Staff Paper

Evaluating a Chapter 9 Bankruptcy for City of Detroit:
Reality Check or Turnaround Solution?

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Executive Summary

A strategic public policy decision confronting many states is whether to allow a local unit of government to file for Chapter 9 municipal bankruptcy. This is especially problematic when the pending insolvency is the result of years of structural operating deficits. Alternative strategies rely on equally undesirable public policy decisions. These range from management intervention to simply plugging the financial hole in the short-term rather than solving long-term imbalances.

This paper will examine Chapter 9 in light of the fiscal crisis that has plagued the City of Detroit for many years. Critical to this analysis is understanding how Chapter 9 Adjustments of Debts of a Municipality works and how it is very different from the more common Chapter 11 Reorganization used in the private sector. No major decision is complete without weighing the obvious advantages with underlying long-term consequences. Lastly, the City of Detroit does not exist in a vacuum. The outcomes of Detroit's financial challenges have potential implications for the State of Michigan and other Michigan local units of government.

INTRODUCTION

The purpose of this report is to assess the implications of a potential City of Detroit bankruptcy filing. It should be stated upfront that it is not the intention of this report to advocate for or against a bankruptcy filing. Instead, this report uses what we do know about municipal bankruptcy to provide policy makers with the possible advantages and disadvantages of a bankruptcy filing. This will include examining lessons learned from six municipal bankruptcy cases including the cities of Vallejo, CA, Bridgeport, CT, and Central Falls, RI. These experiences can help inform the Detroit situation.

Any local government official would be pressed to name a year when they did not experience budget pressures. Since the Great Recession of 2008 - 2009, however, local governments throughout the United States are faced with budget imbalances not seen in decades. To address the levels of severity, it is helpful to clarify some key terminology. *Fiscal stress*, as it is used in this paper, refers to indicators that merit further attention. Fiscal stress may be indicated by budget shortfalls, decreasing cash balances, or increasing debt loads. *Fiscal crisis* occurs when a government is unable to raise revenues that are equal to or exceed expenditures. The existence of stress often precedes a crisis. *Financial crisis* occurs when an organization cannot repay its current liabilities on time. It is possible that an organization can be in a fiscal crisis yet still avoid a financial crisis.[1] Since 2009, fiscal crisis is not an uncommon scenario. By delaying expenditures and incrementally reducing services, many local governments remain in fiscal stress but are still able to pay the bills. These distinctions are important because the depth and timing of intervention needed to address fiscal stress, fiscal crisis, or financial crisis vary to avoid the worst of all scenarios: a system collapse.[2] It is at that point that Chapter 9, the venue of last resort for municipal debtors and their constituents, is contemplated.[3]

The path to Chapter 9 (Adjustments of Debts of a Municipality) will be explained as it is a relatively rare occurrence. Key points will be addressed such as 1) how it is materially different from the more common Chapter 11 (Reorganization) as used by the private sector, 2) limitations on the federal courts' role in deference to our system of federalism, 3) the requirement that the bankruptcy petition have state authorization, 4) the debtor's (i.e. local

[1] Abraham Carmeli, "Introduction: Fiscal and Financial Crises of Local Governments," International Journal of Public Administration, 2003, Vol. 26, No. 13. In addition, Carmeli cites the following two works. R. G. Downing, "Urban County Fiscal Stress: A Survey of Public Officials' Perceptions and Government Experiences," Urban Affairs Quarterly, 1991, Vol. 27 and Beth W. Honadle, "The State's Role in U.S. Local Government Fiscal Crises: A Theoretical Model and Results of a National Survey," International Journal of Public Administration, 2003, Vol. 26, No. 13.
[2] Ibid.
[3] Ryan Preston Dahl, "Collective Bargaining Agreements and Chapter 9 Bankruptcy," The American Bankruptcy Law Journal, 81(3).

government's) level of autonomy in the process, and 5) the ability to cancel executory contracts including collective bargaining agreements.[4] The ability to renegotiate collective bargaining agreements is considered one of the principal advantages of utilizing Chapter 9 to address a systemic financial crisis.

To set the stage for the technical discussion of Chapter 9 and to serve as a basis of comparison with other Chapter 9 filers, it is important to first understand the City of Detroit's current financial picture. The City of Detroit has demonstrated fiscal stress for many years. More recently, however, evidence of fiscal crisis is looming based on cautionary cash flow projections. This has precipitated a review of City finances under Michigan Public Act 4 of 2011 (Local Government and School District Fiscal Accountability Act). When the largest city in the state has a potential financial emergency, it behooves decision makers to evaluate all the options available to make the best informed decision for the long-term. Finally, this report ends with a summation of the lessons learned as City and State leaders determine the best course of action for all of the stakeholders involved.

CITY OF DETROIT FINANCES

The City of Detroit's finances have been the topic of many research reports to better understand the issues and to propose effective policy. Most notably, the Citizens' Research Council of Michigan and the State of Michigan Senate Fiscal Agency have conducted such thorough analysis that it is not necessary to replicate that information here.[5] As a frame of reference, financial highlights are provided to enhance the Chapter 9 discussion and to establish the magnitude of the fiscal challenges facing City of Detroit leaders. It is also important to note that any discussion of financial matters often appears to exclude those who are most impacted. It is important to remember that the overriding impetus for attaining fiscal stability is to provide quality, reliable services to residents, taxpayers, and other constituents.

Scope of Financial Analysis

The City of Detroit is a full service city that provides a complex array of municipal services. The City's governmental activities include police, fire, public works, health, recreation, culture, and economic development. Enterprise activities include a mass transit system, water treatment

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[4] Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," The University of Chicago Law Review, Vol. 60, No. 2 (Spring 1993).

[5] For further study of City of Detroit finances and economic analyses see Citizens' Research Council of Michigan, "Report 373: Legacy Costs and Indebtedness of the City of Detroit," December 2011 available online at http://www.crcmich.org/PUBLICAT/2010s/2011LIST.HTM; Citizens' Research Council of Michigan, "Report 361: The Fiscal Condition of the City of Detroit," April 2010 available online at http://www.crcmich.org/PUBLICAT/2010s/2010/rpt361.html; Eric Scorsone, "Review of the Financial Situation of the City of Detroit, Michigan," State of Michigan Senate Fiscal Agency, October 2010, available online at http://www.senate.michigan.gov/sfa/Publications/Issues/DetroitFinancialSituation/DetroitFinancialSituation.pdf.

and distribution, sewage disposal and treatment, and public parking systems. This report focuses primarily on the City's General Fund and other governmental activities as these are the primary sources of fiscal stressors. A summary of enterprise fund activity is presented so that the reader has a sense of the volume of activity that the City manages.

General Fund Overview

A synopsis of the City's General Fund for fiscal years 2002 through 2011 is presented in Exhibit 1. From reviewing this data, it is evident that the City of Detroit experienced persistent fiscal stress. The City ended seven consecutive years with a deficit fund balance. In eight out of ten years, the net change in fund balance was negative. This means that fund balance reserves were first depleted then the accumulated deficit situation worsened. The overall trend shows declining revenue. The City responded with steady decreases in expenditures. Unfortunately those reductions did not keep pace with revenue losses.

Exhibit 1 – City of Detroit General Fund

City of Detroit General Fund
Revenues, Expenditures and Changes in Fund Balance
For the years ended June 30,
(all amounts in 000's)

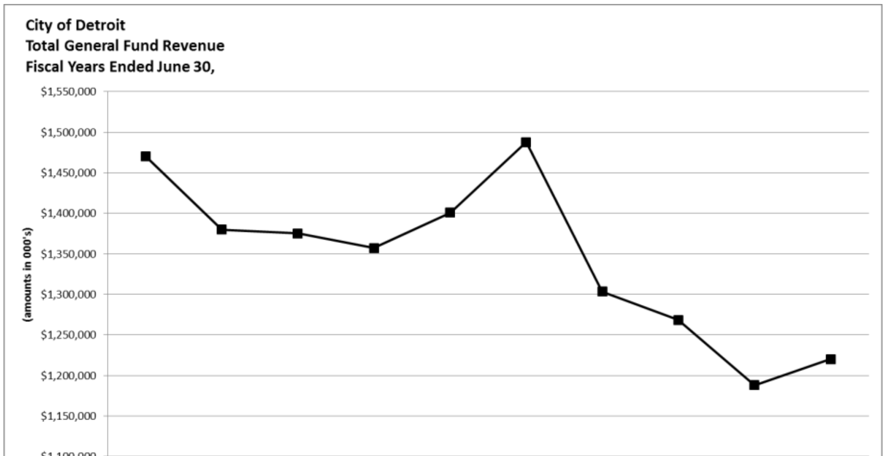
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Revenues	$ 1,470,461	$ 1,379,941	$ 1,375,067	$ 1,357,023	$ 1,400,872	$ 1,487,435	$ 1,303,430	$ 1,268,371	$ 1,187,977	$ 1,220,258
Expenditures	1,441,544	1,463,659	1,577,562	1,492,451	1,410,081	1,278,109	1,181,358	1,155,897	1,068,938	1,070,181
Net	28,917	(83,718)	(202,495)	(135,428)	(9,209)	209,326	122,071	112,474	119,039	150,077
Other Financing:										
Sources	117,367	168,669	311,194	281,492	85,138	12,602	91,827	12,420	269,254	8,959
(Uses)	(183,926)	(150,867)	(179,787)	(248,874)	(149,511)	(206,158)	(264,178)	(249,943)	(212,654)	(216,013)
Net Change in Fund Balance	(37,642)	(65,916)	(71,088)	(102,811)	(73,582)	15,770	(50,279)	(125,048)	175,639	(56,977)
Fund Balance (Deficit)										
Beginning of Year	243,862	206,220	140,304	69,216	(33,594)	(107,176)	(91,406)	(141,685)	(266,734)	(91,095)
End of Year	$ 206,220	$ 140,304	$ 69,216	$ (33,594)	$ (107,176)	$ (91,406)	$ (141,685)	$ (266,734)	$ (91,095)	$ (148,072)

Source: City of Detroit Comprehensive Annual Reports

General Fund Revenues

The City's total General Fund revenue is shown in Exhibit 2 for fiscal years 2002 through 2011. With the exception of two years, the City experienced decreased operating revenues (which excludes bond financing proceeds and transfers in) each year. From 2002 to 2011 the net decrease in annual revenue was 17% or $250.2 million. To gain a better understanding of the City's revenue stream, further analysis is provided for the five largest sources of operating revenue. Together those sources accounted for 80% of the City's General Fund revenue for 2011: property tax (15%), city income tax (19%), wagering tax (14%), state shared revenue (20%), and sales and charges (13%). As shown by the percentage allocations, no one source of revenue accounts for the majority of operating revenues. Approximately the same revenue mix existed in fiscal year 2002.

