GOVERNMENT BUDGETS AS THE HUNGER GAMES: THE BRUTAL COMPETITION FOR STATE AND LOCAL GOVERNMENT RESOURCES GIVEN MUNICIPAL SECURITIES DEBT, PENSION AND OBEP OBLIGATIONS, AND TAXPAYER NEEDS

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Introduction

Once a standard-bearer of American industrial might, Detroit, Michigan is a "shadow of the thriving metropolis that it once was," overcome by "decades of fiscal mismanagement, plummeting population, employment and revenues, decaying City infrastructure, deteriorating City services and excessive borrowing that provided short term band-aids at the cost of deepening insolvency."[1] The City's collapse is reflected in its blight and crime statistics. There are now more than 140,000 blighted properties in Detroit, and approximately 78,000 "abandoned and blighted" structures, of which 38,000 are considered dangerous.[2] Detroit's violent crime rate is "five times the national average" and higher than any U.S. city with a population greater than 200,000.[3] Citizens wait almost one hour for police to respond to calls,[4] and the City's case clearance rate for violent crimes is "substantially below" those of comparable

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[1] Declaration of Kevyn D. Orr in Support of City of Detroit, Mich.'s Statement of Qualifications Pursuant to Section 109(c) of the Bankr. Code at 4–5, *In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013) (No. 13-53846) [hereinafter Orr Declaration]; *accord In re* City of Detroit, Mich., 504 B.R. 97, 112, 120–21 (Bankr. E.D. Mich. 2013) (eligibility opinion).

[2] Orr Declaration, *supra* note 1, at 25. The number of abandoned and blighted structures represents approximately one fifth of the City's housing stock. Memorandum in Support of Statement of Qualifications Pursuant to Section 109(c) of the Bankr. Code at 25, *In re City of Detroit*, 504 B.R. 97 (No. 13-53846) [hereinafter Memorandum in Support of Qualifications]; Orr Declaration, *supra* note 1, at 25; Nick Carey, *Detroit Area's Battle with Blight May Be Key to Survival*, REUTERS (July 25, 2013, 12:17 AM), http://reuters.com/article/2013/07/25/us-usa-detroit-blight-idUSBRE96O02T20130725.

[3] *In re City of Detroit*, 504 B.R. at 120; *accord* OFFICE OF THE EMERGENCY MANAGER, CITY OF DETROIT: PROPOSAL FOR CREDITORS 9–11 (2013), *available at* http://www.detroitmi.gov/Portals/0/docs/EM/ Reports/ City%20 of%20Detroit%20Proposal%20for%20Creditors1.pdf [hereinafter PROPOSAL FOR CREDITORS].

[4] *In re City of Detroit*, 504 B.R. at 120; *see also* Orr Declaration, *supra* note 1, at 22; Statement of Qualifications Pursuant to Section 109(c) of the Bankr. Code at 12 (Exhibit A Letter from Richard D. Snyder, Governor of the State of Mich., to Kevyn D. Orr, Emergency Manager, City of Detroit & Andrew Dillon, State Treasurer of Mich. Dep't of Treasury), *In re City of Detroit*, 504 B.R. 97 (No. 13-45846) [hereinafter Statement of Qualifications].

municipalities.[5] Police, fire, and EMS services have resorted to accepting charitable donations in order to inspect and upgrade vehicles,[6] and first responders struggle to reach blighted, impoverished, and depopulated areas of the City, which have become "breeding ground[s]" for crime.[7]

The City's collapse follows decades of economic decay. The number of jobs in Detroit has declined precipitously over time,[8] and the City's unemployment rate stood at 18.3% as of June 2012, having nearly tripled since 2000.[9] Those Detroiters fortunate enough to be employed are likely to earn far less than other residents of Michigan, and the percentage of Detroiters living below the poverty line is far greater than in Michigan as a whole.[10] As economic conditions have declined, the City's population has plummeted, falling 63% since the City's "postwar peak" and 26% since just 2000.[11] This has eroded the City's tax base, causing tax revenues to decline[12] even as residents' per capita tax burden has become the highest in the state of Michigan.[13] Together, these developments

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[5] Orr Declaration, *supra* note 1, at 23.
[6] *Id.* at 28–29.
[7] Memorandum in Support of Qualifications, *supra* note 2, at 25 (citing Orr Declaration, *supra* note 1, at 25–26).
[8] Orr Declaration, *supra* note 1, at 15 ("The number of jobs in Detroit (for residents and non-residents) declined from 735,104 in 1970, to 562,120 in 1980, to 412,490 in 1990, to 346,545 in 2012." (citation omitted)).
[9] *E.g.*, Orr Declaration, *supra* note 1, at 16 (citing SE. MICHIGAN COUNCIL OF GOV'TS, POPULATION AND HOUSEHOLD ESTIMATES FOR SOUTHEAST MICHIGAN (Dec. 2012), *available at* http://www.semcog.org/uploadedFiles/Population_and_Household_Estimates_for_December_2012.pdf); PROPOSAL FOR CREDITORS, *supra* note 3, at 1.
[10] Orr Declaration, *supra* note 1, at 17–18 ("Detroiters' average *per capita* annual income from 2007 to 2011 was $15,261; the median household income for that same period was $27,862. During that period, an estimated 36% of Detroiters were living below the poverty line. Only 54% of Detroiters owned a home, the median value of which was $71,100. To put these numbers in perspective, the average *per capita* annual income in Michigan from 2007 to 2011 was $25,482, the median household income was $48,669 and only 16% of Michigan citizens lived below the poverty line. The state-wide homeownership rate was 74%, and the median home value was $137,300." (citations omitted)).
[11] PROPOSAL FOR CREDITORS, *supra* note 3, at 1; *accord* Orr Declaration, *supra* note 1, at 13.
[12] Orr Declaration, *supra* note 1, at 16, 18.
[13] *Id.* at 16, 20.

have torn the fabric of city life in ways both large and small. Forty percent of the City's streetlights do not work,[14] and there are reports of abandoned dogs roaming the streets.[15]

Detroit's collapse has pit stakeholders against one another in a brutal, unwinnable competition for the City's meager resources. First, there are Detroit's taxpayers. Although they are responsible for paying the City's debts through taxes and fees, they (i) face an enormous tax burden, already levied at or near statutory maximums, (ii) have limited resources to meet this burden due to population loss, economic decline, and unemployment, and (iii) face escalating expenses, crumbling infrastructure, and grossly inadequate services, despite their tax burden.[16] Next, there are public workers, especially retired workers with accrued pensions and other post-employment benefits.[17] These workers are not wealthy (pensioners reportedly receive an average of $18,000 per year),[18] and they were promised benefits, but the City's overwhelming debt load makes it difficult to see how these and other obligations can be met.[19] Finally, there are the City's creditors/lenders, including general obligation bondholders, some of whom were promised that the City's taxing power, and/or dedicated revenue streams would be available for repayment, but who now are being told that they should expect substantial losses.[20] Put simply, the City faces a toxic stew of competing rights and obligations, and it cannot simply tax, cut, or borrow its way out of economic distress.

On July 18, 2013, in the face of these challenges, Detroit's Emergency Manager Kevyn Orr filed a petition on behalf of the City seeking bankruptcy protection under Chapter 9 of the United States Bankruptcy Code.[21] The City's bankruptcy filings reveal that Detroit

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[14] *Id*. at 24.

[15] Mark Binelli, *City of Strays*, ROLLING STONE, Mar. 29, 2012, at 50 ("Estimates vary, but groups place the number of strays in the city at anywhere between 20,000 and 50,000.").

[16] PROPOSAL FOR CREDITORS, *supra* note 3, at 3–4.

[17] *In re* City of Detroit, Mich., 504 B.R. 97, 114 (Bankr. E.D. Mich. 2013).

[18] *Id.*

[19] In fact, the City estimates that its pension plans are underfunded by approximately $3.5 billion. *Id.* at 175.

[20] *See generally* PROPOSAL FOR CREDITORS, *supra* note 3.

[21] Bankr. Petition, *In re City of Detroit*, 504 B.R. 97 (No. 13-53846) [hereinafter Bankr. Petition]. For a discussion of the events leading to the appointment of Orr as Emergency Manager, see *In re* City of Detroit, 504 B.R. at 122–26; Orr Declaration, *supra* note 1, at 1–3. As Emergency

has more than 100,000 creditors and owes those creditors more than \$18 billion.[22] The City's debts, which are comprised of \$11.9 billion in unsecured debt and \$6.4 billion in secured debt,[23] include the following:

> (a) \$5.85 billion in special revenue obligations; (b) \$6.4 billion in other post-employment benefits, or "OPEB," liabilities; (c) \$3.5 billion in underfunded pension liabilities based on current actuarial estimates; (d) \$1.13 billion in securities and unsecured general obligation ("GO") liabilities; (e) \$1.43 billion in liabilities under pension-related certifications of participation ("COPs"); (f) \$296.5 million in swap liabilities related to the COPs[;] and (g) \$300 million in other liabilities.[24]

The City's bankruptcy filings also reflect that "[d]ebt service on obligations other than those secured by special revenues consumed a staggering 42.5% of the City's revenues in the 2013 fiscal year," a percentage the City estimates will increase to 65% of revenues by 2017.[25]

Given the magnitude of Detroit's collapse, it is tempting to think of the City as an outlier—a uniquely vulnerable community overcome by a perfect storm of economic, social, political, and

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Manager, Orr acts "in the place and stead of[] the City's elected mayor." Orr Declaration, *supra* note 1, at 2; *accord* EMERGENCY MANAGER, CITY OF DETROIT, ORDER NO. 13, FILING OF A PETITION UNDER CHAPTER 9 OF TITLE 11 OF THE UNITED STATES CODE 1 (2013); Statement of Qualifications, *supra* note 4; Orr Declaration, *supra* note 1, at Exhibit J (Letter from Kevyn D. Orr to Richard D. Snyder, Governor of the State of Michigan and Andrew Dillon, Treasurer of the State of Michigan (July 16, 2013)).

22 *In re City of Detroit*, 504 B.R. at 113; Memorandum in Support of Qualifications, *supra* note 2, at 2–3.

23 *In re City of Detroit*, 504 B.R. at 113. Detroit reportedly is the largest municipal bankruptcy case filed in U.S. history. Michael A. Fletcher, *Detroit Goes Bankrupt, Largest Municipal Filing in U.S. History*, WASH. POST (July 18, 2013), http://washingtonpost.com/business/economy/detroit-files-largest-municipal-bankruptcy-in-us-history/2013/07/18/a8db3f0e-efe6-11e2-bed3-b9b6fe264871_story.html.

24 Memorandum in Support of Qualifications, *supra* note 2, at 2–3.

25 *Id.* at 3.

demographic forces. But, it would be a mistake to view Detroit as an exceptional case, because, while the magnitude of the City's insolvency is exceptional, the reasons for City's collapse are not. For example, Detroit is not alone in its struggle to pay for pension benefits and OPEB for its public workforce (current and former). According to the Pew Center on the States, as early as 2008, there was a $1 trillion gap between the $2.35 trillion that states and participating localities had set aside to pay pensions, health care, and OPEB promised to public sector employees, and the $3.5 trillion in estimated actual cost.[26] More recently, the Pew Center found that "thirty cities at the center of the nation's most populous metropolitan areas faced more than $192 billion in unpaid commitments for pensions and other retiree benefits, primarily health care, as of fiscal 2009," including a "long-term shortfall of $88 billion for pensions and $104 billion for retiree health care and other non-pension benefits."[27] As these figures suggest, pension benefits and OPEB represent a challenge to the fiscal health of local governments across the United States.

Detroit also is not the only municipality to struggle with complex financial instruments. Detroit used so-called COPs and interest rate swaps to manage pension obligations.[28] According to Judge Steven Rhodes (the bankruptcy court judge handling the Detroit bankruptcy), these transactions were a high stakes wager, [29] and when interest rates declined in 2008, Detroit "lost

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[26] PEW CTR. ON THE STATES, THE TRILLION DOLLAR GAP: UNDERFUNDED STATE RETIREMENT SYSTEMS AND THE ROADS TO REFORM 1 (2010), *available at* http://pewstates.org/uploadedFiles/PCS_Assets/2010/Trillion_Dollar_Gap_Underfunded_State_Retirement_Systems_and_the_Roads_to_Reform.pdf [hereinafter PEW CTR.]. According to the Government Accountability Office ("GAO"), "[n]early twenty million employees and over seven million retirees and survivors are covered by state and local government pension plans." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-754, STATE AND LOCAL GOVERNMENT PENSION PLANS: GOVERNANCE PRACTICES AND LONG-TERM INVESTMENT STRATEGIES HAVE EVOLVED GRADUALLY AS PLANS TAKE ON INCREASED RISK 1 (2010).

[27] PEW CHARITABLE TRUSTS, CITIES SQUEEZED BY PENSION AND RETIREE HEALTH CARE SHORTFALLS 1 (2013), *available at* http://www.pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_city_pensions_brief.pdf.

[28] *In re City of Detroit*, 504 B.R. at 115–16.

[29] *Id.*

catastrophically on the swaps bet."[30] Nationally, while some local governments appear to have used complex, non-traditional financial instruments and derivatives with success, others (including Orange County, California[31] and Jefferson County, Alabama[32]) have struggled, especially with products carrying interest rate risk and the possibility of high termination fees.

In this Article, I discuss how obligations associated with public employment (including pension and OPEB) and obligations associated with complex financial instruments (including derivatives) fit into the puzzle of local government fiscal health, given the obligation of government to pay for infrastructure and public services. I argue that these obligations, especially when combined with fiscal mismanagement or corruption, can strain local government resources. Focusing on the federal securities laws, I argue that certain reforms designed to standardize financial reporting, aggregate data respecting pension and OPEB obligations and the use of complex financial instruments, and enhanced duties of care and loyalty could contribute to state and local government fiscal health. In particular, in Parts I and II, I discuss state and local governments' obligation to provide infrastructure and public service in the face of constraints on resources and expense and debt relief. In Part III, I discuss how public workers' salary, pension, and OPEB benefits fit into this financial puzzle. In Part IV, I discuss non-traditional securities and their relationship to state and local government fiscal health. In Part V, I discuss the current regime of

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[30] *Id*. at 116.

