times from other issuer revenues? Who maintains possession of the segregated funds? Can moneys held in a segregated fund or account be borrowed temporarily for other purposes?

- Is there a lien on the revenues pledged to payment of the bonds? If so, is the lien created by contract or is the lien a statutory lien? Is any action necessary to perfect the lien of the pledge? If perfection depends upon possession, how does the issuer maintain continuous possession (or deemed possession) at all times?

- Does state law establish a priority for payment of debt service?

- Is any unpaid obligation or security or lien extinguished at the end of the current fiscal year or would it carry over into the next fiscal year with the same or different characteristics?

- Is there an intercept mechanism to assure that certain pledged revenues are made available only to pay debt service?

- Is the obligation to fund debt service for LTGOs or GFGOs senior to the payment of regular operating expenses?

- What is the nature of state intervention regimes (legislative or judicial) for distressed governments in the jurisdiction? How might the bankruptcy risk be different in states with strong or weak state involvement?

As noted earlier in this paper, it is not possible to reach conclusions about the treatment of all general obligation bonds in a Chapter 9 proceeding. For many issuers of general obligation bonds, any detailed discussion about issues that may arise in a Chapter 9 proceeding will not be material. But if the issuer, its lawyers and other professionals conclude that a discussion of Chapter 9 issues is material in connection with a particular issue of general obligation bonds, the following may be matters to be considered in preparing the Official Statement:

- Does state law currently authorize the issuer to file for bankruptcy? If so, what are the conditions to filing and what are they? Should there be a disclosure that both state and federal law may change before the final maturity of the bonds?

- To the extent there is a clear answer under applicable precedent, should there be disclosure about whether the general obligation bonds would be considered to be secured, by a statutory lien or special revenues, or unsecured? If it is not clear, should there be disclosure describing the uncertainty of treatment of general obligation bonds in a Chapter 9 proceeding?

CONCLUSION

All general obligation bonds are not the same. Moreover, the remedies available upon a default depend upon the applicable state and local laws and the discretion of local officials and judges. Further, the law of Chapter 9 bankruptcy proceedings continues to develop with unpredictable effects and outcomes. While the name "general obligation bond" may be mandated by state or local law, investors, issuers, lawyers, underwriters, financial advisors, rating agencies and other market participants should look behind the name and carefully consider the attributes of the particular issue of general obligation bonds. Issuers, lawyers and other bond professionals should consider the issues raised in this paper and embodied in applicable law to properly ascertain relevant investment considerations and risks when drafting Official Statements or other offering documents for any general obligation bonds.

APPENDIX A

R.I. Gen. Laws §45-12-1

§ 45-12-1. Payment of indebtedness (a) The outstanding notes, bonds, and contracts of cities and towns shall be paid and fulfilled according to their tenor, and all public works now authorized to be prosecuted shall be prosecuted, and all indebtedness now authorized to be incurred on account thereof may be incurred, according to the tenor of the authority therefor. The power and obligation of each city and town to pay its general obligation bonds and notes, whether or not issued pursuant to this chapter, shall be unlimited, and each city and town shall levy ad valorem taxes upon all the taxable property within the city or town for the payment of the general obligation bonds or notes and interest on these bonds or notes, without limitation of rate or amount, except as otherwise provided by or pursuant to law. The faith and credit ad valorem taxes, and general fund revenues of each city, town and district shall be pledged for the payment of the principal of, premium and the interest on, all general obligation bonds and notes of the city or town whether or not the pledge is stated in the bonds or notes, or in the proceedings authorizing their issue and shall constitute a first lien on such ad valorem taxes and general fund revenues. Each city, town and district shall annually appropriate a sum sufficient to pay the principal, premium and interest coming due within the year on all its general obligation bonds and notes to the extent that moneys for the general obligation bonds and notes are not otherwise provided. If that sum is not appropriated, it shall nevertheless be added to the annual tax levy. Annual appropriations for payment of financing leases and obligations securing bonds, notes or certificates ("other financing obligations"), shall also have a first lien on ad valorem taxes and general fund revenues commencing on the date of each annual appropriation. Amounts appropriated or added to the tax levy to pay principal of, premium and interest on, general obligation bonds or notes and payments of other financing obligations shall be applied to the payment of such obligations. Any municipal or district employee or official who intentionally violates the provisions of this section shall be personally liable to the city, town or district for any amounts not expended in accordance with such appropriations. The superior court shall have jurisdiction to adjudicate claims brought by any city, town or district hereunder and to order such relief as the court may find appropriate to prevent further violations of this section. Any municipal or district employee or official who violates the provisions of this section shall be subject to removal.

(b) Notwithstanding any provision of any other law, including the uniform commercial code, title 6A of the Rhode Island general laws:

(1) The pledge of ad valorem taxes and general fund revenues to the payment of the principal, premium and interest on general obligation bonds and notes and payment of other financing obligations, whether or not issued pursuant to this chapter, is valid and binding, and deemed continuously perfected from the time the bonds or notes or other financing obligations are issued;

(2) No filing need be made under the uniform commercial code or otherwise to perfect the first lien on ad valorem taxes or general fund revenues;

(3) The pledge of ad valorem taxes and general fund revenues is subject to the lien of the pledge without delivery or segregation, and the first lien on ad valorem taxes and general fund revenues is valid and binding against all parties having claims of contract or tort or otherwise against the city or town, whether or not the parties have notice thereof.

(4) The pledge shall be a statutory lien effective by operation of law and shall apply to all general obligation bonds and notes and other financing obligations of cities, towns and districts heretofore or hereafter issued and shall not require a security agreement to be effective. Such pledge shall not constitute a security agreement under Rhode Island law.

(c) The pledge of ad valorem taxes and general fund revenues to the payment of principal, premium and interest on general obligation bonds and notes, under this section constitutes a sufficient appropriation for the purposes of any provision for appropriation, and the ad valorem taxes and general fund revenues may be applied as required by the pledge without further appropriation; provided, however, that this subsection (c) shall not apply to other financing obligations which are subject to annual appropriation.

(d) As used in this section, the following words shall have the following meanings:

(1) “Ad valorem taxes” shall mean all ad valorem taxes levied by cities, towns and districts on property, including motor vehicle excise taxes, except for "project revenues" as defined in subdivision 45-33.2-3(5) of the general laws.

(2) “Pledge” shall mean a first lien on, and a grant of a security interest in, ad valorem taxes and general fund revenues.

(3) “General fund revenues” shall mean all taxes, fees, assessments, charges, receipts and other monies (including unrestricted fund balance) derived from any source, to the extent that such monies are deposited or required to be deposited to the general fund of the city, town, or district, and all accounts and rights to receive the ad valorem taxes and general fund revenues and the proceeds thereof.

(e) If any provision of this section or the application thereof shall for any reason be judged invalid, that judgment shall not affect, impair or invalidate the remainder of the law, but shall be confined in its effect to the provisions or application directly involved in the controversy giving rise to the judgment.”