Exhibit 2 – City of Detroit Total General Fund Revenue

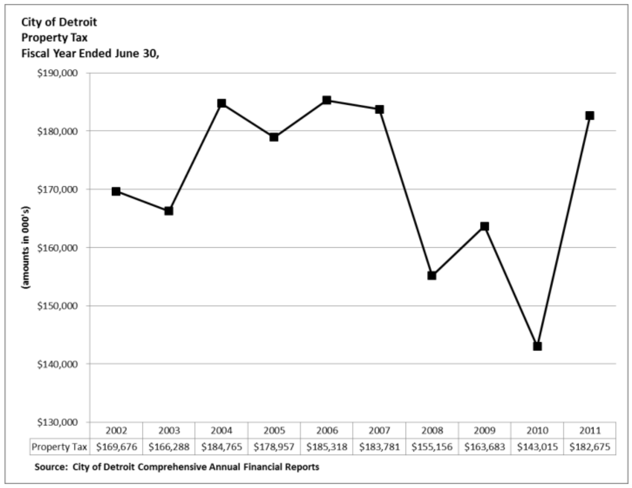


	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total Revenue - General Fund	$1,470,461	$1,379,941	$1,375,067	$1,357,023	$1,400,872	$1,487,435	$1,303,430	$1,268,371	$1,187,977	$1,220,258

Source: City of Detroit Comprehensive Annual Financial Reports

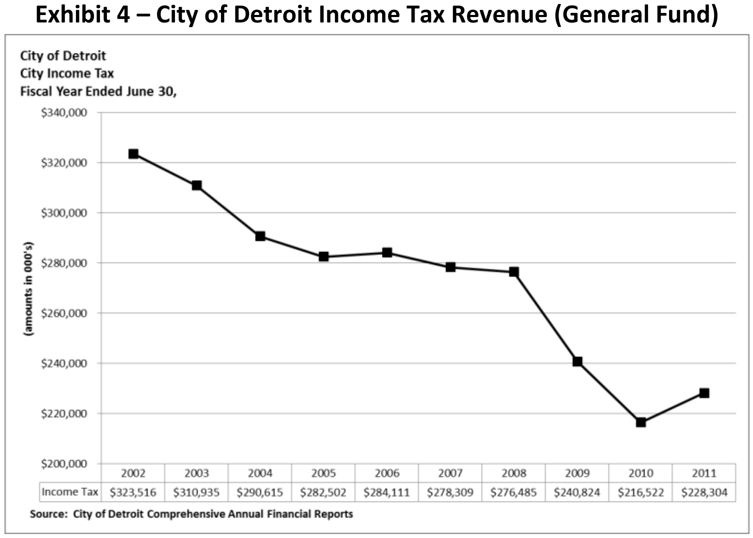
The City's Property Tax Revenue (Exhibit 3) accounted for 15% of General Fund revenues in fiscal year 2011. The increase in property tax revenue for 2011 is somewhat misleading. That fluctuation is due to a conservative over-estimate in fiscal year 2010 for delinquent taxes. As explained by the City of Detroit in its fiscal year 2011 comprehensive annual financial report (CAFR), actual General Fund property tax collections were $12.4 million less than in the prior year. Like many Michigan municipalities the City has seen a significant decline in taxable value. Over the past ten years, fiscal year 2008 had the peak taxable value at $10.1 billion. The taxable value in fiscal year 2011 was $9.4 billion, or a three year decrease of 7%. An additional concern is that fiscal year 2011 experienced the lowest level of current property tax collections at the rate of 79.92% over that same ten year period.

Exhibit 3 – City of Detroit Property Tax Revenue (General Fund)



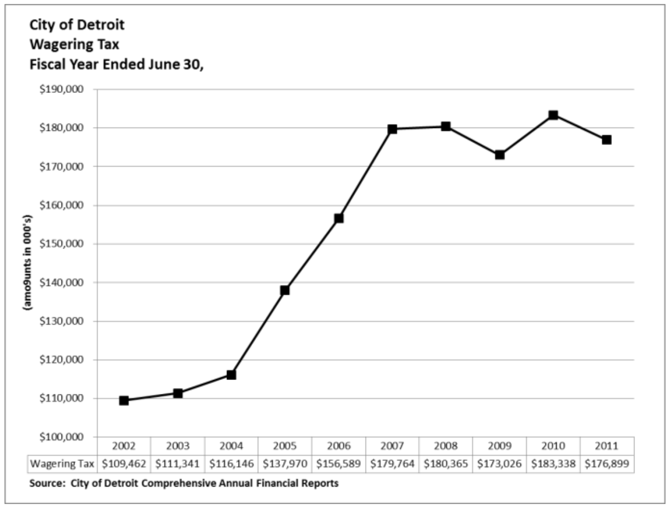
The City's Income Tax Revenue (Exhibit 4) accounted for 19% of the General Fund revenue in fiscal year 2011. This chart demonstrates the elasticity of income tax revenue with the sharp decline as the recession took hold in 2008. The City attributes the 5% increase in fiscal year 2011 to increased employment in the City. That being said, this source of revenue decreased by 29% from fiscal year 2002 to 2011.

Exhibit 4 – City of Detroit Income Tax Revenue (General Fund)



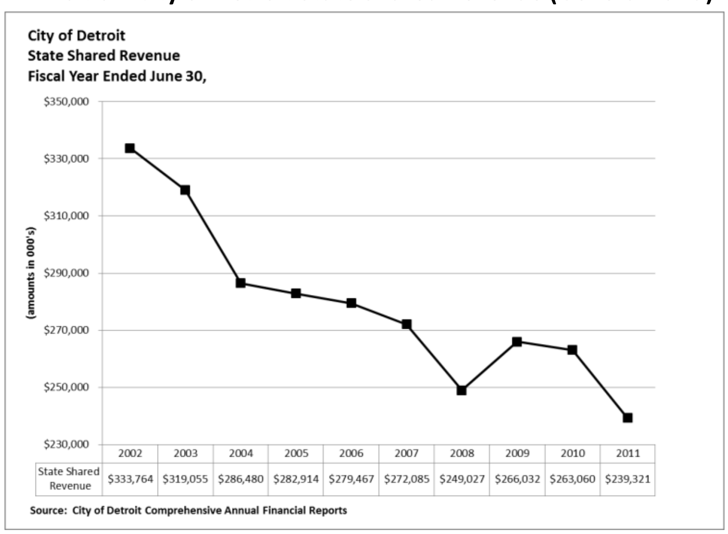
The City's Wagering Tax Revenue (Exhibit 5) accounted for 14% of the General Fund revenue in fiscal year 2011. This revenue comes from a casino wagering tax imposed on two casinos operating in the City. In its 2011 CAFR, the City indicates that the decreased revenue in 2011 was mainly due to a $9.6 million settlement from one of the casinos relating to revenue incurred in the prior year. Presumably if it were not for that timing difference, there would not have been a decline in wagering tax revenue in 2011.

Exhibit 5 – City of Detroit Wagering Tax Revenue (General Fund)



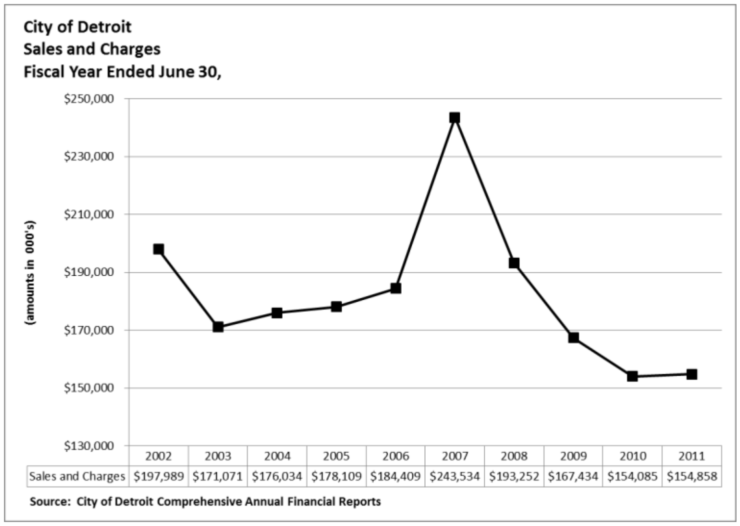
State Shared Revenue (Exhibit 6) accounted for 20% of the General Fund revenue in fiscal year 2011. This source of revenue decreased by 28% from fiscal year 2002 to 2011.

Exhibit 6 – City of Detroit State Shared Revenue (General Fund)



Sales and charges (Exhibit 7) accounted for 20% of the General Fund revenue in fiscal year 2011. This source of revenue decreased by 22% from fiscal year 2002 to 2011. From reviewing the City CAFRs it appears that several types of revenue may be included in this category including interdepartmental billings which were decreased in FY 2008 according to the CAFR for that year.

Exhibit 7 – City of Detroit Sales and Charges Revenue (General Fund)



	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Sales and Charges	$197,989	$171,071	$176,034	$178,109	$184,409	$243,534	$193,252	$167,434	$154,085	$154,858

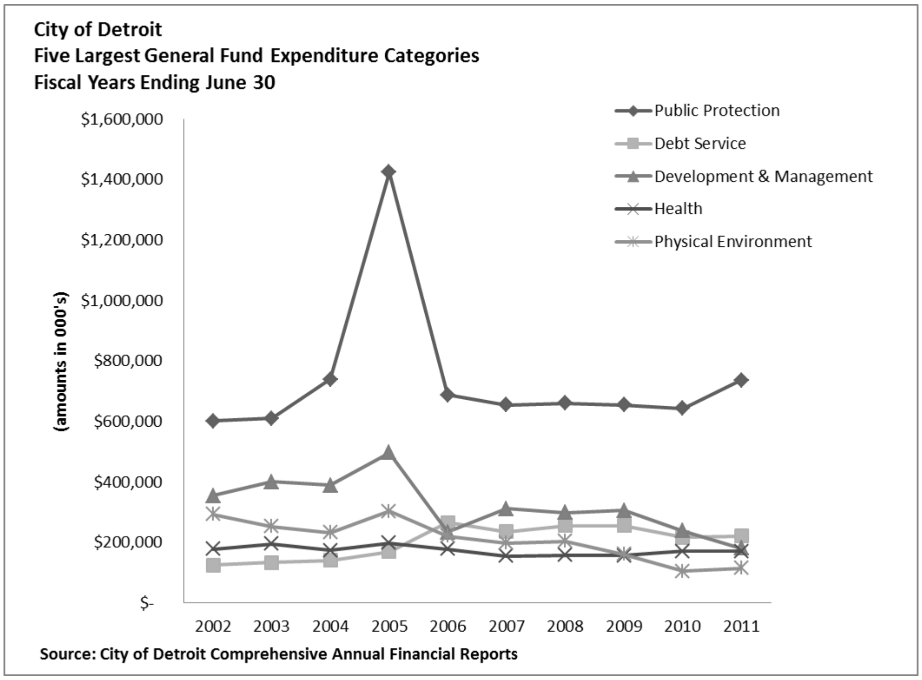
Source: City of Detroit Comprehensive Annual Financial Reports

As the City evaluates its long-term financial plan, it will be hard pressed to forecast significant increases in most of these revenue categories. Without new sources of revenue, the City is forced to focus on the expenditure side of the equation.