[31] For discussion of Orange County's bankruptcy and threatened default, see Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427, 454 (1996) (describing Orange County crisis and losses); Merton H. Miller & David J. Ross, *The Orange County Bankruptcy and Its Aftermath: Some New Evidence*, 4 J. DERIVATIVES no. 4, Summer 1997, at 51, 60 (discussing Orange County's decision to file for bankruptcy).

See generally In the Matter of County of Orange, California, Exchange Act Release No. 36,761, 61 SEC Docket 382 (Jan. 24, 1996). For a brief discussion of market risk control failure and the Orange County situation, see Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 27–28 (1997) (citing *Municipal Finance Issues: Hearings Concerning the Municipal Securities Market Before the H. Comm. on Commerce*, 105th Cong. (1995) (Testimony of Arthur Levitt, Chairman, SEC)).

[32] For a discussion of the Jefferson County case, see *infra* Part II.E.

municipal securities regulation and argue that the current system, even as bolstered by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank" or "Act"), does not go far enough to support prudent financial decision-making or to protect stakeholders from unacceptable levels of risk. Finally, in Part VI, I suggest reforms to federal securities law designed to incent and support well-informed, transparent financial decision-making by public officials, financial intermediaries, taxpayers, and public workers. Among other specific reforms, I recommend (i) requiring compliance with uniform accounting standards, so that stakeholders can get a better sense of the state of state and local government budgets; (ii) creating a data collection resource and oversight body to help identify and manage risks associated with complex instruments, (iii) creating a data collection resources and oversight body to help identify and management risks associated with public employee compensation (particularly pensions and OPEB), and (iv) expanding the reach of the fiduciary standard to a broader range of stakeholders involved in local government financial decision-making, including public officials, underwriters, and derivatives counterparties. Part VII concludes.

I. A Spending Mandate

State and local governments face a fundamental challenge to fiscal health: governments have an obligation to spend on public infrastructure and public services, and to meet day-to-day funding needs, but they have constrained revenues with which to meet this obligation, and few opportunities for expense reduction or debt relief.[33] Focusing first on governments' spending mandate, unlike businesses, which may shut down operations or reduce head-count when times are tough, state and local governments must provide at

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[33] Shaheen Borna & Krishna G. Mantripragada, *Morality of Public Deficits: A Historical Perspective*, 9 PUB. BUDGETING & FIN., no. 1, Spring 1989, at 33, 35 ("The goal of public finance . . . is, ideally, to bring about maximum social welfare . . . ."). As I have argued elsewhere, this funding imperative means that municipalities may have less flexibility than their corporate counterparts respecting the timing and amount of borrowing and expenditures, and less flexibility to reduce expenses through deferral, head-count reduction or the sale or leveraging of assets. Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rages, and Opportunities for Reform*, 34 CARDOZO L. REV. 1455, 1481–84 (2013).

least basic infrastructure, education, and health and safety services at all times. In fact, the obligation to remain "open for business" drives government spending. According to the United States Census Bureau's 2011 summary of state and local government spending, for example, education and utility expenditures "topped their [local government] spending at $599.3 billion and $183.7 billion, respectively."[34] Public safety spending (police and fire in particular) also weighed heavily on local governments, according to the Census Bureau,[35] as did spending on water and gas supply.[36] Expenditures on education and public safety have grown substantially—and steadily—since the late 1970s in dollar terms, according to the Government Accountability Office's ("GAO") analysis of Census Bureau statistics[37]:

[34] JEFFREY L. BARNETT & PHILLIP M. VIDAL, U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2011, at 4 (2013), *available at* http://www2.census.gov/govs/local/summary_report.pdf [hereinafter BARNETT & VIDAL 2011 SUMMARY].

[35] *Id.* ("Public safety spending (comprised of police, fire, and corrections) was dominated by local governments, with the exception of spending on corrections. Local governments comprised 86.7% of the state and local government total spending on police protection. Spending on fire protection was an entirely local government function. State government spending comprised 63.9% of state and local government spending on correction.").

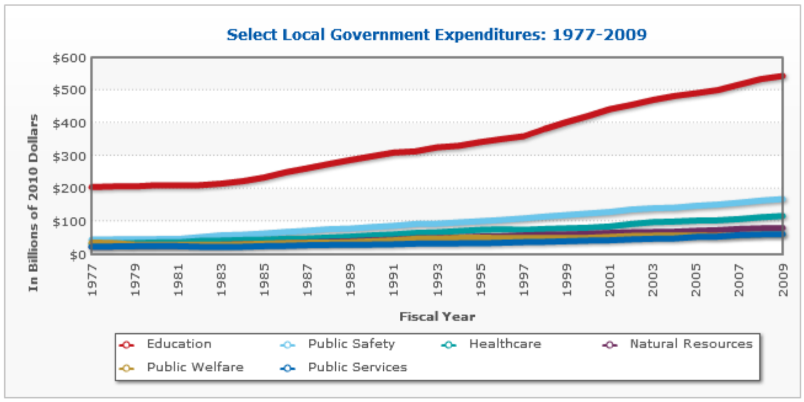
[36] *Id.* ("Utility spending was also dominated by local governments, with spending on water supply and gas supply almost entirely conducted by local governments, at 99.4% and 99.8%, respectively.").

[37] *About Local Government Finances*, U.S. GOV'T ACCOUNTABILITY OFFICE, http://www.gao.gov/fiscal_outlook/state_local_fiscal_model/interactive_graphic/about_local_finances (last visited Apr. 16, 2014). The GAO notes, however, that "[l]ocal government expenditures, when viewed as a percentage of GDP, have remained quite flat, indicating that they generally kept pace with the growth of the broader economy." *Id.*

Figure 1. Select Local Government Expenditures[38]

What are the key categories of local expenditures and how have they changed over time?

While local government expenditures for many categories were relatively consistent from 1977 to 2009, the two largest categories of expenditures, education and public safety, increased considerably. During this time period, local government expenditures for education increased by 165 percent from $205 billion in 1977 to $543 billion in 2009 (in constant 2010 dollars). Expenditures for public safety also grew significantly over the time period from $45 billion in 1977 to $168 billion in 2009. Other categories in the top six local expenditures were health care (which excludes Medicaid and Medicare), natural resources, public welfare (which includes Medicaid), and public service.



Source: GAO Analysis of U.S. Census Bureau Government Finance Statistics. Although the original sources for finance statistics are accounting records of governments, the data derived from them are purely statistical in nature. Consequently, the Census Bureau statistics on government finance cannot be used as financial statements or to measure a government's fiscal condition. Link to PDF of data shown in graphic.

Note: The components of general current expenditure include current operations, interest on debt, assistance and subsidies, and intergovernmental expenditures.

This obligation to spend on infrastructure and services means that state and local governments are subject to budgetary pressures that most private enterprises do not share.[39] Compare, for example, Detroit's non-waivable obligation to provide basic infrastructure and services (including fire, police, EMS, and a public education for its children)[40] with smartphone maker Blackberry, Ltd.'s freedom to lay off 4500 workers and scale back operations in response to

[38] *Id.* (graph entitled "Select Local Government General Revenue: 1977–2009," based on GAO Analysis of the U.S. Census Bureau Government Finance Statistics).

[39] DANIEL DISALVO, MANHATTAN INST., GOVERNMENT CROWDED OUT: HOW EMPLOYEE COMPENSATION COSTS ARE RESHAPING STATE AND LOCAL GOVERNMENT 1 (2013), *available at* http://www.manhattan-institute.org/pdf/cr_77.pdf ("As governments pay more and more for [pension and health care] benefits—usually without choice or review because the expenditures are governed by law or by union contract—policymakers find that governments have less and less to spend on the services that citizens need and expect.").

[40] *See generally* Orr Declaration, *supra* note 1.

deteriorating sales and revenue numbers.[41] Likewise, compare Detroit's obligation to provide infrastructure despite its insolvency, with auto manufacturers' flexibility to shutter plants, lay off workers, and even declare bankruptcy in response to fiscal stress.[42]

II. Resources Constrained by Economic, Political, Demographic, and Legal Forces

But, if state and local governments are obligated to spend on infrastructure and services, their sources of revenue for this work—assistance from higher levels of government, taxes, and borrowing/financing via the public markets—are constrained by legal, economic, and political forces.[43]

A. Grant Money Constrained by Economic, Demographic, and Political Forces

Although assistance from higher levels of government is a critical revenue source for local governments (representing more than 35% of local government revenues in 2011),[44] relying on grant money is not a sustainable path towards fiscal health.[45] Higher levels

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[41] Hugo Miller, *BlackBerry to Fire 4,500, Write Down up to $960 Million*, BLOOMBERG (Sept. 20, 2013, 5:12 PM), http://bloomberg.com/news/2013-09-20/blackberry-to-fire-4-500-write-down-up-to-960-million.html.

[42] Bill Vlasic & Nick Bunkley, *Obama Is Upbeat for G.M. Future on a Day of Pain*, N.Y. TIMES, June 2, 2009, at A1 (discussing General Motors' 2009 bankruptcy filing); MARIAN J. KRZYZOWSKI & LAWRENCE A. MOLNAR, UNIV. OF MICH. OFFICE OF THE VICE PRESIDENT FOR RESEARCH INST. FOR RESEARCH ON LABOR, EMP'T, AND THE ECON., IMPACTS OF THE AUTOMOTIVE INDUSTRY'S RESTRUCTURING 12 (2009), http://www.chicagofed.org/digital_assets/others/events/2009/automotive_communities/presentation_impact_of_restructuring.pdf (referencing case study by the University of Michigan's Institute for Labor, Employment, and the Economy which found that the closure of a single plant (the General Motors' Moraine Assembly Plant in Montgomery County, Ohio) led to the loss of thousands of jobs, and had a total economic impact to the regional economy in excess of $700,000,000).

[43] *See infra* Part II (describing constraints on grant money, taxes, borrowing, and from the recession and corruption).

[44] BARNETT & VIDAL 2011 SUMMARY, *supra* note 34, at 6.

[45] *E.g.*, John Johnston, *Playing with Fire: Departments Rely on Federal Grants*, CINCINNATI.COM (Feb. 21, 2014), http://cincinnati.com/article/20140222/NEWS/302220020 (describing problems that fire departments

of government do not have the resources or the political will to fund every worthy municipal project or service.[46] In the 1970s, for example, reductions in federal aid caused state and local governments to look to the municipal securities market to meet funding needs.[47] Moreover, for struggling cities like Detroit, demographic trends can lead to reductions in assistance from higher levels of government despite increasing need. According to Detroit's bankruptcy filings, for example, "[s]tate revenue sharing [from Michigan to Detroit] has decreased by $161 million since FY 2002 (approximately 48%) and by $76 million (approximately 30.6%) since 2008 due to the City's declining population and significant reductions in statutory revenue sharing by the State."[48] Since revenue sharing is tied to population, the City anticipates that "revenue

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relying on federal grants face); Rebecca Thiess, *Recent Impacts on Grant Funding to State-Level Programs*, ECON. POL'Y INST. (June 7, 2013, 3:06 PM), http://epi.org/blog/impacts-grant-funding-state-level-programs (discussing how "the sequestration decreased federal funding for state grants by $5.1 billion in the 2013 fiscal year").

[46] *E.g.*, NICHOLAS JOHNSON & MICHAEL LEACHMAN, CTR. ON BUDGET AND POLICY PRIORITIES, FOUR BIG THREATS TO STATE FINANCES COULD UNDERMINE FUTURE U.S. PROSPERITY 1–2 (2013), *available at* http://www.cbpp.org/files/2-14-13sfp.pdf (explaining cuts in grant programs "will push federal funding for a wide range of state and local services—schools, water treatment, law enforcement, and other areas—to its lowest level in four decades as a share of the economy"); Ramit Plushnick-Masti, *FEMA Denies Funds to Rebuild West, Texas After Fertilizer Plant Explosion*, HUFFPOST POLITICS (June 12, 2013, 6:11 PM), http://huffingtonpost.com/2013/06/12/fema-west-texas_n_3428743.html ("The Federal Emergency Management Agency is refusing to provide additional money to help rebuild the small Texas town where a deadly fertilizer plant explosion leveled numerous homes and a school, and killed fifteen people.").

[47] W. Bartley Hildreth & C. Kurt Zorn, *The Evolution of the State and Local Government Municipal Debt Market over the Past Quarter Century*, 25 PUB. BUDGETING & FIN., no. 4S, 2005, at 132–33 (observing that state and local governments were forced to turn to the municipal securities market in the late 1970s and early 1980s due to "mounting capital needs and fewer degrees of freedom to deal with these needs because of high interest rates, inflation and a slowing economy, reduction in federal aid as a result of concern over mounting budget deficits, and tax and expenditure limitations on state and local governments").

[48] Orr Declaration, *supra* note 1, at 19; *accord* PROPOSAL FOR CREDITORS, *supra* note 3, at 4.

sharing amounts will decrease further if the City's population continues to decline."[49]

B. Taxes Constrained by Political and Economic Forces, Legal Constraints

Along with grant money, taxes also are limited by legal, political, economic, and demographic realities.[50] Taxes are a critical source of revenue for local governments, comprising almost 40% of local government revenues in 2011, with property taxes comprising the lion's share of local government tax revenues at 74.2%.[51] Even in the best of times, taxes are a politically fraught issue.[52] For residents of financially strapped cities like Detroit, tax increases are not a realistic source of additional revenue.[53] Detroit's residents already face an overwhelming tax burden: the City's filings note that "[t]he *per capita* tax burden on Detroit residents is the highest in Michigan."[54] This "burden is made heavier still by the residents' relative inability to pay" given high rates of unemployment, poverty,

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[49] PROPOSAL FOR CREDITORS, *supra* note 3, at 4.