General Fund Expenditures

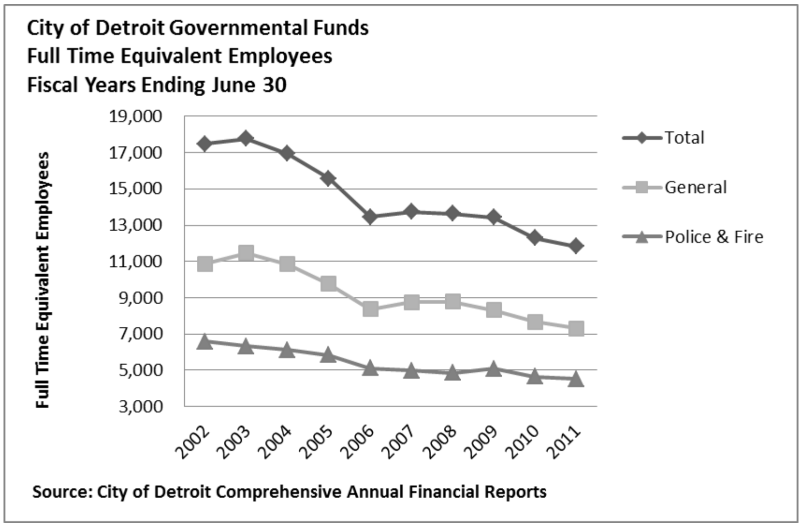
As shown in Exhibit 1, the City has reduced spending, but not at the same pace as revenue losses. The five largest expenditure categories in 2011 and their respective percentage of total expenditures are: public protection (43%), debt service (13%), development and management (11%), health (10%), and physical environment (7%). Together these categories account for 84% of operating expenditures. The ten year trend indicates that budget reductions were fairly consistent among the categories with some exception for public protection which includes police and fire as shown in Exhibit 8.

Exhibit 8 – City of Detroit Five Largest Expenditure Categories (General Fund)



Since cities are service organizations, any discussion of expenditures should address staffing levels. It is often observed that reductions in personnel do not equate to a corresponding decrease in expenditures. For cities in fiscal stress, this is typically because pension and retiree healthcare plan contributions are increasing at a rate faster than the overall cost containment measures. The City of Detroit has decreased its total workforce (Exhibit 9) from 17,480 full time equivalent employees (FTEs) to 11,824 over the ten year period of fiscal years 2002 through 2011. The reduction among the main employee groups was relatively consistent (police and fire at 31% and general employee group at 33%). When compared with the increase in public protection expenditures of 22% for that same time period the disconnect between loss of personnel and cost reduction becomes evident.

Exhibit 9 – City of Detroit Full Time Equivalent Employees



Legacy Costs

Pension and Other Post-Employment Benefits (OPEB) for retiree health and other benefits are collectively referred to as legacy costs. To get relate the legacy cost burden to the city's available financial resources, the annual required contribution (ARC) is compared to the total primary government revenues (both governmental and business type activities) which acts as a spending ceiling. As shown in Exhibit 10, legacy costs approximate 19.1% of total primary government revenues. This ratio has more than doubled over the past ten years further highlighting fiscal stress.

Exhibit 10 – City of Detroit Annual Required Contribution for Legacy Costs

City of Detroit
Annual Required Contributions for Legacy Costs
For Fiscal Years Ended June 30,

	Annual Required Contribution (ARC)				
Fiscal Year	Pension	OPEB*	Total	Total Primary Government Revenues**	ARC as a % of Total Revenues**
2011	$ 133,382,816	$ 325,097,046	$ 458,479,862	$ 2,398,589,000	19.1%
2010	92,633,718	312,286,087	404,919,805	2,344,484,000	17.3%
2009	97,569,164	309,833,162	407,402,326	2,512,755,000	16.2%
2008	97,116,174	297,916,739	395,032,913	2,281,856,000	17.3%
2007	99,903,345	145,813,264	245,716,609	2,647,104,000	9.3%
2006	110,616,497	147,580,550	258,197,047	2,573,435,000	10.0%
2005	202,217,003	145,714,632	347,931,635	2,289,116,000	15.2%
2004	165,351,278	145,923,226	311,274,504	2,250,428,000	13.8%
2003	139,702,275	132,400,535	272,102,810	2,447,571,000	11.1%
2002	76,241,133	119,073,430	195,314,563	2,506,185,000	7.8%

* Fiscal years 2002 through 2006 did not report ARC. Actual contributions therefore used in analysis for those years.
** Net of capital grant revenue.

Source: City of Detroit Comprehensive Annual Financial Reports

When the City of Detroit's financial data is compared to other cities, additional insight is garnered to understand the level of fiscal stress. In Exhibit 11, the City of Detroit's ARC as a percent of government wide revenues is compared to six other cities. The selected cities were deemed to be comparable for purposes of a labor arbitration hearing in April 2011.[6] From this analysis, the City of Detroit is on the high end of the range indicating that the City's burden may be excessive. With a ratio of 17.3%, it means that 17.3 cents of each revenue dollar is needed to adequately fund pension and OPEB commitments.

Exhibit 11 – Comparison of Annual Required Contribution for Legacy Costs

City of Detroit
Annual Required Contributions for Legacy Costs
Based on Selected Cities
For Fiscal Year Ended June 30, 2010

City	Population	Legacy Cost ARC	Total Primary Government Revenues	ARC as a % of Total Revenues
Saint Louis	319,294	71,923,000	926,700,000	7.8%
Cleveland	396,815	114,065,836	1,279,852,000	8.9%
Philadelphia	1,526,006	674,725,000	6,192,600,000	10.9%
Baltimore	620,961	346,586,000	2,157,788,000	16.1%
Detroit	**713,777**	**404,919,805**	**2,344,484,000**	**17.3%**
Pittsburgh	305,704	83,370,505	471,000,000	17.7%
Chicago	2,695,598	1,343,605,000	6,673,400,000	20.1%

Source: Comprehensive Annual Financial Reports for listed cities.

The greater concern, however, is the unfunded accrued actuarial liability for legacy costs. As shown in Exhibit 12, the pension is funded at an acceptable level (with the caveat that $1.44 billion on certificates of participation were issued in June 2005 to fund the pension liability). The net unfunded OPEB liability of approximately $5 billion is more than double the City's long-term debt for governmental activities. That liability is among the highest of U. S. cities.

[6] Thomas W. Brookover, Act 312 Arbitration Award in the Matter of City of Detroit and Detroit Police Lieutenants and Sergeants Association, Case No. D09-G0786, April 1, 2011 accessed online at http://turf.lib.msu.edu/awards/pdfs/awards/r2353.pdf.

Exhibit 12 – Unfunded Accrued Actuarial Liability for Legacy Costs

City of Detroit
Unfunded Accrued Actuarial Liability for Legacy Costs
As of June 30, 2011
(amounts in 000's)

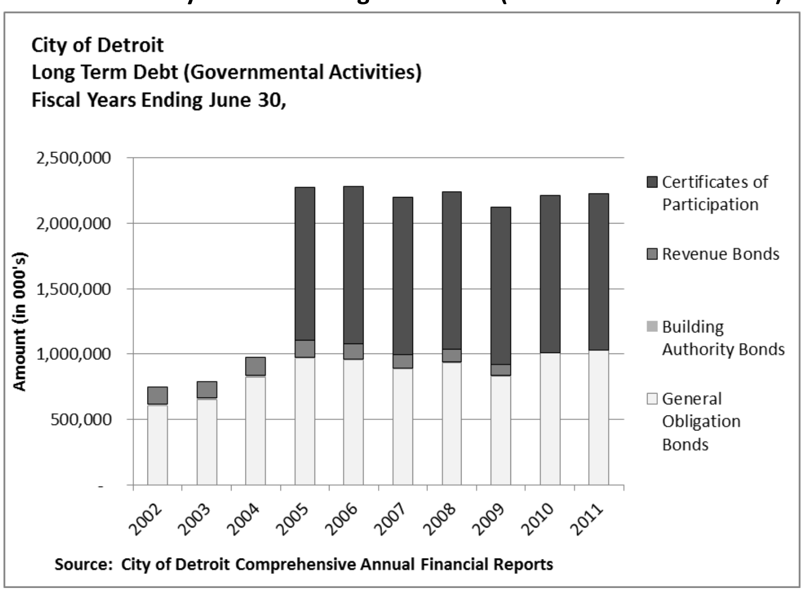
	Pension	OPEB	Total Legacy Costs
Actuarial Value of Assets	$ 7,091,410	$ 24,068	$ 7,115,478
Actuarial Accrued Liability	7,707,111	5,006,423	12,713,534
Unfunded (Overfunded) AAL	$ (615,701)	$ (4,982,355)	$ (5,598,056)
Funded Percent	92.0%	0.5%	56.0%

Source: City of Detroit Comprehensive Annual Financial Report

Debt

The City's long-term has increased significantly due to the issuance of $1.4 billion of taxable Pension Obligation Certificates of Participation (POCs) in June 2005. The purpose of the bonds was to pay unfunded accrued actuarial liabilities for the City's two pension systems. The bonds are payable through 2025. As of June 30, 2011, the City's bonded debt for governmental activities was equal to $2.2 billion (Exhibit 13).

Exhibit 13 – City of Detroit Long Term Debt (Governmental Activities)



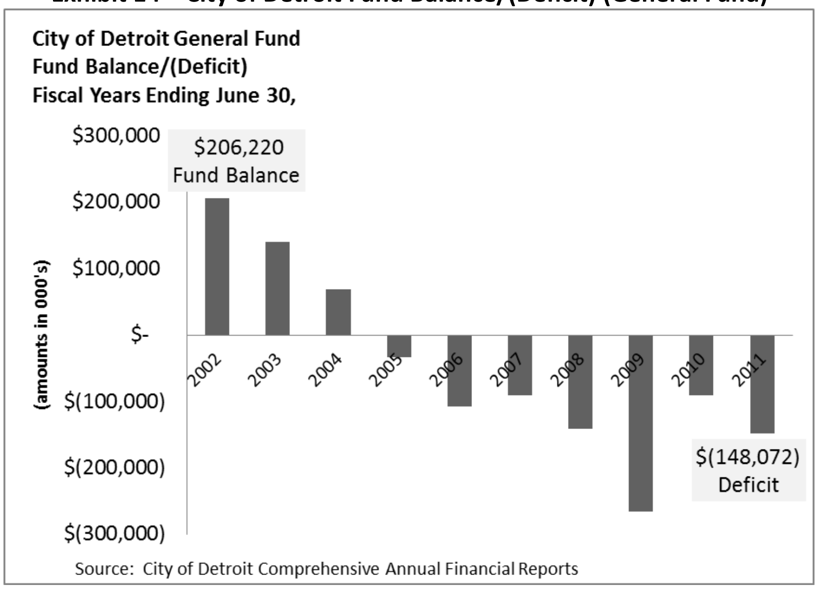
Debt for the City's business type activities is funded by the related revenue source. The City's June 30, 2011 CAFR includes an analysis of debt coverage for pledged enterprise revenues. Both sewage disposal bonds and parking revenue bonds have debt coverage of less than 1. This may be an additional indicator of fiscal stress depending on the terms of the bond agreement.

Rating agency reviews provide insight into how the market may react to news of fiscal stress. In June 2011, Fitch Ratings downgraded the City's unlimited tax (BB-), limited tax (B+), and pension obligation certificates (BB-) with a negative outlook. Concerns included a high debt to overall market value at 18%, optimistic revenue projections, and delayed implementation of needed labor reductions to restore a balanced budget.[7]

Fund Balance/Deficit

As of June 30, 2011, the City of Detroit completed the seventh consecutive year with a General Fund deficit (Exhibit 14). The likelihood of reversing that situation in the near term is unlikely.

Exhibit 14 – City of Detroit Fund Balance/(Deficit) (General Fund)



Conversely, in total, the City ended the June 30, 2011 fiscal year with a positive fund balance in the other governmental funds. Maintaining an adequate fund balance in those funds is critical because they tend to be more dependent on intergovernmental revenues. In addition, the increasing cost of employee benefits will continue to consume additional resources in those funds.

Cash

As cities move from fiscal stress to a fiscal crisis, managing cash becomes a critical function. The City of Detroit's ten year history shows that the General Fund cash balances are typically low. In the long-term, the combination of low cash balances and ongoing deficits is a problem

[7] Amy R. Laskey and Karen Wagner, "Fitch Downgrades Detroit, MI ULTGOs to 'BB-' and LTGOs to B+; Outlook Negative," Fitch Ratings, New York, June 24, 2011.

that cannot be avoided. As shown in Exhibit 14, the City generally ends the fiscal year with less than one month of unrestricted cash and investments.

Exhibit 14 – City of Detroit Months of Cash (General Fund)

City of Detroit General Fund
Months of Cash
As of June 30,
(all amounts in 000's)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Expenditure Levels	$ 1,441,544	$ 1,463,659	$ 1,577,562	$ 1,492,451	$ 1,410,081	$ 1,278,109	$ 1,181,358	$ 1,155,897	$ 1,068,938	$ 1,070,181
Unrestricted Cash & Investments	$ 53,893	$ 81,843	$ 35,159	$ 66,112	$ 113,424	$ 153,109	$ 314,056	$ 75,731	$ 48,659	$ 73,662
Months of cash	**0.45**	**0.67**	**0.27**	**0.53**	**0.97**	**1.44**	**3.19**	**0.79**	**0.55**	**0.83**

Source: City of Detroit Comprehensive Annual Reports

Cash plays a key role in the Chapter 9 bankruptcy decision process. After reviewing the basics of municipal bankruptcy, we will return to the topic of cash availability.

Enterprise Funds

The ten year history of the City's enterprise funds (Exhibit 15) indicates some level of fiscal stress. Nine of the ten years had an operating loss. Upon further review of the City's CAFRs for this time period, the primary source of fiscal stress is originating from the transportation fund. In 2011, operating revenues were $27.4 million compared to operating expenses of $209 million. That equates to an operating loss of $181.6 million or 87%. Fiscal year 2011 was not an isolated incident. The transportation fund is heavily dependent on General Fund transfers and capital contributions.

During the ten year time period, the beginning net asset amount was restated three times. In 2004, the Detroit Housing Commission was deemed to be a separate legal entity and removed from the enterprise fund grouping. In 2008, net assets were reduced by $142 million for an outflow project that was abandoned. In 2010, asset impairment was incurred thereby reducing net assets.

Exhibit 15 – City of Detroit Enterprise Funds Overview

City of Detroit Enterprise Funds
Revenues, Expenditures and Changes in Net Assets
For the years ended June 30,
(all amounts in 000's)

	2002	2003	2004*	2005	2006	2007	2008*	2009	2010*	2011
Operating Revenues	$ 534,102	$ 591,014	$ 620,391	$ 611,969	$ 677,975	$ 660,442	$ 688,490	$ 711,205	$ 693,578	$ 763,075
Operating Expenses	677,804	698,104	653,294	636,452	673,872	719,937	773,438	776,945	766,967	853,016
Operating Income/(Loss)	(143,702)	(107,091)	(32,904)	(24,483)	4,103	(59,495)	(84,948)	(65,740)	(73,389)	(89,941)
Non-Operating Revenues (Expenses)	49,053	28,210	(14,220)	(6,211)	9,387	(110,365)	(113,775)	(157,137)	(205,791)	(237,164)
Net Income (Loss) Before Contributions and	(94,649)	(78,881)	(47,124)	(30,694)	13,490	(169,861)	(198,723)	(222,877)	(279,180)	(327,105)
Capital Contributions	56,035	41,632	33,460	14,059	9,502	14,098	39,540	33,897	47,947	29,794
Transfers In	85,569	79,276	77,108	89,585	35,228	71,720	109,502	73,992	74579.168	73,391
Transfers Out	-	-	-	-	-	-	(8,064)	-	-	-
Special Item	-	-	-	-	-	-	(141,963)	(36,900)	-	-
Increase/(Decrease) in Net Assets	46,956	42,027	63,444	72,951	58,220	(84,043)	(199,707)	(151,887)	(156,653)	(223,921)
Beginning of Year	1,501,778	1,548,734	1,482,598	1,546,041	1,618,992	1,677,212	1,434,056	1,234,349	889,637	732,984
End of Year	$ 1,548,734	$ 1,590,761	$ 1,546,041	$ 1,618,992	$ 1,677,212	$ 1,593,169	$ 1,234,349	$ 1,082,462	$ 732,984	$ 509,063

* Net Assets were restated at the beginning of the fiscal year.

Source: City of Detroit Comprehensive Annual Financial Reports

The level of unrestricted cash at the end of fiscal year 2011 is in excess of three months (Exhibit 16) which is significantly better that the City's General Fund.

Exhibit 16 – City of Detroit Months of Cash (Enterprise Funds)

City of Detroit Enterprise Funds
Months of Cash
For the years ended June 30,
(all amounts in 000's)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Operating Expenses	$ 677,804	$ 698,104	$ 653,294	$ 636,452	$ 673,872	$ 719,937	$ 773,438	$ 776,945	$ 766,967	$ 853,016
Unrestricted Cash and Investments	$ 30,627	$ 40,653	$ 63,575	$ 62,425	$ 86,356	$ 108,816	$ 172,194	$ 92,813	$ 83,016	$ 224,496
Months of Cash	**0.54**	**0.70**	**1.17**	**1.18**	**1.54**	**1.81**	**2.67**	**1.43**	**1.30**	**3.16**

Source: City of Detroit Comprehensive Annual Financial Reports

THE BANKRUPTCY ENVIRONMENT

To understand the applicability or implications of a municipal bankruptcy filing, we will first explain the basics of Chapter 9 bankruptcy. This includes the different types of bankruptcy scenarios, an explanation of the federal bankruptcy court, the State of Michigan's Emergency Manager Law, and a comparison of municipal and private bankruptcy in an attempt to clear up any misconceptions.

Municipal Bankruptcy Scenarios

The premise of this paper, supported by current literature on the topic, is that there are two general scenarios which describe municipal bankruptcy cases. The first scenario is a sudden event or a large legal judgment against a municipality that creates a liquidity problem.[8] One example is Orange County, California's 1994 recognition of catastrophic investment portfolio losses. With the extension of time provided under Chapter 9, the County was eventually able to pay bondholders in full by reducing services and increasing taxes. The second bankruptcy scenario is the result of years of ongoing structural operating deficits.[9] The triggering event is a cash crisis that results in an inability to pay creditors and employees. Recent examples include Vallejo, CA and Central Falls, RI. For both of these cities, operating deficits from unmanageable pension and retiree healthcare promises were cited as the causes that led to Chapter 9 bankruptcies. Just as the City of Vallejo received clearance to emerge from three years of bankruptcy protection in August 2011, the City of Central Falls was two weeks into that process.

Federal Bankruptcy Court

Article 1, Section 8 of the U.S. Constitution provides for Congress to have the power to establish uniform laws on the subject of bankruptcies throughout the United States. The federal bankruptcy law is codified under Title 11 – Bankruptcy of the United States Code. Pertinent Title 11 provisions for this discussion include Chapter 1 General Provisions, Chapter 3 Case Administration, and Chapter 9 Adjustment of Debts of a Municipality. The authorization to enter Chapter 9 is guided by Chapters 1 and 3. Key provisions from those chapters are presented below to facilitate the applicability of Chapter 9 for a city in fiscal crisis.

Chapter 1 identifies who may be a debtor (11 USC Sec. 109) *(emphasis added)*.

(c) An entity may be a debtor under chapter 9 of this title if and only if such entity -

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[8] Daniel B. Bergstresser and Randolph B Cohen, "Why Fears about Municipal Credit are Overblown," April 30, 2011, Harvard Business School Finance Working Paper No. 1836678. Available at SSRN: http://ssrn.com/abstract=1836678 or doi:10.2139/ssrn.1836678

[9] Ibid.

(1) is a municipality;

(2) 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;

(3) is insolvent;

(4) desires to effect a plan to adjust such debts; and

(5) (A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

Chapter 1 also defines municipal insolvency (11 USC Sec. 101).

32) The term "insolvent" means -

(C) with reference to a municipality, financial condition such that the municipality is -

(i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or

(ii) unable to pay its debts as they become due.

Chapter 3 addresses the assumption or rejection of executory contracts (11 USC Sec. 365). It should be noted that case law has established that collective bargaining agreements are considered executory contracts (emphasis added).[10]

Sec. 365. Executory contracts and unexpired leases

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.

The formal Chapter 9 process begins with filing a petition in federal bankruptcy court if authorized to do so as noted in Chapter 1 above (11 USC Sec. 109(c)(2)). By requiring state

[10] NLRB v. Bildisco & Bildisco, 465 US 513, 525-26 (1984) as cited by Ryan Preston Dahl, "Collective Bargaining Agreements and Chapter 9 Bankruptcy," The American Bankruptcy Law Journal, Vol. 81, Iss. 3.

consent to the bankruptcy, any objections to rights available under the Bankruptcy Code based on state sovereignty are eliminated.[11] The authorization process varies among the fifty states (and is nonexistent in some). In Michigan, that process is defined in Public Act 4 of 2011 commonly known as the Emergency Manager law.

Michigan Public Act 4 of 2011

The core function of state government is providing for the health, safety, and welfare of its citizens. These services are delivered by the political subdivisions created by each state. Political subdivisions are the local governments that impact our lives on a daily basis: cities, townships, villages, counties, school districts, and other special units. In the event of insolvency of these local governments, critical services would be impaired thereby jeopardizing health, safety, and welfare. For this reason, states have enacted varying levels of intervention to address fiscal accountability as well as protect the credit of the state and its political subdivisions. In the State of Michigan, the public policy to achieve local government fiscal accountability is delivered by three levels of intervention. Each level is briefly described to portray the essence of State involvement.