[50] DISALVO, *supra* note 39, at 2, 5 (describing how states and local governments are struggling to raise revenue through taxes).

[51] BARNETT & VIDAL 2011 SUMMARY, *supra* note 34, at 3 (explaining taxes represented "39.6% of general revenue for local governments," of which 74.2% was property taxes).

[52] *E.g.*, RICK TIMBS, STATEWIDE SCH. FIN. CONSORTIUM, THE NUMBERS DON'T LIE: THE CURRENT CRISIS OF NEW YORK STATE SCHOOL DISTRICT FINANCES 3–6 (2012), *available at* http://statewideonline.org/data/SSFC_2012_Whitepaper_FINAL_9-26-2012.pdf.

[53] As Robert Tannenwald points out, the long-term erosion of the tax base in cities like Detroit represents a structural problem, especially when municipal budgets shrink while public needs increase:

> An analysis of the mix of the nation's subnational revenues reveals two reasons why both state and local governments are so concerned about long-run erosion of their tax capacity. First, both depend heavily on uncertain flows of fiscal assistance from a higher level of government. Second, many state and local governments lack a diverse mix of "own-source revenues"—taxes and user charges that they collection on their own authority.

Robert Tannenwald, *Are State and Local Revenue Systems Becoming Obsolete?*, 55 NAT'L TAX J. 467, 467 (Sept. 2002).

[54] Orr Declaration, *supra* note 1, at 20.

and population decline.[55] Even if Detroit's citizens could absorb property tax increases as an economic matter, it is unlikely that incremental additional tax revenue would make a meaningful dent in the City's debt. From 2007 to 2011, "[o]nly 54% of Detroiters owned a home, the median value of which was $71,100," reflecting the degree to which Detroit's property tax revenues are constrained by poverty and blight.[56]

In any event, tax cap legislation makes the legal authority for any tax increases in Detroit suspect. Michigan Public Act 394 of 2012 fixed Detroit's "maximum income tax rates at their current levels,"[57] and state law limits on property tax rates and certain utility users' taxes are fixed and at statutory maximums.[58] The City has

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[55] *Id.*

[56] *Id.* at 17 (citing U.S. Census Bureau, *State & County QuickFacts, Detroit, Michigan*, CENSUS.GOV, http://quickfacts.census.gov/qfd/states/26/2622000.html). In fact, Detroit's assessed property values have decreased by more than $1 billion over the past five years, resulting in double-digit declines in tax revenues. *Id.* at 18. Detroit's property tax receipts likewise have suffered. *Id.* "Between 1970 and 1990, the real value of the City's property tax base declined by nearly two-thirds." *Id.* This trend has reasserted itself in earnest in the wake of the Great Recession. "According to the Citizens' Research Council of Michigan, over the last five years, Detroit's assessed property values have decreased by approximately $1.6 billion." *Id.* "Property tax revenues for the City's 2013 fiscal year were $134.9 million, a $12.9 million (or approximately 10%) reduction from the prior fiscal year and $23.6 million (or approximately 15%) lower than the average property tax revenue for the preceding five fiscal years." *Id.*

[57] MICH. COMP. LAWS ANN. § 141.503(2) (West 2012); Memorandum in Support of Qualifications, *supra* note 2, at 29–30 ("[E]ven if it were advisable to do so (which it almost certainly is not), the City is legally incapable of raising revenue through additional taxation."); Orr Declaration, *supra* note 1, at 20.

[58] Michigan law limits municipalities' property tax rates to twenty mills. MICH. COMP. LAWS ANN. § 117.3 (West 2012) ("Each city charter shall provide for all of the following: . . . (g) The annual laying and collecting taxes in a sum, except as otherwise provided by law, not to exceed 2% of the taxable value of the real and personal property in the city."); MICH. COMP. LAWS ANN. § 117.5 (West 2011) ("A city does not have power: (a) To increase the rate of taxation now fixed by law, unless the authority to do so is given by a majority of the electors of the city voting at the election at which the proposition is submitted, but the increase in any case shall not be in an amount as to cause the rate to exceed 2%, except as provided by law, of the assessed value of the real and personal property in the city."). A constitutionally required rollback limits property tax rates to 19.952 mills

taken the position in bankruptcy that "even if it were advisable" to increase taxes (which, according to the City "it almost certainly is not") the City is legally incapable of raising revenue through additional taxation."[59]

Lest one think that Detroit's situation is unique, consider Vallejo, California. A city of 117,000 located about thirty miles northeast of San Francisco, Vallejo was hit hard by the housing market crash and California's struggling economy.[60] Between 2005 and 2008, as revenues faltered and employment costs rose, the City operated at a substantial deficit.[61] As its financial condition deteriorated, Vallejo tried a number of strategies to deal with its financial difficulties. Initially, the City drew upon general fund reserves to fund its deficits.[62] By mid-2008, however, the City estimated that funding its annual operating deficit for the 2008 fiscal year would entirely deplete the City's general fund and cause the City to lack sufficient general fund revenues or cash flows to pay its bills as they came due.[63] The City also negotiated with labor associations representing City workers in an effort to reduce labor costs (the largest expenditure the city incurred during each fiscal year),[64] cut "expenditures that did not require the mutual agreement of other parties,"[65] cut jobs, services, and staff,[66] and reduced or

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(which is the rate that Detroit now charges). CITIZENS RESEARCH COUNCIL OF MICH., DETROIT CITY GOV'T REVENUES 15 (2013), *available at* http://www.crcmich.org/PUBLICAT/2010s/2013/rpt382.pdf. Utility users' tax and casino wagering tax are likewise fixed at current 5% and 9.9%, respectively, under state law. MICH. COMP. LAWS ANN. §§ 141.1152(1), 432.212(4) (West 2012).

[59] Memorandum in Support of Qualifications, *supra* note 2, at 29–30. Moreover, while the City has increased corporate tax rates and enhanced its collection activities, such measures will not be enough to bridge the city's funding gap. Orr Declaration, *supra* note 1, at 10, 47.

[60] Memorandum of Fact and Law in Support of Statement of Qualifications Under Section 109(c) at 3, *In re* City of Vallejo, Cal., No. 2:08-BK-26813 (Bankr. E.D. Cal. May 23, 2008) [hereinafter Memorandum of Fact and Law]; *Demographic Profile*, CITY OF VALLEJO CAL., http://www.ci.vallejo.ca.us/about_vallejo/demographic_profile (last visited Apr. 16, 2014).

[61] Memorandum of Fact and Law, *supra* note 60, at 3.

[62] *Id.*

[63] *Id.* at 1.

[64] *Id.* at 4, 8.

[65] *Id.* at 5.

[66] *Id.* at 7.

eliminated funding for almost all of its general fund "services and programs beyond levels which the city viewed as minimally acceptable."[67] Finally, the City negotiated with the issuer of several letters of credit supporting the City's $54 million in outstanding bonds respecting the City's potential bankruptcy filing and other possible adjustment strategies.[68] While the bank reportedly was willing to negotiate with the City, it deferred "detailed discussions regarding adjustments to the City's General Fund bond obligations until the City and labor groups" reached agreement respecting the City's labor costs.[69]

Unfortunately, none of these initiatives solved the City's financial crisis.[70] On May 23, 2008, the City filed a Chapter 9 bankruptcy petition over the objections of city workers, who argued that the City was not insolvent, and that it had filed for bankruptcy as a stratagem to reduce or avoid obligations owed to public workers.[71] In its petition and supporting documents, the City cited several reasons for its financial distress, including (i) a decrease in revenues, (ii) $3.4 million in unbudgeted pension cost and other expenses relating to public employee compensation or benefits; (iii) cuts in funding from the State of California as taking away additional sources of revenue that would have been used to pay for bond servicing; and (iv) limits on the City's ability to raise funds through taxation or additional indebtedness.[72]

With respect to limits on taxation, city officials cited Proposition 13 and related tax-cap legislation as contributing to Vallejo's financial difficulties.[73] Enacted three decades ago,

[67] *Id.* at 1, 7.
[68] *Id.* at 11–12.
[69] *Id.* at 12.
[70] *Id.*
[71] *Id.* at 13.
[72] *Id.* at 7, 13, 21–22 ("[T]he City anticipates that in fiscal year 2008–09 the State of California will withhold from the City, along with other cities and counties, funds that the state annually provides the City and on which the City relies . . . . As these numbers show, the City's annual revenues are, at best, flat, and in many cases decreasing . . . . Nonetheless, while the City intends to pursue all potentially viable methods of generating new revenues, history shows that raising taxes or assessments is not necessarily a realistic tool in solving local agency fiscal problems . . . . Nor can the city borrow the money necessary to balance its General Fund budget or generate a positive cash flow.").
[73] *Id.* at 4.

Proposition 13 both rolled back and froze assessments for residential and commercial real estate property at 1976 levels.[74] It then set the tax rate at 1% of that valuation,[75] and limited annual increases to 2%.[76] Because values are reassessed only when properties are sold, people who have owned their homes for years may pay substantially less in taxes than neighbors who recently purchased a comparable home.[77] While the law has reduced property taxes—according to the Board of Equalization, the average real estate tax in California is 60% lower than when the law was passed—some have argued that it is in part responsible for California's perennial budget crisis and declines in per-student spending.[78]

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[74] CAL. CONST. art. XIIIA, §§ 1(a)–2(a); Julie K. Koyama, Comment, *Financing Local Government in the Post-Proposition 13 Era: The Use and Effectiveness of Nontaxing Revenue Sources*, 22 PAC. L.J. 1333, 1334 (1991) (explaining that Proposition 13 limited jurisdictions which taxed in California to the 1975–76 assessed value of the real property).

[75] CAL. CONST. art. XIIIA, § 1(a).

[76] *Id.* § 2(b).

[77] *See id.* § 2(a); Jonathan Schwartz, Note, *Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal Land Use Decisions*, 71 S. CAL. L. REV. 183, 193 (1997).

[78] *E.g.*, Michael B. Marois & James Nash, *California Schools Suffering as Proposition 13 Tax Cap Breeds Fiscal Chaos*, BLOOMBERG (July 12, 2011, 12:01 AM), http://bloomberg.com/news/2011-07-12/california-schools-suffering-as-proposition-13-tax-cap-breeds-fiscal-chaos.html; Christopher Palmeri, *Bloomberg: California Diminished by Tax Revolt of 1978 Shows How U.S. Invites Decline*, INLANDPOLITICS.COM (Oct. 16, 2011, 9:01 PM), http://inlandpolitics.com/blog/2011/10/17/bloomberg-california-diminished-by-tax-revolt-of-1978-shows-how-u-s-invites-decline. Some have opined that Proposition 13 also played a role in Orange County's bankruptcy. James E. Spiotto, *Municipal Finance and Chapter 9 Bankruptcy*, 17 MUN. FIN. J., no. 1, Spring 1996, at 1, 3 ("The investment losses suffered by Orange County are best attributed to the desperate efforts of a revenue-starved municipality that had faced shrinking revenues and expanding costs because of a constitutionally imposed tax cap (Proposition 13). The difficulty with an artificial and unrealistic tax cap and similar constitutional limits on taxation is that there are certain municipal services that are required and expected by the citizens. If revenues available to municipalities are capped in an unrealistic and artificial way, the ability of municipalities to supply those necessary services is significantly curtailed."). For an early analysis of the impact of Proposition 13, see generally Fed. Reserve Bank of S.F., *Proposition 13 and Financial Markets*, ECON. REV., Winter 1979, at 5, 5.

Vallejo's bankruptcy documents also cited California Proposition 218 as a further constraint on the City's ability to raise sales taxes.[79] Proposition 218 "requires that a majority of voters approve any new or increased general tax, and that a two-thirds majority approve any new or increased special tax."[80] City officials also claimed that article XVI, section 18 of the California Constitution prohibited the ity from borrowing money to deal with its revenue or cash flow shortfall.[81] This provision of the California Constitution prohibits cities such as Vallejo from "incurring in any year a debt which it cannot pay from revenues attributable to that same year."[82]

Although Vallejo's bankruptcy filing gave the city breathing room to adjust debts owed to various creditor constituencies, respite came at a cost.[83] Through the bankruptcy process, the City adjusted compensation and benefits packages with city workers, with the

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[79] Memorandum of Fact and Law, *supra* note 60, at 4.

[80] *Id.*; *accord* CAL. CONST., art. XIIIC, § 2.

[81] Memorandum of Fact and Law, *supra* note 60, at 4 ("Article XVI, Section 18 of the California Constitution prohibits the City form incurring in any year a debt which it cannot pay from revenues attributable to the same year.").

[82] *Id.*; *accord* CAL. CONST., art. XVI, § 18.