The first level of intervention mandates minimum standards for accounting, budgeting, and audit requirements. The primary statute is Public Act 2 of 1968, the Uniform Budgeting and Accounting Act (the "Budget Act"). The purpose of the Budget Act is to require that all local units of government in Michigan adopt balanced budgets; establish responsibilities and define the procedure for the preparation, adoption, and maintenance of the budget; and, to require certain information for the budget process.

The second level establishes monitoring of fiscal health. This is accomplished through the filing of audit reports with the Department of Treasury pursuant to Public Act 2. In addition, cities are subject to Public Act 140 of 1971, the Glenn Steil State Revenue Sharing Act. Under this act, a local unit of government that ends its fiscal year in a deficit must formulate and file a plan with the Department of Treasury on how they will eliminate the deficit.

The third level provides a mechanism to conduct an in-depth review when the first two levels indicate a repeated failure to achieve fiscal stability. Michigan Public Act 4 (PA4), the Local Government and School District Fiscal Accountability Act, identifies fifteen events which may trigger a preliminary review by Department of Treasury personnel. If it is found that the possibility of financial stress exits, the Governor may appoint a Review Team who conducts a more thorough review. The Team includes members from inside and outside of State government. If the Team finds severe stress, as defined by the statute, a consent agreement

[11] Ryan Preston Dahl, "Collective Bargaining Agreements and Chapter 9 Bankruptcy," The American Bankruptcy Law Journal, Vol. 81, Iss. 3.

may be formulated where the local officials work to resolve the fiscal crisis themselves with additional powers granted under PA4. The alternative result may be a finding a fiscal stress with no consent agreement reached or a finding that a financial emergency exists (also defined by statute). If the Governor concurs that a financial emergency exists he may appoint an emergency manager (EM) subject to an appeal and hearing process. If an EM is appointed, the city is then considered to be in receivership. Under PA4, the EM is granted additional powers to remedy the financial emergency. The EM may 1) resolve the financial emergency and recommend that the receivership end, 2) may disincorporate or consolidate the government, or 3) request authorization from the Governor to file for bankruptcy under United States Code Title 11 Bankruptcy. This last option defines the process that is needed to give federal courts jurisdiction to consider a bankruptcy filing from a Michigan municipality.

The actions of an EM do not operate in a vacuum. There are additional transparency measures that they must adhere to such as reporting the following to the State and publicly on the internet: contracts awarded in excess of $5,000, a description of any position created or eliminated, a financial and operating plan, and quarterly reports after the first six months.

In any crisis, one also has to consider the range of potential outcomes. If Chapter 9 is a potential outcome, the EM should be cognizant of the Title 11 provisions identified earlier. This includes what it means to reach insolvency as defined by 11 USC Sec. 101(32)(C). In addition, demonstrating efforts pursuant to 11 USC Sec. 109(C)(5)(b) to have "negotiated in good faith with creditors and has failed to obtain the agreement of creditors" also becomes important. For this reason, bankruptcy is often considered to be the "result of failed negotiations rather than a lack of negotiations."[12]

The road to bankruptcy is anything but a straight line but warning signs are often evident for years. There are several observations for cities that face ongoing structural deficits that may elevate to the level of insolvency. First, early action to right the course when signs of fiscal stress are detected is essential. Second, local officials in Michigan, through updated and amended deficit elimination plans are traditionally given years to resolve their financial crises years before a PA4 review commences. Given that the deficit elimination plans are adopted by resolution of the local governing body, local officials are active participants in the evolving fiscal crisis. Third, even if the municipality is unable or unwilling to cure the deficit situation, a reaction such as a preliminary review under PA4 often occurs after years of fiscal stress. Fourth, the path to considering bankruptcy is an extensive process with multiple levels of review. At that point it is not a secret to the bond community, citizens, businesses and other

[12] Barry Winograd, "San Jose Revisited: A Proposal for Negotiated Modification of Public Sector Bargaining Agreements Rejected Under Chapter 9 of the Bankruptcy Code," 37 Hastings Law Journal 231 (1985) as cited by Ryan Preston Dahl, "Collective Bargaining Agreements and Chapter 9 Bankruptcy," The American Bankruptcy Law Journal, Vol. 81, Iss. 3.

stakeholders that grave financial challenges exist. By then, budget reductions have occurred which impact health, safety, and welfare in order to fund other financial commitments. Out of necessity, managing the crisis takes priority over addressing long-term solutions.

<u>Municipal vs. Private Bankruptcy</u>

Given the recent experience of the General Motors and Chrysler bankruptcies, it is natural that policy makers may attempt to translate those experiences into the municipal world. However, there are major differences between a municipal bankruptcy and a Chapter 11 Reorganization (which we will also refer to as a corporate or private bankruptcy). These differences are crucial in understanding the implications of a municipal bankruptcy for the City of Detroit.

Managing expectations of a Chapter 9 bankruptcy outcome is important because it is similar yet very different from other more familiar forms of bankruptcy. In particular the public may expect that a municipal bankruptcy may contain some of the elements that exist in Chapter 11 Reorganization. Key differences include the following.

- In Chapter 11, the court scrutinizes expenditures to ensure that any available surplus will be devoted to creditors' claims.[13] The functions of the bankruptcy court in Chapter 9 are significantly limited to maintain the structural principles of federalism. The powers of the federal court therefore do not interfere with local decision making about expenditures or the power of state laws as they relate to municipalities.
- The Court's first primary function is to approve or deny the bankruptcy petition in a Chapter 9 filing. If approved, the Court confirms a plan of debt adjustment and ensures implementation of the plan. The municipality may consent to have the court exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy. By doing so, the municipality may obtain the protection of court orders and eliminate the need for multiple forums to decide issues.[14] In Chapter 11, the Court is significantly more involve in the decisions that are made.
- Chapter 9 recognizes the uniqueness of municipalities. Consequently, there is no liquidation of public assets and distribution of the proceeds to creditors as there is in Chapter 11.

[13] Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," The University of Chicago Law Review, Vol. 60, No. 2 (Spring 1993).
[14] James C. Duff, "Bankruptcy Basics Applicable to Cases Filed on or After October 17, 2005," Administrative Office of the United States Courts, Bankruptcy Judges Division, April 2010 (Revised Third Edition) accessed online at http://www.uscourts.gov/uscourts/FederalCourts/BankruptcyResources/bankbasics.pdf.

- Unlike Chapter 11, the municipal debtor in Chapter 9 may employ professionals without court approval or authorization of fees. In Chapter 9, the court's review of fees is in the context of plan confirmation when the reasonableness of the fees is determined.[15]
- The requirement that the plan be in the "best interests of creditors" means something different under Chapter 9 than under Chapter 11. Under Chapter 11, a plan is said to be in the "best interest of creditors" if creditors would receive as much under the plan as they would if the debtor were liquidated. Since a municipality's assets cannot be liquidated to pay creditors, "best interests of creditors" test has generally been interpreted to mean that the plan must be better than other alternatives available to the creditors. The premise is whether the municipal debtor exercised reasonable effort that resulted in a better alternative for its creditors than if the case were dismissed.[16]

The sum of these differences is that municipalities have greater power in bankruptcy than corporations. A federal judge has certain limitations imposed on him or her that is quite different from a corporate bankruptcy. The question then is who is in control during the bankruptcy process? The answer is that local leadership continues to manage the insolvent municipality.[17] In Michigan, the EM would serve in that capacity.

Critics of Chapter 9 identify the disconnect between the nature of government and the two main theories of bankruptcy: the contractual theory and the fresh start theory. Under the contractual theory, bankruptcy addresses the common pool problem faced by creditors. By pooling their interests in a bankruptcy, the creditors receive greater value from the bankruptcy settlement and decrease the price of credit in the market. Under the fresh start theory, bankruptcy decreases the debtor's burden to promote economic activity and rehabilitation as seen in the case of General Motors. When applying these theories to municipalities, it can be argued that 1) the common pool problem does not exist because the debtor has exclusive rights to submit debt readjustment plans including a "cram down" provision, 2) Chapter 9 decreases the value creditors receive because the local governments continue to be in charge of their operations, and 3) although the municipal debt is decreased, it will not bring about financial

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[15] James C. Duff, "Bankruptcy Basics Applicable to Cases Filed on or After October 17, 2005," Administrative Office of the United States Courts, Bankruptcy Judges Division, April 2010 (Revised Third Edition) accessed online at http://www.uscourts.gov/uscourts/FederalCourts/BankruptcyResources/bankbasics.pdf.

[16] 6 COLLIER ON BANKRUPTCY § 943.03[7] (15th ed. rev. 2005) as cited by James C. Duff, "Bankruptcy Basics Applicable to Cases Filed on or After October 17, 2005," Administrative Office of the United States Courts, Bankruptcy Judges Division, April 2010 (Revised Third Edition) accessed online at http://www.uscourts.gov/uscourts/FederalCourts/BankruptcyResources/bankbasics.pdf.

[17] Omer Kimhi, "Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem," Yale Journal on Regulation, Vol. 27, Iss. 2.

rehabilitation because the problems that caused the crisis often continue after the filing.[18] This latter argument bears significant consideration. Consider the case of Prichard, AL filing for Chapter 9 in 2011, just 9 years after emerging from bankruptcy in 2002. Early indications for the post-bankruptcy Vallejo, California in 2012 reflect a similarly weak fiscal outlook.[19]

Expanding on the fresh start theory further, we are directed to consider the theories of financial distress versus economic distress as applied to corporate insolvency in Chapter 11 cases.[20] Financial distress occurs when the entity is able to make an operating profit but does not have sufficient funds to pay its debt. Economic distress occurs when revenues are consistently less than operating costs. In corporate Chapter 11 bankruptcy, the debts of the financially distressed firm are restructured so that creditors receive equity interests in return for giving up a portion of the debt. The economically distressed firm, however, follows the path of liquidation as it is not economically viable. Translating these theories to municipal bankruptcy is somewhat problematic. Instances of financial distress, such as Orange County, can be rehabilitated. In instances of economic distress, such as in the City of Detroit, liquidation is not an option because local governments exist to provide public goods. It is argued that bankruptcy is not the solution to rehabilitate the economically distressed community because it does not address the underlying socioeconomic and local political problems.[21]

It is also noteworthy that "insolvency" is defined differently for the purposes of a municipal versus a private bankruptcy. Generally, the bankruptcy balance sheet test is whether, at fair valuation, the assets of the entity are exceeded by the liabilities. Certain liabilities and assets may be exempt from this calculation depending on the circumstances. However, the definition with a municipality is different. As noted earlier the insolvency definition for a municipality is whether it is "generally not paying its debts as they come due." Thus, the emphasis in Chapter 9 bankruptcy is on cash.