[83] Leon R. Barson & Francis J. Lawall, *Chapter 9 Bankruptcy: Restructuring Municipalities in Financial Distress*, *in* CHAPTER 9 BANKRUPTCY STRATEGIES: LEADING LAWYERS ON NAVIGATING THE CHAPTER 9 FILING PROCESS, COUNSELING MUNICIPALITIES, AND ANALYZING RECENT TRENDS AND CASES 7, 9 (2011) (acknowledging Chapter 9 filing gives distressed municipalities time—and "breathing room"—to develop debt adjustment plans). In *City of Vallejo*, Vallejo sought to reject its collective bargaining agreements with public workers less than one month after filing its petition for relief under Chapter 9 of the Bankruptcy Code. *In re* City of Vallejo, Cal., 403 B.R. 72, 74 (Bankr. E.D. Cal. 2009), *aff'd*, 432 B.R. 262 (E.D. Cal. 2010). The Court held that the less stringent standards for rejection of union contracts available under 11 U.S.C. § 365 and the Bildisco line of cases applied to Vallejo's petition versus the more exacting standards for rejection of union contracts under 11 U.S.C. § 1113. *Id.* at 78 (holding Bildisco standard, which permits a debtor to reject a collective bargaining agreement under 11 U.S.C. § 365 if it shows "(1) the collective bargaining agreement burdens the estate;" (2) upon scrutiny, "the balance of equities favors contract rejection;" and (3) "'reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution'" applies) (citations omitted).

reported result that, "city staffers now contribute more to their health insurance, new firefighters have lower pension plans, and the fire department no longer has minimum staffing requirements."[84] "Even though the City emerged from bankruptcy last year, sales taxes remain high, public services remain 'hollowed-out,' and there are neighborhoods with dilapidated homes."[85] City workers and taxpayers have also had to deal with over $8 million in legal fees that the City incurred in connection with the bankruptcy.[86] Notably, Vallejo's bondholders appear to have survived the City's bankruptcy relatively unscathed: according to press reports, Vallejo paid bondholders in full and on time.[87]

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[84] Carolyn Jones, *Vallejo's Bankruptcy Ends After 3 Tough Years*, SFGATE (Nov. 1, 2011, 5:02 PM), http://sfgate.com/bayarea/article/Vallejo-s-bankruptcy-ends-after-3-tough-years-2324840.php. Fire and police unions opposed Vallejo's bankruptcy filing on the grounds that the city used bankruptcy strategically as a means of avoiding contractual obligations respecting benefits. *Id.*

[85] Bobby White, *In Vallejo, Bankruptcy Scars Still Visible*, WALL ST. J. (Jan. 19, 2012), http://online.wsj.com/news/articles/SB10001424052970204555904577167013455352608.

[86] Among other reasons for the legal fees, the city and certain of its public workers engaged in extensive litigation over whether the bankruptcy filing was necessary, or whether it was means of avoiding collective bargaining obligations. *E.g.*, Opposition to Application for Order Setting Deadline for Objections at 4, *In re City of Vallejo*, 403 B.R. 72 (No. 2:08-BK-26813) [hereinafter Opposition to Deadline Order] ("The Unions are appropriately concerned that Vallejo's bankruptcy petition is aimed primarily at strong-arming a renegotiation of the collective bargaining agreements rather than readjusting all its debts fairly."); Patrick McGee, *Vallejo Shows the Way*, BOND BUYER, Mar. 1, 2011, at 1.

[87] McGee, *supra* note 86 ("Vallejo bonds backed by non-general fund revenues amount to $62 million of debt. They have been paid in full and on time throughout the bankruptcy proceeding."). According to Hildreth and Zorn, the San Jose School District in California also paid its debt service on schedule despite seeking bankruptcy protection in 1983 "due, in part, to Proposition 13 tax limits, but, more pointedly, to void a labor arbitration award." Hildreth & Zorn, *supra* note 47, at 145. Some state and local governments reportedly have attempted to deal with soaring pension liabilities by issuing pension obligation bonds. PEW CTR., *supra* note 26, at 34. As the Pew report reflects, pension obligation bonds entail a number of risks for issuers and those responsible for repayment. For example, because pension obligation bonds are sensitive to market conditions, returns can vary from year to year: when returns are robust, they may be sufficient to fund pension plans. *Id.* If returns falter, however, they may not be sufficient

C. Borrowing Constrained by Legal Regime, Politics, and Economics

The third source of revenue—borrowing via the public markets—also is constrained and potentially risky, particularly for struggling municipalities like Detroit.

1. Municipal Securities and the Municipal Securities Market: Brief Background

Unlike businesses, which may issue a variety of securities to raise money (debt, equities),[88] local governments depend on municipal bonds (debt) and related financial instruments to meet funding needs.[89] Municipal bonds are "securities issued by states and their political subdivisions and instrumentalities[90] to pay for public

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to meet funding obligations, or even to meet borrowing costs. *Id.* If that happens, issuers have the potential to lose billions of dollars on these deals. *Id.* For a critical take on pension obligation bonds, see D. Roderick Kieweit, *The Day After Tomorrow: The Politics of Public Employee Retirement Benefits*, 2 CAL. J. POL. & POL'Y, no. 3, 2010, at 13–14; Nathaniel Popper, *More Municipalities Bet on Bonds to Cover Pensions*, L.A. TIMES, Mar. 26, 2012, at B1.

[88] For example, AMC Entertainment Holdings, reportedly the second largest movie theater owners in North America, announced in September 2013 that it sought to raise $400 million via an initial public offering of stock and that it planned to use the proceeds of the offering for capital expenditures and to reduce debt. William Alden, *AMC Aims to Raise $400 Million in I.P.O*, N.Y. TIMES (Sept. 13, 2013, 12:05 PM), http://dealbook.nytimes.com/2013/09/03/amc-aims-to-raise-400-million-in-i-p-o/?_r=0.

[89] ROBERT S. AMDURSKY, CLAYTON P. GILLETTE & G. ALLEN BASS, MUNICIPAL DEBT FINANCE LAW: THEORY AND PRACTICE §§ 1.1.3–1.4 (2d ed. 2013) (discussing municipalities' use of debt to fund improvements, history of state and local government indebtedness and characteristics of municipal bonds); *id.* §§ 1.1.1–1.1.2 (discussing municipalities' focus on public good); FITCH RATINGS, TOP TEN DIFFERENCES BETWEEN MUNICIPAL BONDS AND CORPORATE BONDS 2 (2010), *available at* http://naic.org/documents/committees_e_rating_agency_101118_hearing_fitch_doc3.pdf (explaining that "[c]orporations can raise equity, while governments cannot").

[90] Instrumentalities include entities like school districts, special districts, and public authorities. For information regarding the history of authorities

projects like the construction of water, sewer and power plants, highways, bridges, hospitals and schools, and to meet day-to-day funding needs."[91] Municipalities traditionally have used two types of bonds to meet funding needs—general obligation bonds and revenue bonds.[92] General obligation bonds are secured by the taxing power or "faith and credit" of the issuer,[93] and generally are subject to laws which restrain state and local governments from incurring debt without voter approval or from exceeding debt limits.[94] Issuers use

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and special districts, see Lynn Wilson & Clayton Eichelberger, *New York State Public Authority Reform: Where We Have Come from and Where We Need to Go*, 11 N.Y. ST. B.A. GOV'T, L. & POL'Y J., no. 2, Fall 2009, at 15–22. *See generally* William J. Quirk & Leon E. Wein, *A Short Constitutional History of Entities Commonly Known as Authorities*, 56 CORNELL L. REV. 521 (1971). Over the past one hundred years, the number of authorities and special districts has grown significantly. *See* 1 U. S. CENSUS BUREAU, 2002 CENSUS OF GOVERNMENTS, GOVERNMENT ORGANIZATION vi (2002) (discussing historical increases in the number of municipal governments in the United States). Commentators have opined that this growth reflects increasing demand for services provided by authorities and special districts, as well as the desire to circumvent restrictions on issuances of debt by state and local governments. SIFMA, THE FUNDAMENTALS OF MUNICIPAL BONDS 57 (John Wiley & Sons, 6th ed. 2012).

[91] SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET 7 (2012) [hereinafter SEC REPORT], *available at* http://www.sec.gov/news/studies/2012/munireport073112.pdf.

[92] In addition to the types of securities listed above, municipal securities issuers have used a variety of other instruments over the years. *See, e.g.*, JOE MYSAK, ENCYCLOPEDIA OF MUNICIPAL BONDS 117–18 (2012).

[93] *See, e.g.*, U.S. Census Bureau, *State Government Finances—Definitions*, CENSUS.GOV, https://census.gov/govs/state/definitions.html (last visited Apr. 16, 2014) ("Full-faith and credit debt [means] [l]ong-term debt for which the credit of the government concerned, implying the power of taxation, is unconditionally pledged. Includes debt payable initially from specific taxes on nontax sources, but representing a liability payable from any other available resources if the pledged sources are insufficient.").

[94] In addition to straightforward limits, municipal entities may be subject to state statutes designed to spread the costs of public projects over time. For example, New York law prohibits municipalities, school districts, or public corporations from incurring indebtedness for a period longer than the useful life of the project as set forth in the statute. *See* N.Y. LOCAL FIN. LAW § 11 (McKinney 2011) (stating in part, "A municipality, school district or district corporation may not contract indebtedness for any object or purpose for a period longer than the period of probable usefulness set forth below . . . ."); *see also* CAL. CONST. art. XVI, § 18 ("No county, city, town, township,

long-term general obligation bonds to finance public facilities that do not produce revenues, or when it is thought to be inappropriate to levee fees for use as a matter of public policy.[95] If an issuer defaults on a general obligation bond, bondholders typically have the right to compel a tax levy or a legislative appropriation.[96] Revenue bonds are bonds secured by revenues or receipts from the funded project or other special funds.[97] The idea is that issuers will use funds raised through revenue bond offerings to construct facilities that, "theoretically, through the imposition of fees or charges, will generate sufficient revenues to amortize the debt over the useful life of the facility."[98] "[R]evenue bond financing has been traditionally

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board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds of the qualified electors thereof."). Note, however, that the courts have recognized qualifications to requirements like those set forth in section 18. *See, e.g.*, L.A. Cnty. Trans. Comm'n. v. Richmond, 643 P.2d 941, 947 (Cal. 1982) (holding transit commission not a "special district" so two-thirds vote not required). Note also that debt limits may not apply to certain court-ordered expenditures.

[95] *See* Ann J. Gellis, *Mandatory Disclosure for Municipal Securities: A Reevaluation*, 36 BUFF. L. REV. 15, 23 (1987) ("Long-term general obligation bond financing, once the mainstay of municipal financing, is used for funding those public facilities that either do not produce revenues (for example, town halls, police stations[,] etc.), or for which it is considered, as a matter of public policy, inappropriate to levy fees for public use (for example, public schools or parks.").

[96] *See, e.g.*, 15 EUGENE MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS 1045–47 (3d ed. 2005).

[97] Revenues pledged for repayment may be derived from "operation of the financed project, grants or excise or other specified non-ad-valorum taxes." *Certain Types of Municipal Securities*, MUNICIPAL SEC. RULEMAKING BD., http://msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx (last visited Apr. 16, 2014). Some revenue bonds are issued by governmental agencies to fund facilities for essential public services like water and sewer systems. With these types of revenue bonds, the issuer typically pledges revenues obtained through assessments towards repayment. *Id.* Such pledges typically identify the specific assessments that the issuer can use to pay interest and repay principal, the issuer's authority and ability to increase assessments to satisfy payment and repayment obligations, and any other, superior claims on the assessment. *Id.*

[98] Gellis, *supra* note 95, at 22; *accord* ROBERT L. BLAND, A BUDGETING GUIDE FOR LOCAL GOVERNMENT 171 (2d ed. 2007) ("[A] revenue bond

associated with the construction of toll roads, bridges, and community water, sewer, and power systems."[99] Prior to the mid-1970s, most offerings took the form of general obligation bonds with standardized terms.[100] Today, revenue bonds dominate new offerings.[101]

In addition to traditional types of municipal bonds, issuers seeking to access lower interest rates available at the short end of the yield curve have begun to use complex, non-traditional instruments such as variable rate demand obligations ("VRDO"),[102] auction rate

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represents a limited pledge of revenue sources to the repayment of qualifying bonds. Usually, revenue bonds are used to finance a revenue-producing project, such as a public housing complex, public hospital, toll road, water or wastewater facilities and lines, or a parking garage. Only revenues earned from the project can be used to repay the bonds used to build the facility. The government does not pledge its full faith and credit to the repayment of these bonds, although it may subsidize the project with general tax revenues, especially during the development phase. Because of the more limited pledge, voter approval is usually not required, and the bonds incur slightly higher interest rates because of the higher risk of default. However, investor can see a clear link between the use of the debt and the repayment of the bonds, which normally increases their confidence that the government will repay the debt.").

[99] Gellis, *supra* note 95, at 22.

[100] Gellis, *supra* note 31, at 428.

[101] *Statistics: Municipal: US Municipal Issuance*, SIFMA, http://www.sifma.org/research/statistics.aspx (last updated Apr. 1, 2014) (Excel spreadsheet).

[102] For a brief, "plain English" description of VRDOs, see *Understanding Variable Rate Demand Obligations*, MUNI. SEC. RULEMAKING BD., http://emma.msrb.org/educationcenter/UnderstandingVRDOs.aspx (last visited Apr. 16, 2014); *see also* SEC REPORT, *supra* note 91, at 9–10. Generally speaking, VRDOs are municipal securities for which the interest rate resets on a periodic basis, and which permit investors to liquidate their holdings at par through a "put" or "tender" feature. *Id.* at 9. A dealer or remarketing agent is responsible for reselling tendered VRDOs to new investors and ensuring that investors are able to use the "put" or "tender" feature in the event a remarketing agent is unable to locate a new purchaser. *Id.* at 9 n.39. VRDOs typically operate with a liquidity facility (typically a letter of credit or Standby Bond Purchase Agreement). *Id.*; *see also* MOODY'S INVESTORS SERVS., U.S. PUBLIC FINANCE, SPECIAL COMMENT, POTENTIAL RISKS OF VARIABLE RATE DEBT AND INTEREST RATE SWAPS FOR U.S. STATE AND LOCAL GOVERNMENTS ARE HEIGHTENED BY ECONOMIC AND FINANCIAL CRISIS 3 (2009) ("The majority of Moody's rated municipal issuers or variable rate demand obligations use dedicated

securities, and interest rate swaps in their funding plans in recent years.[103] While markets for these types of instruments contracted during the recent economic crisis, complex non-traditional securities (including derivatives) remain very much a part of the current landscape, and even smaller issuers now regularly use these more complicated and potentially volatile products to meet funding needs.[104]

In terms of market structure, the municipal securities market remains less liquid and more opaque than the markets for U.S. Treasury securities, equities, futures, and foreign exchange markets despite increases in size[105] and complexity.[106] There are several

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bank liquidity facilities (either standby bond purchase agreements or letters of credit) to support potential tenders by investors.") (on file with author).

[103] *See* Registration of Municipal Advisors, Exchange Act Release No. 63,576, 100 SEC Docket 4317 (Dec. 20, 2010) ("[T]he municipal securities market has experienced a proliferation of complex derivative products beginning generally with interest rate swap transactions in the mid-1980s."); *see also* Erik Sirri, *Testimony Concerning Credit Default Swaps*, SEC (Nov. 20, 2008), http://sec.gov/news/testimony/2008/ts112008ers.htm.

[104] *See, e.g.*, SIFMA, MUNICIPAL BOND CREDIT REPORT RESEARCH REPORT FOR FOURTH QUARTER 2011, at 3 (2011) ("Issuance of variable-rate demand obligations (VRDOs), long-term municipal bonds with a floating interest rate that resets periodically and a put feature, rose in the fourth quarter. According to Thomson Reuters, $11.4 billion were issued in 4Q'11, more than double the amount from 3Q'11 ($3.5 billion), but a 6.5 percent decline year-over-year ($11.4 billion). While the fourth quarter spike in issuance quarter-over-quarter is typically seasonal (in the last 10 years, fourth-quarter issuance composed on average 30.7 percent of annual issuance, compared to third quarter's 21.5 percent), issuance in the fourth quarter composed nearly 60 percent of issuance in 2011. Despite the jump, only $20.1 billion was issued in aggregate for 2011, a 19.5 percent decline from 2010 and the lowest issuance in 15 years. For 2012, survey participants in the SIFMA Municipal Survey project a continued decline in VRDO issuance to $10 billion.").

[105] As late as 1975, there were approximately $235.4 billion of municipal bonds estimated to be outstanding following an issuance of $58 billion of bonds that year. *See* 14 THE BOND BUYER'S MUNICIPAL FINANCE STATISTICS 5, 19 (1976); *see also* Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 740 (2009) (citing Fireside Chat on Municipal Securities by Michael McCarthy, Professor of Law, Georgetown Univ. with Christopher Taylor, Exec. Dir., Mun. Sec. Rulemaking Bd. & Donald Langevoort, Chairman, Bond Mkt. Found. (Apr. 20, 2004), *available at* http://sechistorical.org/collection/programs/Transcript_2004_0420.pdf).

reasons for this. Unlike the market for publicly-traded corporate equity securities, there is no centralized, organized exchange where municipal securities are listed or traded,[107] nor is there a two-sided quotation or formal market maker system.[108] Instead, trading in the municipal securities market occurs on an over-the-counter basis.[109] Investors who wish to buy or sell municipal securities generally must work through a municipal securities dealer via a broker-assisted transaction, or through the purchase or sale of a municipal bond fund.

The municipal securities market is also characterized by a comparatively large number of issuers and highly disparate offerings[110]—offerings which may be accompanied by companion

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Today, there are approximately $3,743.4 trillion of municipal bonds estimated to be outstanding, following annual issuances in excess of $200 billion for the past fifteen years. *See* SIFMA, *supra* note 101. Statistics reflecting the size of the municipal securities market over time also are available online. *The State of the Municipal Securities Market*, SEC (Dec. 17, 2012), http://sec.gov/spotlight/municipalsecurities.shtml (providing dates and amounts for the municipal securities market). Statistics showing the size are also available in multiple speeches by Members and Staff of the SEC. *See, e.g.*, Elisse B. Walter, Comm'r, SEC, 10th Annual A.A. Sommer, Jr. Corporate, Securities and Financial Law Lecture on Regulation of the Municipal Securities Market: Investors Are Not Second Class Citizens (Oct. 28, 2009), *available at* http://sec.gov/news/speech/2009/spch102809ebw.htm (discussing the history of the municipal securities market, including important dates and the market size).

[106] *E.g.*, Junbo Wang, Chunchi Wu & Frank Zhang, *Liquidity, Default, Taxes and Yields on Municipal Bonds* 4–6 (Fin. & Econ. Discussion Series, Fed. Reserve Bd., Working Paper No. 2005–35, 2005), *available at* http://federalreserve.gov/pubs/feds/2005/200535/200535pap.pdf (discussing comparative lack of liquidity and transparency in municipal bond market and opining that "liquidity risk premium accounts for a significant portion of municipal bond yields").

[107] SEC, REPORT, *supra* note 91, at v, 19–20 ("Those municipal securities that do trade do so in a decentralized over–the–counter dealer market that is illiquid and opaque."); *What Are Bonds?*, MUN. SEC. RULEMAKING BD., http://emma.msrb.org/educationcenter/WhatAreBonds.aspx (last visited Apr. 16, 2014).

[108] *Municipal Bond Turmoil: Impact on Cities, Towns, and States*: *Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 24–30 (2008) (statement by Rep. Barney Frank, Chairman, H. Comm. on Fin. Servs.) [hereinafter *Bond Turmoil Hearings*]; SEC REPORT, *supra* note 91, at v–vi.

[109] SEC REPORT, *supra* note 91, at v–vi.

[110] This has long been the case. *See* U.S. GEN. ACCOUNTING OFFICE,

derivatives transactions as part of larger funding plan (e.g., a bond offering accompanied by a swaps deal, as occurred in Jefferson County, Alabama, or complex pensions-related securities accompanied by interest rate swaps, as occurred in Detroit).[111] There are approximately 60,000 municipal securities issuers in this country.[112] "Approximately 1.3 million different municipal securities are outstanding in the market at any given time."[113] Issuances range from multi-billion dollar financings of large infrastructure projects involving state or local governments, to offerings of less than $100,000 in securities by localities, school districts, fire districts, and other local authorities.[114] Due in part to the large number of highly disparate issues and issuers, the municipal securities market has tended to be more fragmented, and more dependent upon the participation of regional underwriting firms, as compared to markets for other securities.[115]

GAO/PAD-83-46, REPORT TO THE CHAIRMAN, SUBCOMMITTEE ON ECONOMIC STABILIZATION, COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS: TRENDS AND CHANGES IN THE MUNICIPAL BOND MARKET AS THEY RELATE TO FINANCING STATE AND LOCAL PUBLIC INFRASTRUCTURE 2–3 (1983) (explaining a large number of disparate issues and decentralized nature of market, compared to corporate securities market).

[111] *See infra* Part II.E (discussing Jefferson County).

[112] *See* MUN. SEC. RULEMAKING BD., *supra* note 107 ("There are approximately 60,000 different issuers of municipal securities, and many of these issuers may issue different types of securities. This wide array of choices in the municipal market contrasts sharply with the corporate market, where the number of issuers and issues is much smaller."); *see, e.g.*, DEAN MICHAEL MEAD, WHAT YOU SHOULD KNOW ABOUT YOUR LOCAL GOVERNMENT'S FINANCES: A GUIDE TO FINANCIAL STATEMENTS 1 (2d ed. 2011) (describing municipal issuers as approximately 90,000 state and local governments in the United States, including tens of thousands of local governments (counties, cities, towns, villages), school districts, water districts, parks districts, fire districts, and special districts for myriad other purposes); *see also* U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2009, at 1 (2011), *available at* http://www2.census.gov/govs/estimate/09_summary_report.pdf [hereinafter STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2009] (reviewing approximately 90,000 state and local governments).

[113] *Secondary Market Trading*, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works/Secondary-Market-Trading.aspx (last visited Apr. 16, 2014).

[114] *Bond Turmoil Hearings*, *supra* note 108, at 234.

[115] *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-265, REPORT

Finally, as I have argued in earlier work, there are important differences between corporate and municipal securities (and the market for these instruments) having to do with governance.[116] In the private sector, investors can decide if and when to invest in a particular corporation's securities. If an equity investor becomes unhappy, she may be able to express her displeasure in a variety of ways, including: (i) voting against incumbent board members during annual director elections and proposing replacement slates of directors; (ii) making proposals during meetings and/or through the

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TO CONGRESSIONAL COMMITTEES: MUNICIPAL SECURITIES: OVERVIEW OF MARKET STRUCTURE, PRICING AND REGULATION 6–7 (2012) ("The municipal securities market is geographically fragmented, with secondary trading supported by national and regional broker-dealer firms that serve institutional investors (institutional broker-dealers) or individual investors (retail broker-dealers), and in some firms, both. Several national broker-dealer firms have enough capital and geographic presence to underwrite large new issuances nationwide, trade in large volume with institutional investors, and offer expertise in virtually every sector of the market. Some mid-sized broker-dealer firms also have nationwide coverage for institutional and individual investors on a smaller scale. But other broker-dealer firms provide inventory and expertise in well-defined geographic areas, allowing them to serve individual investors–many of whom invest in municipal securities to enjoy state or local income tax benefits–as well as institutional investors who need access to local markets.") (footnote omitted); *see also* Ehsan H. Feroz & Earl R. Wilson, *Market Segmentation and the Association Between Municipal Financial Disclosure and Net Interest Costs*, 67 ACCT. REV. 480, 481–82 (1992) (referencing geographic segmentation of primary markets for municipal bonds). Scholars have noted that information asymmetries may be greater in the municipal securities market due to the number of issuers, the regional nature of the market, the prevalence of first time offerings and smaller issuers who are not well-known to investors, the large role played by individual investors, and the relative lack of disclosure compared to corporate securities offerings and transactions. *See, e.g.*, Jun Peng & Peter F. Brucato, Jr., *An Empirical Analysis of Market and Institutional Mechanisms for Alleviating Information Asymmetry in the Municipal Bond Market*, 28 J. ECON. & FIN. 226, 226 (2004).

[116] MEAD, *supra* note 112, at 2; Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 569–72 (2011) (examining limits of private ordering on risk shifting in derivatives markets). *See generally* Jerold L. Zimmerman, *The Municipal Accounting Maze: An Analysis of Political Incentives*, 15 J. ACCT. RES. 107 (1977) (examining the differences between corporate and municipal markets and governance structures).

proxy system; and (iii) voting against major transactions proposed by incumbent boards and management when a shareholder vote is required or sought. Corporate security-holders may also use exit discipline—i.e., selling ones securities—to express disapproval. Of course, there are variations in voting rights across security-types and across corporations. Moreover, not every corporate security (debt or equity) is liquid or freely transferrable. That said, since shareholder losses are generally limited to the amount of the shareholder's investment, shareholder losses are capped even if the shareholder is unsuccessful in convincing the company to change course and even if there are transaction costs associated with exit discipline.

With municipal securities, voter/taxpayers take the place of shareholders, and municipal officers take the place of corporate officers and directors. Once a taxpayer "buys in" to the municipal enterprise through the purchase of residential real estate or the use of municipal services, her choices are limited.[117] She must pay government levies whether or not she agrees with a particular expenditure. She may vote against bond offerings—if the offering is subject to a vote—but her point of view may not prevail, and opportunities to challenge issuances through litigation are limited.[118] If she wishes to unseat government officials responsible for particular offerings, she may have to wait until the next election (assuming the local officials behind the offering are elected) or pressure government officials to terminate appointed personnel.[119]

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[117] *See, e.g.*, Mead, *supra* note 112, at 2; Gellis, *supra* note 95, at 59–63 (comparing citizens in municipalities and shareholders in corporations as well as to consumers of a firm's products); Zimmerman, *supra* note 116, at 114 (discussing the limited control of corporations and of municipalities).

[118] According to Amdursky and Gillette, "[i]n recent years, courts and legislatures have restricted the ability of taxpayers to contest the issuance of [municipal] bonds." AMDURDSKY ET AL., *supra* note 89, § 2.7.4. As Amdursky and Gillette explain, judicial review may be limited to specific issues, such as "(1) the regularity of the proceedings at which the bonds are issued; (2) the validity of the bonds; and (3) the legality of the purpose for which the bonds are issued." *Id.*; *accord* City of Lubbock v. Isom, 615 S.W.2d 171, 172 (Tex. 1981) (holding challengers of city bond issues were barred from suing under Texas statute which provided that judicial decree validating bonds constituted permanent injunction against any action or proceeding contesting validity of bonds if no appeal taken in statutorily proscribed time frame).

[119] As Professor Gellis points out, using the New York City bond crisis as an example, politicians may be incented to focus on the potential for short-

She also may have to deal with government structures that entrench existing managers and make it difficult for taxpayers to alter the composition of decision-making bodies.[120] If the taxpayer is not happy with this state of affairs, she may be left with having to sell her real estate and move out of town.[121] This is likely to involve significant transaction costs, especially when real estate markets are in turmoil.

2. Risks Associated with Borrowing Via Public Market

Although I focus on risks associated with non-traditional instruments in this article, it is worth noting that even "plain vanilla" general obligation and revenue bonds create risks for municipalities

term gains rather than the possibility of long-term costs or losses. Gellis, *supra* note 95, at 45–59. This can lead to sub-optimal decision-making on issues relating to municipal finance. *Id.*

[120] There is empirical research suggesting that certain governance structures may impact the likelihood and impact of restatements by municipal securities issuers. Professor Baber and his co-authors investigated the role of voter oversight in connection with accounting restatements in the municipal context and found that

> [t]he results indicate that municipal debt costs increase following financial restatement disclosure. Additional analysis indicates that municipalities reduce the use of debt financing and are more likely to issue secured than unsecured debt following a financial restatement. Moreover, the *Post-restatement* increase in municipal debt financing costs is more substantial when municipal governance is poor. In particular, debt cost increases are greater when audit oversight is low and when municipal managers are entrenched—that is, when the ability of voters to alter the composition of the city council or to intervene directly in the municipal decision-making process is restricted.