The overriding implication is that municipal bankruptcy law, unlike corporate bankruptcy, performs the debt adjustment function without serving the reorganization function.[22] Chapter 9 does not appear to provide a means to get to an economically viable end for municipalities. Debt may be reduced, but the structural factors that contributed to failure remain in place.

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[18] Omer Kimhi, "Chapter 9 of the Bankruptcy Code; A Solution in Search of a Problem," Yale Journal on Regulation, Vol. 27, Iss. 2.
[19] Bobby White, "In Vallejo, Bankruptcy Scars Still Visible," The Wall Street Journal, January 12, 2012, accessed online at http://online.wsj.com/article/SB10001424052970204555904577167013455352608.html.
[20] Omer Kimhi, "Chapter 9 of the Bankruptcy Code; A Solution in Search of a Problem," Yale Journal on Regulation, Vol. 27, Iss. 2.
[21] Ibid.
[22] Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," The University of Chicago Law Review, Vol. 60, No. 2 (Spring 1993).

DIRECT IMPACT ON CITY FINANCES AND SERVICES

Looking to the experiences from six other municipalities, implications from a Chapter 9 filing can be identified. Focused on the struggle between providing services versus funding long-term commitments, these officials obviously felt that they could not right the course on their own. No two outcomes were the same.

Vallejo, CA

The City of Vallejo, CA is one of the most recent and important municipal bankruptcy filings. In 2008, the City filed for bankruptcy and City employee groups sued to block access to Chapter 9. They argued that the City had not met the bankruptcy eligibility test including the insolvency test. Their argument rested on the fact that the City had many millions of dollars in different reserve accounts that it could access to pay its bills. They also argued that city government had flexibility in changing operating conditions that would reduce costs and prevent insolvency.

The court ultimately rejected these arguments and the Appeals Court held up the ruling on appeal. More importantly perhaps, the entire eligibility question took enormous resources and time. This part of the bankruptcy process, just getting into Chapter 9, took over a year and required the expenditure of many resources. This type of challenge is not an issue in a private bankruptcy. The time required is one the reasons that municipal bankruptcy is often not a favored solution.

The Appeals Court findings are particularly relevant for the City of Detroit and other cities in Michigan. The Court found several important points that led to a reaffirmation of Vallejo's insolvency including:

- Vallejo's projected revenues in FY 2008-09 were $74 million and expenditures were to be $95 million
- City had attempted to reduce costs and change operations over last few years
- City was unable to borrow money from restricted funds for the General Fund
- City and unions could not agree on adequate concessions
- City estimated that it would not have adequate General Fund cash to meet July 2008 payroll

The Court found that the City's CAFR did not adequately reflect all of the fund restrictions that prevented the City from using reserves in those funds to bail out the General Fund. They thus rejected the union argument that there were excess reserves available. In the Vallejo case, the Court did find that the evidence supported the factors that Vallejo was insolvent and would be unable to pay its debt as they came due.

While the Vallejo case may have taken longer to resolve because this was untested waters, bankruptcy could be a lengthy process. To better understand the time line, the following table is presented beginning with the initial filing to plan acceptance over three years later.

Date	**Event**
May 23, 2008	City of Vallejo files for Chapter 9.
July 1, 2008	Date at which City can no longer pay for services (including payroll).
September 2008	Bankruptcy Court ruled that the City was eligible for Chapter 9 relief thereby overcoming objections filed by creditors.
September 2008	Three of the City's four unions appealed the Court's ruling to accept the bankruptcy petition filing with the Bankruptcy Appellate Panel (BAP). The primary rationale is objection to insolvency status.
February 2009	Two of the City's unions reach agreement with the City. At the same time an evidentiary hearing was conducted with the other two unions on the City's ability to reject collective bargaining agreements.
March 2009	Bankruptcy Court issues a decision establishing the standard for rejection of CBAs under Chapter 9.
June 2009	The BAP affirms the Bankruptcy Court's decision to accept the Chapter 9 filing.
January 18, 2011	City files its Plan for Adjustment of Debts
August 1, 2011	City's final plan is accepted and emerges from bankruptcy.

Vallejo's debt restructuring plan called for unsecured creditors to receive between a nickel and 20 cents on the dollar. Retirees' pension payments remain untouched, but the City's retirees' health insurance premiums contribution are now limited to $300 a month of instead of the $1,500 it had been paying.[23] The healthcare benefit reduction reduced the OPEB liability by 40% as shown in Exhibit 16. Despite that benefit reduction, the City is still not able to prefund the liability.

[23] Mark Curriden, "The Next Chapter," ABA Journal, November 2011, Vol. 97, Iss. 11.

Exhibit 16 – City of Vallejo, CA OPEB Liability

Vallejo, California
OPEB Liabiity
As of June 30, 2010

Schedule of funding progress for the Post-Employment Benefit Plan

Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	(Unfunded) AAL(UAAL) (a-b)	Funded Ratio (a/b)
6/30/2009	$ -	$ 81,224,000	$ (81,224,000)	**0%**
6/30/2008	-	$ 135,400,000	(135,400,000)	**0%**

Source: City of Vallejo audited financial statements.

In addition to the lengthy process, it is costly. In August 2011, the city manager was quoted as stating that the City spent $11 million in legal fees over the three years.[24]

In January 2012, the Wall Street Journal reported that the City of Vallejo is facing familiar problems: finances remain tight, property-tax revenue continues to be unpredictable with a high rate of home foreclosures, the credit rating was lowered to junk level making it making it cost prohibitive to borrow, sales taxes were raised by 1% in November 2011, three union contracts expire this year (police, fire, and administrative employees) and escalating pension costs.[25]

The City of Vallejo also points towards the potential advantages for a Detroit bankruptcy scenario. While these benefits may be possible under bankruptcy, an obvious question is whether the same changes can be undertaken outside of bankruptcy with its costs and potential delays. One of the biggest questions is the issue of eligibility to file for Chapter 9. This question is critical because unlike other bankruptcy filings only a municipality may file, a creditor may not force such an action on a municipality. Some examples from other states will help clarify the eligibility question.

Bridgeport, CT

The City of Bridgeport, CT attempted to enter bankruptcy in 1991 when faced with a projected

[24] Tim White, "Lessons in Bankruptcy Learned from West Coast," WPRI, Central Falls, Rhode Island, August 4, 2011, accessed online at http://www.wpri.com/dpp/target_12/lessons-in-bankruptcy-from-west-coast?2.
[25] Bobby White, "In Vallejo, Bankruptcy Scars Still Visible," The Wall Street Journal, January 12, 2012, accessed online at http://online.wsj.com/article/SB10001424052970204555904577167013455352608.html.

fiscal year 1992 budget deficit of $16 million.[26] The State argued that Bridgeport could in fact pay its debts by reason that it was paying its debts currently and thus was not eligible for bankruptcy. The court found that this was not a sound argument. The court cited the 1988 bankruptcy amendments which stated that "a construction of this provision under which a city would not be able to seek chapter 9 protection unless and until it was actually not paying its bills could defeat that purpose". Thus, the Judge ruled that the City could project forward that it potentially could not pay its debts as they come due as part of a Chapter 9 filing.

However, in the end, the City of Bridgeport could not convince a judge that in fact it would not be able to pay its debts in the future and was denied Chapter 9 protection. The City was only able to prove that it might run out of money in the following fiscal year and not the current fiscal year. This was deemed weak evidence as a basis for Chapter 9 and subject to many fluctuating conditions. In August 1991, Bridgeport was denied access to the federal bankruptcy system.[27] The State of Connecticut was successful in blocking the action by arguing that in fact the city was not "insolvent" as required under federal law.

Jefferson County, AL

In November 2011, Jefferson County, AL filed for bankruptcy related to $3.2 billion of sewer warrants, some of which are general obligation. As of January 2012, the filing is pending. The declaration of bankruptcy has been fought by some bond holders. This fight hinges on whether Jefferson County has issued "debt obligations." The bond holders claim that Jefferson County in fact issued warrants and not debt in the forms of bonds. While this may seem like a technicality, this question plays an important role in eligibility because Alabama law requires a municipality to have issued debt to be eligible for federal bankruptcy protection.

This case also serves as an opportunity to describe the treatment of special revenue versus general obligation bonds in Chapter 9. The revenue pledge is considered to be a secured lien to the extent that there are sufficient revenues. General obligation bonds, in Chapter 9, are treated as unsecured debt. This is known an inversion of credit quality.[28] For this reason, classification of the debt instrument becomes extremely important.

[26] Barbara L. Hankin and Richard D. Zeisler, "Chapter 9 as a Potentially Useful Tool for a Financially Troubled Municipality," Commercial Law Bulletin, May/Jun 1992, Vol.7, Iss. 3.

[27] Thomas Given and Robert J. Murdich, "Bankruptcy Court Dismisses Bridgeport's Chapter 9 Petition," Faulkner & Gray's Bankruptcy Law Review, New York, Winter 1992, Vol. 3, Iss. 4.

[28] W. Clark Watson, Ann Fillingham, George E. Henderson, and Michael P. Coury, "Municipal Bankruptcy: A Guide for Public Attorneys," National Association of Bond Lawyers, October 2011, accessed online at http://www.nabl.org/uploads/cms/documents/municipal_bankruptcy_a_guide_for_public_finance_attorneys.pdf

Harrisburg, PA

The City of Harrisburg, PA presents another case of bankruptcy eligibility. The City of Harrisburg City Council voted to file for Chapter 9 protection from $300 million in debt related to an incinerator project. However, this filing was challenged by civilian employees and police officers of the City as well as the State and the Mayor of Harrisburg, PA. The challenge was based on state legislation entitled PA 26 of 2011 passed in June of 2011. The Act amended Pennsylvania's fiscal code by preventing any third class city from filing bankruptcy through June 30, 2012. The Judge ruled that third class cities had no statutory authority to proceed under bankruptcy at the time and in particular that such authority rested with the Mayor and not the City Council. This ruling makes it clear that state laws play a critical role in the access to the Chapter 9 bankruptcy system. In January 2012, the City is evaluating plans to appeal the decision given their severe fiscal condition.[29]

Prichard, AL

The City of Prichard's decline began in the 1970s with the City's population shrank by 40 percent. The significant loss of population eroded the tax base. By 1999, the City filed for bankruptcy. When the City emerged from bankruptcy in 2002 it had a plan to pay its creditors by 2007 and was required to annually pay into the pension fund. During the bankruptcy, retiree pension benefits were reduced by 8.5 percent. Unfortunately the City did not pay into the pension fund to reduce its shortfall.[30]

By October 2009 the City's pension funds were depleted. Retirees stopped receiving monthly pension checks. As a result, a class action lawsuit was filed in state court to force the city to meet its pension obligation. The City then filed for Chapter 9 bankruptcy for the second time in its history. By May 2011, through mediation, the city and retirees had reached a settlement. Prichard agreed to disburse to retirees the $629,000 that had accumulated in its pension account during the past 20 months from current employees. Going forward, the City agreed to pay approximately one-third of the pension payments and to pay retirees one-third of any tax money it collects above a specified dollar amount.[31]

[29] Eric Veronikis, "Harrisburg bankruptcy filing has already cost taxpayers $380K in legal fees," Pennlive.com, January 9, 2012, accessed online at http://www.pennlive.com/midstate/index.ssf/2012/01/harrisburg_residents_are_on_th.html.
[30] Michael Cooper and Mary Williams Walsh, "Alabama Town's Failed Pension Is a Warning," New York Times, December 22, 2010, accessed online http://www.nytimes.com/2010/12/23/business/23prichard.html?pagewanted=all.
[31] Mark Curriden, "The Next Chapter," ABA Journal, November 2011, Vol. 97, Iss. 11.

Central Falls, RI

On August 1, 2011, the City of Central Falls, Rhode Island filed for Chapter 9 bankruptcy protection in federal court. Robert Flanders, the state appointed receiver, decided that the only option for the City was to enter into federal bankruptcy system. The statement of qualification included the fact that Central Falls is a municipality, has specific state authorization to proceed, is insolvent, and has a plan to proceed.

What facts did the City bring forward in its court filing to qualify for bankruptcy? First, the city stated that it had $80 million of unfunded pension and health care obligations on an actuarial basis. On top of that long run liability, the city is running a nearly $5 million annual deficit with a $16.4 million budget (30.5%) and that the annual deficit was only getting worse. Finally and most importantly perhaps, the City was estimated to not have enough cash on hand as of August 31, 2011 to pay bills coming due. Furthermore, the City would not have enough cash available in every month going forward except for October 2011 to pays it bills. Finally, the City was unable to access the credit markets with a junk bond rating status.[32]

In laying out a potential plan to move forward, the City's documents stated that huge funding cuts had already been incurred and some essential services had been stopped. Personnel costs, including pension and health care for retirees, were consuming a large share of the budget and were controlled via collective bargaining agreements and thus, in essence, a fixed cost. The City finally stated that it would soon be unable to pay bills as they come due (cash flow test) and that all reasonable negotiations had been put forward by the City with unions and therefore there were no other options except a Chapter 9 filing. For whatever reasons, there were no objections to the Chapter 9 filing of Central Falls and the case was able to proceed.

In Central Falls, RI, a major change to employee compensation and benefits was approved by a federal judge in January of 2012. The police and fire unions of the city agreed to the compensation concessions. The city's bondholders, however, are protected by state legislation that does not allow for "haircuts" to debt holders. The union agreements require that current and future retirees will experience a nearly 55 percent reduction in pension payouts. As of the bankruptcy filing, the City's pension system was woefully underfunded. This meant that either employees would not be able to receive pension payments or a massive increase in city funding would be necessary to maintain the system. The agreement will cut the unfunded liability of the city's pension from $46 million to $23 million.[33]

[32] Michael McDonald, David McLaughlin and Laura Keeley, "Central Falls Bankruptcy Casts Pall on Pensions," Bloomberg.com, August 2, 2011, accessed online http://www.bloomberg.com/news/2011-08-02/central-falls-bankruptcy-driven-by-pensions-casts-shadow-over-rhode-island.html

[33] Nicole Bullock, "Judge Lets U.S. Bankrupt Town Slash Pensions," The Financial Times, January 10, 2012, available online at http://www.ft.com/intl/cms/s/0/e34df114-3b23-11e1-b7ba-00144feabdc0.html#axzz1l4Hla7Qo

CHAPTER 9 IMPLICATIONS

There are two topics covered in this section. The first is addressing the stakeholders who are directly impacted by the fiscal crisis. If nothing else, a Chapter 9 filing seems to serve as a catalyst for generating serious dialogue regarding a city's finances. The second topic is addressing those who are not at the table but may be impacted by Chapter 9 filing through what is known as the contagion effect on debt issuers as well as those who may be affected by interdependent relationships with the troubled debtor.

<u>Chapter 9 as a Reality Check</u>

Chapter 9 serves as the reality check that brings local stakeholders to the table. Municipal debt instruments are subject to numerous levels of scrutiny before they are issued. Attorneys, accountants and financial advisors ensure that the purpose for issuing the debt is legal and financial projections for repayment are reasonable. State statutes and local charters provide debt limitations. Local elected bodies adopt a series of resolutions authorizing the financing and repayment schedule. In some cases the electorate also pledges the full faith and credit of the local government to assure repayment. Ultimately, the numerous controls in place are likely the reason why so few municipal bond defaults have occurred.

Contrast the municipal debt issuance process with that which gives rise to the other category of long-term liabilities: legacy costs. Unlike bond issuance, there typically is no 20, 30, or 40 year analysis of how the commitment will be paid. Even worse, especially with healthcare, the future amount is not specified. The authorization by a local government to enter into this long-term commitment is not subject to statewide limitations or objective criteria. In the worst cases the decision making process is strongly entangled in local politics while in others it is simply a decision by a local body to do what seems like the right thing.

The recent case studies of Vallejo, CA Central Falls, RI and Prichard, AL all demonstrate years of denial of impending fiscal crisis that preceded the bankruptcy filing. Like Detroit, as those cities' budget shortfalls continued to rise, each city pledged that the new budget would be balanced by working with employee groups to reduce personnel costs through wage and benefit concessions. This resulted in a combination of two outcomes. First, the cities were not able to reach the level of concession needed with employee groups. By the time the fiscal crisis rose to considering bankruptcy, the depth of the concessions needed was greater than what could be achieved without court intervention. Second, this level of denial is understandably strongest by those who will suffer the reduction in benefits. Recognizing the inherent level of conflict and distrust in the nature of labor relations, it is easy for unions to believe that the money can be found elsewhere. Agreeing to extreme concessions without the pressure of court intervention places any labor representative in an undesirable position.

The relationship between Chapter 9, collective bargaining agreements (CBAs), and retiree benefits is emphasized in this paper for four reasons. First, cities are service organizations. The result is that the majority of operating expenditures are personnel costs. Second, absent constitutional protections, employees and retirees become unsecured creditors. This is unlike special revenue bondholders whose debt instruments bear a revenue pledge that is maintained during bankruptcy as long as those special revenues are available.[34] Third, unfunded pensions are liabilities that are unsecured obligations and there is no priority for wages, vacation, healthcare or unfunded pension. As shown in the Prichard, AL case, an unfunded pension plan can result in loss of that pension payment. Fourth, whether a municipality is facing fiscal tress or not, this economy has taught us that we cannot count on unending financial stability. Long-term commitments merit serious consideration before the promise is made.

Impact on Bond Markets

Assuming access to capital has not been blocked, cities in fiscal crisis face increased borrowing costs. Does one city's fiscal crisis affect other governments in the state? What about the State itself? Financial crises, past and present, provide examples of how contagion in the bond market and interdependence among governments present additional concerns for policymakers.

Contagion

Financial contagion occurs when there is a shock or crisis in one part of the market that spills over into other unrelated parts of the market.[35] New York City was on the brink of default in 1975. The City was brought out of the crisis through state intervention. During that period of uncertainty, aggregate interest rates for bond issuers, primarily northern industrial cities, was negatively impacted.[36, 37] The contagion effect is further supported by research of the Orange County bankruptcy in 1994. Utilizing market activity at the time of the Orange County's bankruptcy announcement, it was found that the non-Orange County bond rates and municipal bond funds were negatively impacted.[38] Through further analysis the researchers attributed

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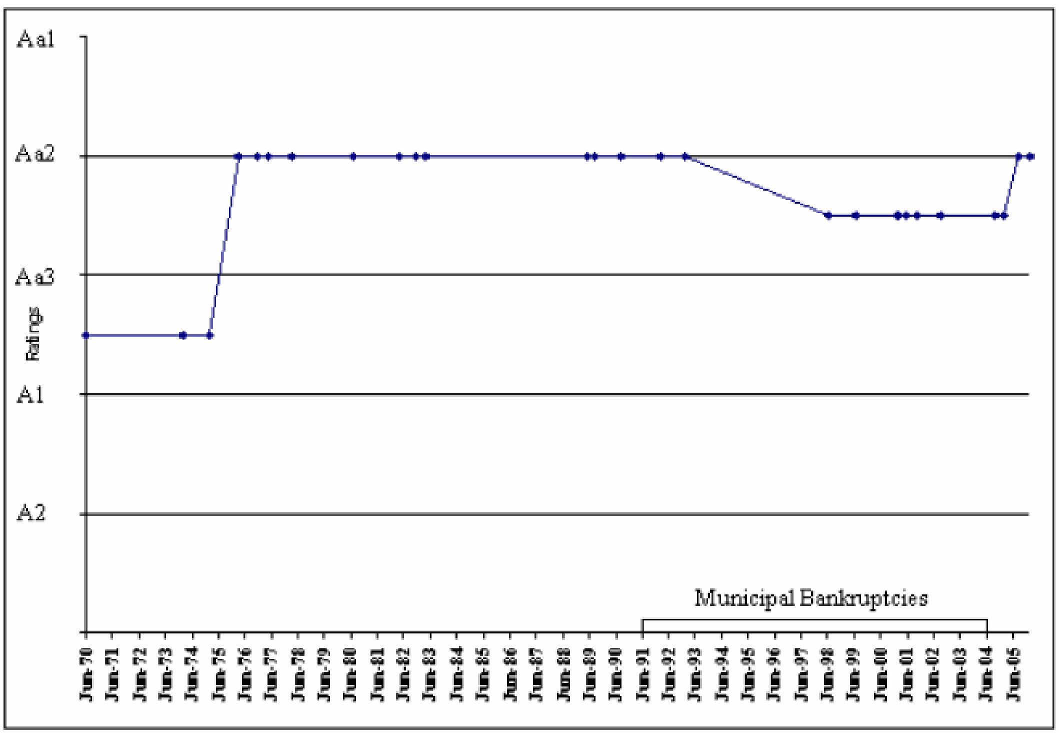
[34] James C. Duff, "Bankruptcy Basics Applicable to Cases Filed on or After October 17, 2005," Administrative Office of the United States Courts, Bankruptcy Judges Division, April 2010 (Revised Third Edition) accessed online at http://www.uscourts.gov/uscourts/FederalCourts/BankruptcyResources/bankbasics.pdf.
[35] Marcello M. Pericoli and Massimo Sbracia, "A primer on Financial Contagion," Journal of Economic Surveys, 2003, Vol. 17, Iss. 4.
[36] David S. Kidwell and Charles A. Trzcinka, "Municipal Bond Pricing and the New York City Fiscal Crisis," The Journal of Finance, Vol. 37, No. 5 (Dec., 1982).
[37] Edward M. Gramlich, "The New York City Fiscal Crisis: What Happened and What is to be Done?" The American Economic Review, Vol. 66, No. 2, Papers and Proceedings of the Eighty-eighth Annual Meeting of the American Economic Association (May, 1976).
[38] Halstead, J. M. (2004). Orange county bankruptcy: Financial contagion in the municipal bond and bank equity markets. The Financial Review, Vol. 39 Iss. 2.

this to more than investor perceptions or irrationality. In Orange County case, the market identified a rational concern for the lack of transparency related to derivative investments by local governments.[39]

The State of Alabama experienced nine municipal bankruptcies from 1991 through 2004.[40] While there may have been other forces at work, the possibility of a contagion effect on the state's bond rating is likely as shown in Exhibit 17. The difference in interest costs to taxpayers is substantial considering the multiple level rating fluctuations. While this example may seem extreme, it serves as a warning to states with multiple local governments with cash flow problems and an unknown economic outlook.