William R. Baber, Angela K. Gore, Kevin T. Rich & Jean X. Zhang, *Accounting Restatements, Governance and Municipal Debt Financing*, 56 J. ACCT. & ECON. 212, 226 (2013).

[121] *See, e.g.*, Mead, *supra* note 112, at 2; Gellis, *supra* note 95, at 59–61 ("The citizen has only one vote which cannot be traded except by moving from one community to another.").

and taxpayers, especially during times of economic stress.[122] When governments issue general obligation and revenue bonds, they pledge their taxing power and dedicated revenue streams, respectively, as security for repayment.[123] If taxes or revenue streams run short, the issuer may have to increase taxes and/or cut spending to meet repayment obligations.[124] Since taxpayers must pay government levies and depend upon public infrastructure and services, tax

[122] Floyd Norris, *A Portent of Peril for Muni Bondholders*, N.Y. TIMES, June 3, 2013, at B1 ("The [Jefferson County] disaster provides an example of how derivative securities can be oversold. Not all risks can be hedged, and certainly not at acceptable costs.").

[123] For general obligation bonds, the notion that issuers must exercise taxing power as necessary to repay obligations is expressed in cases like *Flushing National Bank v. Municipal Assistance Corp. for New York*, where the New York Court of Appeals observed that a city "may not contract indebtedness [under the New York State Constitution] unless it has pledged its faith and credit for the payment of the principal thereof and the interest thereon," an obligation the court described as both "a commitment to pay and a commitment of the city's revenue generating powers to produce the funds to pay." 358 N.E.2d 848, 851 (N.Y. 1976) (citing N.Y. CONST. art. VIII, § 2 and holding that faith and credit pledge is a prior lien on revenues of issuer). According to the *Flushing National Bank* court, the faith and credit requirement, together with a number of other statutory provisions, "express[es] a constitutional imperative: debt obligations must be paid, even if tax limits be exceeded." *Id.* at 852. With its holding, the court distinguished the faith and credit obligation reflected in general obligation bonds with a revenue obligation ("which is limited to a pledge of revenues from a designated source or fund") and a "'moral' obligation, which is backed not by a legally enforceable promise to pay but only by a 'moral' commitment." *Id.* at 851–52. But *Flushing* is a complicated case because while the Court declared the moratorium statute at issue unconstitutional, it nevertheless sought to facilitate a political/legislative solution. *Id.* at 855. Furthermore, the year after *Flushing* was decided, the Court of Appeals modified its views somewhat in *Quirk v. Mun. Assistance Corp. for New York*, holding that only real property taxes are subject to the prior lien of first revenue. 363 N.E.2d 549, 550–51 (N.Y. 1977) ("On the other hand, with respect to the traditional real estate tax levies, the bondholders are constitutionally protected against an attempt by the State to deprive the city of those revenues to meet its obligations.").

[124] Chung, *supra* note 33, at 1462 ("[B]ecause issuers are legally obligated to use their taxing power or dedicated revenue streams to repay investors, issuers may be forced to increase taxes and cut spending on critical infrastructure and services to meet repayment obligations.").

increases, spending cuts, and municipal insolvency can have a devastating impact on finances and community life.

For example, Harrisburg, Pennsylvania was forced into receivership after taking on $300 million in debt—reportedly more than five times the City's annual budget—to renovate and expand trash facilities.[125] In announcing the City's intention to miss payments due on general obligation bonds issued for the trash project, Harrisburg's receiver explained that his "first priority as receiver is to ensure that vital and necessary services such as police and fire are maintained" within Harrisburg during the state of fiscal emergency.[126] The receiver explained that Harrisburg would not make a payment due on the bonds "to ensure sufficient cash flow so the citizens of Harrisburg continue to receive essential services," reflecting the competition for municipal resources that can arise when a municipality experiences financial distress.[127] Similarly, Jefferson County, Alabama reported punishing cuts to public services following its default on bonds issued to pay for water and sewer services and subsequent bankruptcy.[128] Service cuts can be particularly painful and politically difficult in distressed cities like Detroit that are already struggling to meet basic public infrastructure and health and safety needs.[129]

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[125] Romy Varghese, *Harrisburg, Pennsylvania, Plans Default on Bond Payments*, BLOOMBERG BUSINESSWEEK (Mar. 9, 2012), http://www.businessweek.com/news/2012-03-09/harrisburg-pennsylvania-set-to-default-on-5-dot-27-million-go-bond-payments (explaining that Harrisburg, Pennsylvania was placed into receivership in December 2011, with the receiver recently announcing that the city would have to skip $5.27 million in bond payments due on general obligation bonds to meet basic public service needs).

[126] *See id.*

[127] *Id.*

[128] Mary Williams Walsh, *When a County Runs off the Cliff*, N.Y. TIMES, Feb. 19, 2012, at BU1 (discussing public services in Jefferson County, Alabama gutted after the county declared bankruptcy in 2011 in the wake of a corruption scandal tied to more than $1 billion in municipal bond debt and related interest rate swaps).

[129] Orr Declaration, *supra* note 1, at 21–33; Roger Lowenstein, *Broke Town, U.S.A.*, N.Y. TIMES, Mar. 6, 2011 (Magazine), at 26; White, *supra* note 84 (discussing tax increases and reductions in public services in Vallejo, California after the city declared bankruptcy in 2008 in the face of declining revenues, soaring costs and municipal bond-related obligations).

D. The Recession Has Intensified Budgetary Pressures

If the obligation to spend on infrastructure and services can challenge state and local governments even in the best of times, the recent recession has only intensified budget pressures. According to Census Bureau data, for the years 2007 to 2008, 2008 to 2009, 2009 to 2010, and 2010 to 2011, local governments' cost of providing infrastructure and services increased without corresponding gains in own-source (e.g., taxes) revenue.[130] In 2009, for example, state and local government revenues declined 22.1% compared to the prior year (due principally to a decline in insurance trust revenue) with revenue from own sources declining 3.5%.[131] During the same period, expenditures increased 4.6%, indebtedness increased 5.1%, and local governments accounted for 61% of the outstanding state and local debt.[132] In 2010, although overall revenues increased (due principally to an increase in insurance trust revenue), state and local government revenue from owned sources declined 0.5% compared to 2009.[133] In addition, expenditures and indebtedness increased by 4.0% and 4.6%, respectively, with local governments accounting for 60.7% of the total outstanding state and local government debt.[134] Although state and government owned source revenues increased by

[130] BARNETT & VIDAL 2011 SUMMARY, *supra* note 34, at 6–11; JEFFERY L. BARNETT & PHILLIP M. VIDAL, U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2011, at 6–11 (Reissued 2013), *available at* http://www2.census.gov/govs/local/10_summaryreport.pdf [hereinafter BARNETT & VIDAL 2010 SUMMARY]; JEFFREY L. BARNETT, U.S. CENSUS BUREAU, STATE AND LOCAL GOVERNMENT FINANCES SUMMARY: 2009, at 6–11 (2011), *available at* http://www2.census.gov/govs/local/09_summary_report.pdf [hereinafter BARNETT 2009 SUMMARY]; U.S. CENSUS BUREAU, HISTORICAL DATA: 2008 STATE & LOCAL GOVERNMENT: U.S. SUMMARY & ALABAMA—MISSISSIPPI, *available at* http://www.census.gov//govs/local/historical_data_2008.html [hereinafter 2008 STATE & LOCAL GOVERNMENT FINANCES]; U.S. CENSUS BUREAU, HISTORICAL DATA: 2007 STATE & LOCAL GOVERNMENT: U.S. SUMMARY & ALABAMA—MISSISSIPPI, *available at* http://www.census.gov//govs/local/historical_data_2007.html [hereinafter 2007 STATE & LOCAL GOVERNMENT FINANCES].
[131] BARNETT 2009 SUMMARY, *supra* note 130, at 2.
[132] *Id.*
[133] BARNETT & VIDAL 2010 SUMMARY, *supra* note 130, at 2.
[134] *Id.*

4.6% in 2011 compared to 2010, expenditures also increased (up 1.5% percent over 2010), as did indebtedness (up 2.3%, with local governments accounting for 61% of the total outstanding state and local government debt).[135] Moreover, the GAO has tracked declines in tax receipts associated with the recent recession and opined that, unless there are policy changes, state and local governments will face a continued gap between revenues and expenditures, with potentially long-term negative consequences for state and local government fiscal health.[136]

E. Mismanagement and Political Corruption Take Their Toll

Along with the recession, mismanagement and political corruption can take their toll on state and local government budgets as well. In addition to Detroit, where former mayor Kwame M. Kilpatrick's conviction on dozens of counts racketeering and extortion charges likely did not help the City,[137] consider Jefferson County, Alabama. On April 30, 2008, the Securities and Exchange Commission ("SEC" or "Commission") charged Larry Langford (the then-mayor of Birmingham, Alabama and former president of the Jefferson County Commission) and certain industry professionals with securities fraud in connection with an alleged kick-back scheme involving the county's efforts to finance improvements to its water and sewer systems, as required by environmental laws.[138] Langford was also charged in a parallel criminal case for allegedly sending more than $7 million in county bond business to an investment banker in return for bribes worth $241,843.[139] The SEC also brought

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[135] BARNETT & VIDAL 2011 SUMMARY, *supra* note 34, at 2.

[136] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-546SP, STATE AND LOCAL GOVERNMENTS' FISCAL OUTLOOK 1–2 (2013), *available at* http://www.gao.gov/assets/660/654255.pdf.

[137] Indictment, United States v. Kilpatrick, No. 2:10-CR-20403 (E.D. Mich. Dec. 15, 2010); Steve Yaccino, *Ex-Mayor Sentenced to 28 Years in Corruption Case that Helped Detroit Go Broke*, N.Y. TIMES, Oct. 11, 2013, at A12.

[138] Complaint at 1, 8, SEC v. Langford, No. CV-08-B-0761-S (N.D. Ala. 2011).

[139] Indictment, United States v. Langford, Case No. 2:08-CR-0025-LSC-PWG (N.D. Ala. Nov. 25, 2008). On October 28, 2009, Langford was found guilty in a parallel criminal case on sixty-one counts of bribery, mail fraud, wire fraud, and tax evasion. *See* United States v. Langford, 647 F.3d 1309,

related cases against J.P. Morgan Securities Inc. and two of its former managing directors in connection with the alleged scheme.[140]

According to the government, J.P. Morgan made more than $8 million in undisclosed payments to local broker-dealers with ties to the local officials in connection with $5 billion in county sewer bond offerings and associated interest rate swap agreements.[141] The alleged purpose of these payments was to obtain bond business for J.P. Morgan's broker-dealer and swaps business for its affiliated bank.[142] The Commission alleged that as a result of these payments, county commissioners voted to select J.P. Morgan Securities as managing underwriter of the county's bond offerings and the firm's commercial bank affiliate as swap provider.[143] The Commission alleged that J.P. Morgan did not disclose any of the payments or conflicts of interest in the swap confirmation agreements or bond offerings, and yet passed the cost of the unlawful payments on to the county (and its citizens) by charging higher interest rates on the swap transactions.[144] According to Commission staff, "[t]his self-serving strategy of paying hefty secret fees to local firms with ties to county commissioners assured J.P. Morgan Securities the largest municipal

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1314, 1319 (11th Cir. 2011), *cert. denied*, 132 S. Ct. 1121 (2012) (No. 11-7762); *see also* Press Release, Dep't of Justice, Appeals Court Upholds Former Birmingham Mayor and Jefferson County Commission President's Conviction (Aug. 5, 2011), *available at* http://www.justice.gov/usao/aln/News/August%202011/August%205,%202011%20County%20Commission.htm.

[140] Complaint at 1, SEC v. LeCroy, No. 2:09-CV-02238 (N.D. Ala. 2009), *available at* http://www.sec.gov/litigation/complaints/2009/comp21280.pdf [hereinafter LeCroy Complaint]; In the Matter of J.P. Morgan Securities Inc., Exchange Act Release No. 60,928, 97 SEC Docket 139 (Nov. 4, 2009). According to the Commission, LeCroy and MacFaddin allegedly referred to the payments as "payoffs," "giving away free money," and "the price of doing business." LeCroy Complaint, *supra*, at 2. LeCroy also allegedly boasted to MacFaddin "in a taped telephone conversation about his efforts to persuade the two commissioners to select J.P. Morgan Securities for the deal," beating out a rival firm. *Id.* at 11. LeCroy allegedly told MacFaddin that he said to the commissioners, "[w]hatever you want—if that's what you need, that's what you get—just tell us how much." *Id.*

[141] *See* Lecroy Complaint, *supra* note 140, at 1–2.

[142] *Id.* at 2.

[143] *Id.* at 2–3.

[144] *Id.*

auction rate securities and swap agreement transactions in its history."[145]

Due to the way Jefferson County's offerings and swaps transactions were structured, the annual payment on Jefferson County's debt jumped from $53 million to $636 million between 2008 and 2009.[146] As debt obligations grew, and the county's finances worsened,[147] sewer taxes skyrocketed and public services were stripped to the bone.[148] Although the governor of Alabama reportedly tried to negotiate a deal which would have replaced the county's existing debt with new securities with a lower face value and more favorable terms in exchange for a commitment by the state to step in if the county failed to stay current, negotiations ultimately broke down.[149] Participants in the municipal bond market reportedly concluded that the new bonds would not be secure enough to attract buyers at an affordable rate of interest because potential buyers remained concerned that the plan did not give the county enough power to raise sewer rates if revenues were not sufficient to repay bondholders.[150] On November 9, 2011, Jefferson County's commissioners voted four to one to declare bankruptcy on

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[145] Press Release, SEC, J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme (Nov. 4, 2009), *available at* http://www.sec.gov/news/press/2009/2009-232.htm [hereinafter SEC Press Release].

[146] On March 3, 2009, certain of the County's interest rate swap agreements were terminated. On March 6, 2009, J.P. Morgan Securities' affiliated commercial bank notified the County that it owed $647,804,118.00 as the result of the termination of the Swap Agreements. According to Jefferson County's official budget for 2008–2009, budgeted revenues were $289 million. *See* JEFFERSON CNTY. COMM'N, RESOLUTION ADOPTING THE BUDGET FOR OPERATIONS DURING FISCAL YEAR 2008–09, at 15, *available at* http://ftpcontent.worldnow.com/wbrc/docs/2008-2009Jeffcobudget.pdf.

[147] Early in 2008, ratings agencies downgraded the County's sewer bond insurers, and shortly thereafter, also downgraded the County's approximately $3.2 billion of sewer bonds. Shelly Sigo, *Jefferson County, Ala., Takes Sewer Rating Hit*, BOND BUYER, Feb. 26, 2008, at 1. In February 2008, the auction market for the County's auction-rate sewer bonds failed. *See* JEFFERSON CNTY, ALA., SEWER REVENUE WARRANTS: MATERIAL EVENT NOTICE 7 (Feb. 27, 2008).

[148] *See, e.g.*, *Bond Turmoil Hearings*, *supra* note 108, at 4; Matt Taibbi, *Looting Main Street*, ROLLING STONE (Mar. 31, 2010, 8:15 AM), http://rollingstone.com/politics/news/looting-main-street-20100331.

[149] Walsh, *supra* note 128.

[150] *See id.*

approximately $4 billion of sewer debt.[151] While there was some effort to obtain relief for county residents through the settlement with J.P. Morgan, county residents have suffered lasting harm.[152] The county's sewers still do not function properly, county services are operating at skeleton crew levels, and the debt has not gone away.[153] As one county resident reportedly said, "[e]veryone wonders how the county will ever get out of this financial mess."[154]

F. Constraints on Debt Relief

Finally, in addition to resource constraints, limits on expense reduction and debt relief also can make it difficult for state and local governments to overcome financial distress. First, political realities can limit access to debt relief. For example, states may intervene to prevent or prohibit a local government from filing for bankruptcy, and thus obtaining debt relief, either because the state is concerned about the stigma associated with a bankruptcy filing, or because it fears contagion.[155] As Massachusetts Representative Barney Frank explained in 2008 during Congressional hearings on turmoil in the municipal bond market:

> No State, no State legislators, no governor, can allow any one of its municipalities to default because

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[151] *See* Mary Williams Walsh, *Alabama Governor Fails to Prevent County's Record $4 Billion Bankruptcy Filing,* N.Y. TIMES, Nov. 10, 2011, at A16.

[152] J.P. Morgan "agreed to settle the SEC's charges without admitting or denying the allegations by paying $50 million to the County for the purpose of assisting displaced county employees, residents, and sewer rate payers, forfeiting more than $647 million in termination fees allegedly owed under the swap transactions" (an amount that is almost three times the budgeted revenues for Jefferson County in the 2008–2009 budget year), "and paying a $25 million penalty . . . ." SEC Press Release, *supra* note 145.

[153] Walsh, *supra* note 128. New Jersey also has faced considerable turmoil in its efforts to deal with the fiscal problems exposed by the case against it. *See, e.g.*, *State Budgets: The Day of Reckoning*, CBSNEWS (DEC. 19, 2010), http://cbsnews.com/8301-18560_162-7166220.html.

[154] Walsh, *supra* note 128.

[155] PEW CHARITABLE TRUSTS, THE STATE ROLE IN LOCAL GOVERNMENT FINANCIAL DISTRESS 14–16 (2013), *available at* http://pewstates.org/uploadedFiles/PCS_Assets/2013/Pew_State_Role_in_Local_Government_Financial_Distress.pdf.

> then every other municipality would pay through the nose. So that is why this is not just some charity here; this is self-defense.
> The particular municipality, you might pity the municipal workers there. Services may get cut back. Maybe the trash won't get picked up. But we can guarantee you, we have all been there, you can't do that [default]. Because if any one municipality falters, every municipality in that State would pay, and there isn't a State governor and legislature in the country who doesn't understand that, and that's why the State guarantee is such a good one.[156]

Similarly, as the SEC observed in one of its reports on the municipal securities market, bankruptcy generally is a last resort for distressed municipalities:

> The low number of bankruptcies in the municipal sector can be attributed to several factors, both legal and practical, including: the negative effects of a bankruptcy filing on the credit ratings not only of the municipalities themselves, but also the states in which they are located, which means that bankruptcy is often used only as a last resort; the public nature of bankruptcy; state restrictions against filing under Chapter 9; and the negative effects on access to future capital markets, which motivates financially distressed municipalities to rely on mechanisms other than Chapter 9 (including state refinancing authorities, receiverships, and commissions) to restructure debt.[157]

Concerns about stigma and contagion—or at least the perception of stigma and contagion—appear to have played a role in cases of municipal financial distress. In Vallejo, California, the City reportedly was not able to access public debt markets for three years during its bankruptcy for money to maintain its streets or replace its

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[156] *Bond Turmoil Hearings*, *supra* note 108, at 25.
[157] SEC REPORT, *supra* note 91, at 24–25 (footnote omitted).

aging police cars and fire trucks.[158] After the City made extensive cuts to its police and firefighter forces, crime rates rose, as did response times to fire and medical emergencies.[159] Declines in quality of life caused Vallejo to lose population even as cities in the area gained residents.[160] Similarly, in the wake of Detroit's bankruptcy filing, other Michigan municipalities reportedly were forced to delay planned offerings.[161]

1. Municipal Bankruptcy Can Be Complicated, and There Are Few "Happy Endings"

Legal limits and constraints on municipal bankruptcy also may constrain state and local governments' ability to obtain meaningful debt relief. As constitutionally recognized sovereigns, states are not eligible for Chapter 9 relief, and they can neither declare nor be forced into bankruptcy.[162] As a result, while a state's

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[158] Brian Chappatta, *Vallejo Water-Bond Deal to Be City's First Since 2008 Bankruptcy*, BLOOMBERG (Oct. 22, 2013, 1:47 PM), http://bloomberg.com/news/2013-10-22/vallejo-water-bond-deal-to-be-city-s-first-since-2008-bankruptcy.html; Tonya Chin, *Vallejo to Sell First Post-Bankruptcy Bonds*, BOND BUYER, Oct. 25, 2013, at 1.

[159] Melanie Hicken, *Once Bankrupt, Vallejo Still Can't Afford its Pricey Pensions*, CNNMONEY (Mar. 10, 2014, 10:44 AM), http://money.cnn.com/2014/03/10/pf/vallejo-pensions/.

[160] *Id*.

[161] Emily Freeman, *Kellogg Home Is Second Michigan Issuer to Delay Bond Sale*, BLOOMBERG BUSINESSWEEK (Aug. 6, 2013), http://businessweek.com/news/2013-08-06/kellogg-hometown-becomes-second-michigan-muni-to-delay-bond-sale; John Gallagher, *Saginaw Is Third Michigan Community in a Week to Withdraw Bond Sale*, DETROIT FREE PRESS (Aug. 8, 2013, 5:45 PM), http://freep.com/article/20130808/BUSINESS06/308080135/Detroit-Saginaw-municipal-bonds-bankruptcy.

[162] *See* United States v. Bekins, 304 U.S. 27, 54 (1938); 11 U.S.C. § 109 (2012) (providing that states are not among the list of entities permitted to seek bankruptcy protection); *id.* § 903 (stating that Chapter 9, "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of the municipality, including expenditures for such exercise," with two exceptions: a state law prescribing a method of composition of municipal debt does not bind any non-consenting creditor, nor does any judgment entered under such state law bind a non-consenting creditor); *id.* § 904 (limiting power of bankruptcy court to "interfere with

fiscal status may be reflected in deal terms required to gain access to public markets, states cannot use the mechanism of bankruptcy to reorganize or obtain discharge from municipal bond debt, with the result that investor risk of loss on state-issued instruments has remained low.[163]

While non-state issuers may be able to seek bankruptcy protection under Chapter 9 of the Bankruptcy Code, there are eligibility requirements,[164] involuntary bankruptcies are not

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(1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property" unless the debtor consents or the plan so provides).

[163] While there are reports that policymakers are considering whether to let states declare bankruptcy as a means of dealing with crushing debt burdens, see Mary Williams Walsh, *A Path Is Sought for States to Escape Their Debt Burdens*, N.Y. TIMES, Jan. 21, 2011, at A1, that has not happened to date.

[164] To be eligible for Chapter 9, an entity must meet the five criteria listed in section 109(c). *See* 11 U.S.C. § 109(c). Specifically, the entity must (i) be a municipality, as defined by the code; (ii) be "specifically authorized" to be a bankruptcy debtor; (iii) be "insolvent" as defined by section 101(32)(C); (iv) genuinely "desire[] to effect a plan to adjust [its] debts" that exist as of the commencement of the case; and (v) satisfy one of the four alternative statutory requirements for negotiating with its creditors before filing its petition. *Id.* The debtor bears the burden of establishing that it meets each of these statutory requirements. *See, e.g.*, *In re* Cnty. of Orange, Cali., 183 B.R. 594, 599 (Bankr. C.D. Cal. 1995). With respect to the "specifically authorized" criteria, twelve states specifically authorize municipal bankruptcy petitions, assuming the filing municipality meets certain conditions, and another twelve authorize a filing upon a further act of the state, an elected official or other issue. *See* ALA. CODE § 11-81-3 (2014); ARIZ. REV. STAT. ANN. § 35-603 (2013); ARK. CODE ANN. § 14-74-103 (West 2014); CAL. GOV'T CODE § 53760 (West 2014); CONN. GEN. STAT. § 7-566 (2013); FLA. STAT. ANN. § 218.01 (West 2014); IDAHO CODE ANN. § 67-3903 (West 2014); KY. REV. STAT. ANN. § 66.400 (West 2013); LA. REV. STAT. ANN. § 39-619 (2013); MICH. COMP. LAWS § 141.1558 (West 2013); MINN. STAT. § 471.831 (2014); MO. REV. STAT. § 427.100 (2014); MONT. CODE ANN. § 7-7-132 (2013); NEB. REV. STAT. § 13-402 (West 2013); N.J. STAT. ANN. § 52:27-40 (West 2013); N.Y. LOCAL FIN. LAW § 85.80 (McKinney 2014); N.C. GEN. STAT. ANN. § 23-48 (West 2013); OHIO REV. CODE ANN. § 133.36 (West 2014); OKLA. STAT. ANN. tit. 62, §§ 283, 285 (West 2014); 53 PA. STAT. ANN. § 11701.261 (West 2013); R.I. GEN. LAWS ANN. § 45-9-1 (West 2013); S.C. CODE ANN. § 6-1-10 (2013); TEX. LOC. GOV'T CODE § 140.00 (West 2013); WASH. REV. CODE § 39.64.040 (2014). Three states have enacted statutes providing limited

permitted,[165] liquidation is not an option, and the issuer's powers to operate (and thus make payments on debt) may not be affected.[166] For example, because section 928 of the Bankruptcy Code provides that special revenues obtained by a municipal debtor after a bankruptcy filing are subject to liens granted prior to the filing,[167] eligible "revenue bondholders are entitled to receive the revenues pledged to them without any interference and on a timely basis."[168] General obligation bondholders also may continue to receive payment following a Chapter 9 filing if the state statute authorizing the issuance contained a statutory lien.[169] The Bankruptcy Code also provides that payments received by holders of municipal bond or note obligations within ninety days of a commencement of a municipal bankruptcy petition are not preferences subject to claw-back.[170] As a result of provisions like these, issuers may remain obligated despite seeking bankruptcy protection, and bondholders may not incur losses even if an issuer is able to file for bankruptcy.[171]

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authorization for specific municipal issuers/debtors. *See, e.g.*, COLO. REV. STAT. ANN. § 37-32-102 (West 2014) (Colorado, drainage and irrigation districts); 20 ILL. COMP. STAT. ANN. 320/9(b)(4) (West 2013) (Illinois, power); OR. REV. STAT. § 548.705 (West 2014) (Oregon, drainage and irrigation districts); 20 Ill Comp. Stat. Ann. 3855/1-20(b) (15).

165 *See* 11 U.S.C. §§ 301, 904 (2012).

166 For example, despite the automatic stay provision of the Bankruptcy Code, section 922(d) allows municipalities to continue paying pledged special revenue, or revenue bonds without obtaining the court's permission or notifying other creditors. *See id.* § 922(d). By comparison, corporate reorganizations occur in the content of the potential liquidation of the debtor. *See id.* § 1123(a).

167 11 U.S.C. § 928.

168 JAMES E. SPIOTTO, ANN E. ACKER & LAURA E. APPLEBY, MUNICIPALITIES IN DISTRESS? HOW STATES AND INVESTORS DEAL WITH LOCAL GOVERNMENT FINANCIAL EMERGENCIES 54–56 (1st ed. 2012) (discussing the legislative history of this provision).

169 *Id.* at 58. As Spiotto and his co-authors point out, this approach was used in the Orange County bankruptcy case, where the court held that the lien securing tax and revenue anticipate notes arising under state law was a statutory lien that survived the County's Chapter 9 petition. *Id.* (citing *In re* Cnty. of Orange, Cali., 189 B.R. 499, 502 (C.D. Cal. 1995)). According to Spiotto, "[a]t least thirty-two states recognize some form of a statutory lien in relation to their bond obligations." *Id.*

170 11 U.S.C. § 926.