Exhibit 17
Moody's Investment Rating for State of Alabama
General Obligation Debt Issuances
1970 - 2005



Source: Moody's Investor Service, 2007[41]

[39] Ibid.
[40] Keren Deal, "Dissertation: An Examination of Municipal Finance Reform Regarding Municipal Bankruptcies in the United States," Auburn, Alabama, August 4, 2007 accessed online at http://etd.auburn.edu/etd/bitstream/handle/10415/956/DEAL_KEREN_35.pdf?sequence=1
[41] As presented by Dr. Keren H. Deal, CPA, CGFM, Associate Professor of Accounting, Auburn Montgomery to the Government Finance Officers Association of Alabama accessed online at http://www.gfoaa.org/docs/CGAT/CGAT%20Muni%20BR%20Presentation.pdf.

In 2008, the Center for Government & Public Affairs at Auburn University at Montgomery proposed the implementation of a financial monitoring statute to improve state and local government bond ratings. In this process they estimated the additional interest cost that their taxpayers bear for poor bond ratings. Utilizing a $50 million standard bond issuance with semi-annual payments over a 30 period (excluding coupon payments and administrative costs) the interest cost was calculated for each level of bond rating as shown in Exhibit 18. [42]

Exhibit 18 Payback and Interest Costs on a Hypothetical $50M Bond Issue

Rating	Payments	Interest	Total Payback	Interest	Present Value of Payback
Aaa	60	3.76%	$152,864,339	$102,864,339	$25,946,137
Aa	60	3.99%	$163,569,732	$113,569,732	$27,763,196
A	60	4.14%	$170,945,192	$120,945,192	$29,015,056
Baa	60	4.34%	$181,289,899	$131,289,899	$30,770,895
Ba, B	60	4.60%	$195,662,693	$145,662,693	$33,210,434
Caa/Ca	60	4.75%	$204,458,368	$154,458,368	$34,703,351
C	60	4.99%	$219,346,541	$169,346,541	$37,230,366

Source: Auburn University at Montgomery Center for Government and Public Affairs

The contagion effect is on the forefront of state policy issues in other states as well. In Pennsylvania, the legislature is concerned with the contagion effect of a $310 million of incinerator related debt in Harrisburg that is at risk. Controversy has centered on the issue of placing a receiver in Harrisburg under that State's Act 47. By doing so, many would believe that the financial interest of bondholders and the rest of the state's governments would be preserved.[43] Rhode Island legislature is also considering measures to control the negative spillover effect from Central Falls.[44]

It is also important to note that it is believed that perception also impacts the bond market. This phenomenon is often referred to as headline risk. If leaders publicly discuss bankruptcy, there is concern that this casts a negative view of the state's finances as well on other local units of government in that state. In some instances, the potential bankruptcy may be seen as a failure by the state to exercise oversight in maintaining local government fiscal health.

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[42] Center for Government and Public Affairs, "Government Bond Issuance in the State of Alabama: A Case Study of Monitoring Options," Auburn University at Montgomery, December 2008 accessed online at http://billjohnson.org/bond_oversight.pdf.

[43] Paul Burton, "Trends in the Region: Pennsylvania Finance Vet Mark Schwartz Ready to Wade into Harrisburg Quagmire," Bond Buyer, October 3, 2011, Vol. 378, Issue 33592.

[44] Ibid

Analysts from two ratings agencies indicated that a state's involvement to solve a problem is "a very positive factor" and avoid one to wonder "why is it that a large number of municipalities in a certain state are in so much trouble?"[45] Conversely, North Carolina which is known to have a proactive local government monitoring program was rewarded by Fitch. The credit ratings of North Carolina issuers rated below AA were upgraded by one or two steps saving taxpayers millions.[46]

Interdependence

The complexity of intergovernmental relationships cannot be ignored in the addressing a fiscal crisis. Direct financial commitments to special districts or other partnerships may increase contagion exposure to other areas of municipal operations. Lawmakers in Rhode Island are also grappling with the contagion effect from Central Falls' participation in the Rhode Island Health and Educational Building Corp., a quasi-public agency that is a financing pool for capital projects. The pool's bond rating is based on the underlying ratings of the participants. If Central Falls' bond rating declines, it could raise the cost of financing for other pool participants.[47]

In Washington, the Legislature considered a bill in late 2011 to contain the contagion of a default in December 2011 on $42 million in bond anticipation notes by the Greater Wenatchee Regional Events Center Public Facilities District. The District includes two counties and eight municipalities. The State Treasurer's proposal failed due to opposition worried about a bailout precedent being set. After the default, Standard & Poor's downgraded the short-term rating on debt issued by the district to D from SP-3 and downgraded the City of Wenatchee's long-term and underlying rating to BBB from A-minus.[48] It is too early to tell the impact to the two counties and the remaining seven smaller municipalities who are members of the District.

In the context of the City of Detroit's fiscal crisis, the State of Michigan and City of Detroit leadership face an overwhelming task where swift action is needed to mitigate decades of mounting structural fiscal imbalances. Inaction will only make the situation worse, there is no rainy day fund large enough to cure the impending cash flow crisis, and any form of action means that someone loses. Proponents of Chapter 9 see it as a swift process to reset the course even if it is not a long-term solution. Opponents of Chapter 9 would argue, among other

[45] Elizabeth Carvlin, "The Art of Saving Cities: Michigan Fiscal Overseers Face Resentment," December 18, 2002, Bond Buyer, Vol. 342, Iss. 31535.
[46] Omer Kimhi, "Chapter 9 of the Bankruptcy Code; A Solution in Search of a Problem," Yale Journal on Regulation, Vol. 27, Iss. 2.
[47] Paul Burton, "As Central Falls Case Kicks Off, Moody's puts RIHEBC on Review,' Bond Buyer, August 5, 2011, Vol. 377, Issue F330.
[48] Randell Jensen, "Wenatchee Seeks Court OK for Bonds to Pay Investors," Bind Buyer, January 12, 2012, Vol. 121, Issue F302.

concerns, that the stigma of a municipal bankruptcy in Michigan would impair the bond ratings of the State and other units of local government in Michigan. The ripple effect on increased borrowing rates could cost taxpayers millions for the next few decades.

POTENTIAL DETROIT BANKRUPTCY

It is unclear at this time whether the City of Detroit will end up with an Emergency Manager or a consent agreement through the PA 4 process. A bankruptcy filing could only occur if an Emergency Manager is appointed. Even with an Emergency Manager, the State Financial Authority may veto a bankruptcy filing if an EM pursued that route. Finally, even if an EM filed for bankruptcy and it was not vetoed by the state, a federal judge would have to rule on eligibility. Thus, any Detroit bankruptcy would have to go through several steps and this may not be a quick or easy process. In the interim, the City's financial troubles will continue to fester.

The City of Detroit is very similar to the cities discussed, such as Vallejo, CA and Crystal Falls, RI, but it is also vastly different. Its population is more than six times the City of Vallejo. Rather than four unions, it has over 40. Its General Fund is approximately $1.2 billion which is far greater than $65 million. Yet it still suffers from the same structural budget challenges: a staggering level of unfunded legacy costs, declining tax base with statutory restrictions, and increasing demands for service with a particular emphasis on public safety.

The Detroit City Administration and City Council have been developing plans to achieve fiscal sustainability. Like all plans, the execution becomes more difficult. The crisis mode has not lead to meaningful restructuring. It is likely that there are many obstacles to overcome. As a result, leaders are forced into making incremental changes that solves today's potential fiscal collapse but not tomorrow's. As one City Council member noted during budget discussions, "this is death by a thousand cuts." Indeed it is and Detroit is not alone. This scenario is playing out in city halls across the United States.

The advantages of Chapter 9 filing cannot be ignored. Vallejo reduced their OPEB liability by 40%. For Detroit, that would equate to over $2 billion of a reduction the City's OPEB liability. With a financial crisis looming, decision makers could decide that the pain of a Chapter 9 is worth the long-term budgetary relief.

What are the considerations if Detroit were to pursue a Chapter 9 bankruptcy? Has the City been negotiating in good faith with creditors and employee groups? It certainly appears that way. Is it insolvent? No, not yet, but all indications indicate it is heading that way. Even with the issuance of approximately $250 million in Fiscal Stabilization bonds in March 2010, the City continues to have an accumulated deficit of $148 million.

With its ongoing deficits and legacy costs among the highest in the country, something needs to change to achieve fiscal stability. If the stakeholders cannot agree to a meaningful plan to address the legacy costs, the City may not have any other choice than to pursue Chapter 9. That would be unfortunate for all involved. If the process took over three years in Vallejo with four unions, how long would it take the City to work through challenges and appeals in bankruptcy court with over 40 unions? If the bankruptcy process cost $11 million in Vallejo, it would be far higher in a more complex environment. What would be the impact on Detroit's bond rating and financing opportunities? As Vallejo has found, their options are limited or now non-existent. Vallejo, while providing numerous lessons in municipal finance, faced challenges unique to the laws in California. Translating those lessons learned to Michigan laws adds further complexity. Lastly, the impact on employees, residents, and businesses cannot be ignored. Uncertainly impacts location decisions, employments decisions, and compounds the stress that already exists.

CONCLUSION & SUMMARY

Given what has happened in the Vallejo, CA and Central Falls, RI bankruptcies, there are clear advantages and disadvantages to a Chapter 9 municipal bankruptcy. The primary advantage is that it offers a path to secure cost containments that were previously unthinkable. In each of these cases, the federal court process played a significant role that led to major reductions in legacy costs and improvements in cash flow. Those advantages come at a potentially high cost. The bankruptcy process is complex, costly, lengthy, restricts long-term financing flexibility, and is untested on a large city.

Is Chapter 9 Bankruptcy a reality check or a turnaround solution? The outcome of the bankruptcy process has been to reset the financial course for these cities, but the underlying structural problems remain the same. We would therefore be hard pressed to call it a "solution" when there are glaring deficiencies. Instead, the Chapter 9 filings appear to have been the wake up call to bring the stakeholders to the table.

There are other alternatives to a municipal bankruptcy that may accomplish the same goal of fiscal sustainability. State government may be able to play a major legislative role in reshaping public sector employment and benefits in a form that leads to constructive outcomes outside of the bankruptcy process. Employees may see the value in voluntarily agreeing to changes in wages and benefits rather than experiencing the rejection of collective bargaining agreements in bankruptcy court.