171 Some thirty states have laws in place that give holders of general obligations bonds and certain other securities issued by municipalities rights

These legal constraints in part explain why municipal bankruptcies tend to be complicated and relatively rare.[172]

In any event, even when bankruptcy is available, there are few "happy endings," at least for residents and public workers. In Vallejo, California, for example, the City's finances have remained challenging post-bankruptcy, and budget cuts have led to declines in public safety and the loss of population when compared to other nearby communities.[173] Similarly, in Jefferson County, Alabama, public services reportedly were "gutted" in the wake of the county's default and bankruptcy, and county officials say there is little, if any money, to put towards economic growth.[174] In Central Falls, Rhode Island—often cited as a model of efficiency in municipal bankruptcy due to changes in state law which facilitated repayment to bondholders—citizens and public workers have dealt with higher taxes and cuts in pension benefits in the wake of the City's filing and adjustment of its debts.[175] And, as discussed below, the extensive

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of first payment from certain revenue streams even during bankruptcy. *See, e.g.*, SPIOTTO ET AL., *supra* note 168, at 54–55. For a general discussion of municipal insolvency, see Alexander M. Laughlin, *Municipal Insolvencies: An Article on the Treatment of Municipalities Under Chapter 9 of the U.S. Bankruptcy Code*, 26 MUN. FIN. J., no. 2, Summer 2005, at 37, 44.

[172] While 177 municipalities filed for bankruptcy protection from 1991 through 2009, some 49,000 businesses filed for bankruptcy protection during the twelve-month period from March 2008 to March 2009. *See* SIFMA, *supra* note 90, at 174–75; *Bankruptcy Filings Highest Since 2006*, U.S. COURTS (May 14, 2010), http://uscourts.gov/News/NewsView/10-05-14/Bankruptcy_Filings_Highest_Since_2006.aspx. Spiotto and his co-authors also make the point that of the 262 municipal bankruptcy filings made between 1980 and January 11, 2012, "only five [of the filers] have been municipal debt issuers of any significance"—i.e., Orange County, California, City of Bridgeport, Connecticut, City of Vallejo, California, Harrisburg, Pennsylvania, and Jefferson County, Alabama. SPIOTTO ET AL., *supra* note 168, at 50.

[173] Hicken, *supra* note 159.

[174] Michael Connor & Tiziana Barghini, *Analysis: History Offers Few Happy Endings for Detroit to Follow*, REUTERS (July 25, 2013), http://reuters.com/article/idUSBRE96O02R20130725?irpc=932 ("'We have no money for economic growth,' said David Carrington, president of the Jefferson County Commission . . . .").

[175] *E.g.*, Jess Bidgood, *Plan to End Bankruptcy in Rhode Island City Gains Approval*, N.Y. TIMES, Sept. 7, 2012, at A21 (reporting that bondholders were paid through tax increases and deep cuts to pensions and other employee benefits). Notably, in 2011, the Rhode Island State General

litigation in the Detroit bankruptcy reflects just how complicated, wrenching, and expensive debates over debt adjustment can be for insolvent municipalities and their residents.

III. The Role of Public Employee Contracts, Pensions, and OPEB in Municipal Fiscal Distress

A. The Costs of Public Sector Employment

Against this backdrop of mandatory spending, resource constraints, and limits on expense reduction and debt relief, costs associated with public sector employment are an important part of the financial puzzle. There are at least two reasons for this. First, salary, pension benefits, and OPEB obligations are a significant line item in government budgets—local government expenditures on salary and wages and retirement for public workers (notably, not including healthcare costs) constituted approximately 38%, 37.8%, 38.2%, and 38.3%, respectively, during the period from 2008 to 2011.[176] Second, as discussed below, obligations associated with salary, pension benefits, and OPEB are difficult, if not impossible, to modify outside of bankruptcy, with the result that liabilities can linger and grow, especially during times of financial distress.

Assembly enacted a law giving bondholders the right to place liens on tax revenue, which has the effect of ensuring that bondholders will receive payment before other creditors following a municipal bankruptcy. *Id.*

[176] For example, according to the Census Bureau's 2011 Annual Survey of the States, local governments reported total expenditures of $1,664,493,675 and expenditures of $596,050,731 for salary and wages, suggesting that salary and wages represented more than 35% of local government spending during this period. BARNETT & VIDAL 2011 SUMMARY, *supra* note 34, at 7. The Census Bureau further reports that local governments spend $40,428,386 on employee retirement. *Id.* at 8. Taken together, expenditures on salary, wages, and employee retirement constituted more than 38% of total expenditures during 2011. *Id.* at 6–11. Performing this calculation for the years 2008 to 2010 yields the percentages reported above. BARNETT & VIDAL 2010 SUMMARY, *supra* note 130, at 6–11; BARNETT 2009 SUMMARY, *supra* note 130, at 6–11; HISTORICAL 2008 DATA, *supra* note 130; *see also* Elizabeth McNichol, *Some Basic Facts on State and Local Government Workers*, CTR. ON BUDGET & POLICY PRIORITIES 3 (June 15, 2012), http://cbpp.org/cms/?fa=view&id=3410 (stating wages and salaries due to public workers account for more than 40% of local government spending according to some estimates, and if one includes spending on benefits such as health insurance and retirement, the figure rises to over 50%).

Before discussing costs associated with public employment and constraints on the adjustment of associated obligations, it is important to acknowledge that the cost—and numerous benefits—of a public sector work force raise intensely political questions. Some commentators have opined that growth in personnel and/or costs at local government units, together with political pressures surrounding the negotiation of public sector employment contracts, has led to cost increases and budgetary strain at the local government level.[177] San Bernadino, California's 2012 bankruptcy filing tells such a story. San Bernadino sought Chapter 9 bankruptcy protection after declining home prices, falling tax revenues, and increasing expenses rendered the City insolvent.[178] In finding the City an eligible debtor, the bankruptcy court commented that that "City employee salaries and benefits, as in most municipalities, make up 75% of the City's budget and, as the need for services grew in the [pre-recession] boom, so did the number of City employees and consequent expenses."[179] "Adding to the costs," according to the judge "were the particularly lucrative retirement benefits which the Common Council had negotiated in the collective bargaining agreements with the City's seven unions."[180] Public employee contracts, pension, and/or OPEB also have been identified as drivers of distress in Vallejo, California,[181] Central Falls, Rhode Island,[182] and Stockton, California.[183]

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[177] *E.g.*, JAMES E. SPIOTTO, CHAPMAN & CUTLER LLP, UNFUNDED PENSION OBLIGATIONS: IS CHAPTER 9 THE ULTIMATE REMEDY? IS THERE A BETTER RESOLUTION MECHANISM? 12 (2011), *available at* http://sec.gov/spotlight/municipalsecurities/statements072911/spiotto-slides2.pdf (citing STANDARD & POOR'S, RESEARCH: MANAGING STATE PENSION LIABILITIES: A GROWING CREDIT CONCERN (Jan. 2005)).

[178] *In re* City of San Bernardino Cal., 499 B.R. 776, 778 (Bankr. C.D. Cal. 2013) (eligibility opinion); Voluntary Petition, *In re* City of San Bernardino, Cal., No. 6:12-bk-28006 (Bankr. C.D. Cal. Aug. 1, 2012).

[179] *In re City of San Bernardino*, 499 B.R. at 779.

[180] *Id.*

[181] Connor & Barghini, *supra* note 174.

[182] Scott Malone, *Rhode Island's Central Falls Files for Bankruptcy*, REUTERS (Aug. 1, 2011) http://reuters.com/article/2011/08/01/us-rhodeisland-centralfalls-idUSTRE7703ID20110801.

[183] *E.g.*, Jim Christie, *How Stockton Went Broke: A 15-Year Spending Binge*, REUTERS (July 4, 2012), http://reuters.com/article/2012/07/04/stockton-bankruptcy-cause-idUSL2E8I406L20120704.

Other commentators reject the idea that public workers are to blame for local government fiscal distress, arguing that public workers earn less on average their private sector counterparts (e.g., "4-11 percent less than private sector workers with similar education, job tenure and other characteristics").[184] These commentators argue that the recession[185] and fiscal mismanagement are the principal drivers of local government fiscal distress.[186]

Wherever one comes out in this debate—and both "sides" have merit, in my view—the sheer size of salary, pension, and OPEB benefits suggest that we ought to consider how these obligations play into local government fiscal health. According to statistics published by the Department of Labor (Bureau of Labor Statistics ("BLS")), in 2012, there were approximately 5,550,000 state government workers and approximately 14,045,000 local government workers in the United States.[187] Focusing on local government employment, Census

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[184] McNichol, *supra* note 176, at 2 (citing Alicia Munnell et al., CTR. FOR RET. RESEARCH AT BOS. COLL., *Comparing Compensation: State-Local Versus Public Sector Workers*, STATE & LOC. PENSION PLANS, no. 20, 2011); *accord* KEITH A. BENDER & JOHN S. HEYWOOD, CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, NAT'L INST. ON RET. SEC., OUT OF BALANCE? COMPARING PUBLIC AND PRIVATE SECTOR COMPENSATION OVER 20 YEARS (2010); JOAN SCHMITT, CTR. FOR ECON. & POLICY RESEARCH, THE WAGE PENALTY FOR STATE AND LOCAL GOVERNMENT EMPLOYEES (2010), http://cepr.net/index.php/publications/reports/wage-penalty-state-local-gov-employees.

[185] *E.g.*, David Madland & Nick Bunker, *State Budget Deficits Are Not an Employee Compensation Problem*: *The Great Recession Is to Blame*, CTR. FOR AM. PROGRESS ACTION FUND (Mar. 10, 2011), http://americanprogressaction.org/issues/labor/report/2011/03/10/9206/state-budget-deficits-are-not-an-employee-compensation-problem/# ("But budget shortfalls today were largely driven by the downturn in state revenue due to the Great Recession.").

[186] *Id.* ("[S]tate tax revenues declined sharply amid the Great Recession—shortfalls made worse in some states by ill-advised tax cuts for businesses and the wealthy").

[187] BUREAU OF LABOR STATISTICS, CURRENT EMPLOYMENT STATISTICS (NATIONAL) DATA PORTAL, *available at* http://bls.gov/ces/data.htm. At the direction of BLS personnel, I used the one-screen data search tool, and extracted data for 1975 to the present respecting state and local government employment. The data reported above are seasonally adjusted, and spreadsheets obtained through the BLS reflecting the cited figures are on file with the author. BLS data reflect that the number of state and local employees grew steadily from 1975 through 2008, with some leveling off

Bureau data reflect that the largest share of the local public workforce are teachers, aides, and support staff working at public schools.[188] Other categories with comparatively large numbers of workers include protective services (police, fire, EMS, correctional officers), health care, and transportation.[189] As noted previously, wages, salaries, and retirement benefits comprise almost 40% of local government expenditures.[190]

The cost of the public workforce appears to be driven (or at least influenced) by the presence of public sector unions. According to the BLS data, in 2012, public-sector workers had a union membership rate (35.9%) more than five times higher than that of private-sector workers (6.6%), with local government workers having the highest union membership rate at 41.7%.[191] Unionization rates are highest at the local government level because local government payrolls include workers in heavily unionized occupations, such as teachers, police officers, and firefighters.[192] In

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and/or declines from 2009 to the present. *Id*. It is important to note that the increase in local government employment during this period is stated in raw numbers in the BLS data. According to Center on Budget and Policy Priorities, over the past thirty years, "the number of state and local workers grew modestly relative to the overall population, from about 59 per 1,000 in 1980 to 65 per 1,000 in 2008 before declining to 61 per 1,000 in 2011," with growth focused on the education sector. McNichol, *supra* note 176, at 1–2. Some commentators also have suggested that the number of public sector employees as a percentage of the overall workforce has remained steady. SYLVIA ALLEGRETTO, KEN JACOBS & LAUREL LUCIA, CTR. ON WAGE & EMP'T DYNAMICS, THE WRONG TARGET: PUBLIC SECTOR UNIONS AND STATE BUDGET DEFICITS 3 (2011), *available at* http://irle.berkeley.edu/research/state_budget_deficits_oct2011.pdf.

[188] DEIDRE BAKER, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC EMPLOYMENT & PAYROLL SUMMARY REPORT: 2011, at 3–4, 7; U.S. CENSUS BUREAU, 2011 PUBLIC EMPLOYMENT AND PAYROLL DATA LOCAL GOVERNMENTS, UNITED STATES TOTAL (May 2013), *available at* http://www2.census.gov/govs/apes/11locus.txt.

[189] BAKER, *supra* note 188, at 7–9.

[190] McNichol, *supra* note 162, at 3.

[191] Press Release, Bureau of Labor Statistics, Union Members—2012 (Jan. 23, 2013), *available at* http://bls.gov/news.release/archives/union2_01232013.pdf ("In 2012, 7.3 million employees in the public sector belonged to a union, compared with 7.0 million union workers in the private sector. The union membership rate for public-sector workers (35.9%) was substantially higher than the rate for private-sector workers (6.6%).").

[192] *Id.*

2012, among full-time wage and salary workers, union members (both public and private sector) earned more on average than their non-union counterparts: whereas union members had median usual weekly earnings of $943 according to BLS data, those who were not union members had median weekly earnings of $742.[193]

Focusing on local governments, BLS Statistics data reflect that in 2012, median weekly earnings of full-time wage and salary workers who were members of unions ($989) or represented by a union ($975) exceeded that of non-union local government workers ($756).[194] The BLS attributes this disparity to a variety of factors including, but not limited to, collective bargaining.[195] In addition to a wage disparity in favor of unionized public workers, data also suggest that state and local government employees are less likely to be laid off compared to their private sector counterparts.[196] Taken together, these data suggest that local governments with a unionized workforce are likely to pay more for labor, and to have less flexibility to terminate workers' employment, compared to non-unionized employers.

B. Pension and OPEB: A Particular Challenge

Pension benefits and OPEB as a component of public sector compensation may be a particularly important aspect of fiscal health due to design requirements and funding/benefit obligations not shared by private employers.[197] With respect to design requirements, public pension plans must address the lack of social security

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[193] *Id.*
[194] *Id.*
[195] *Id.* ("In addition to coverage by a collective bargaining agreement, this earnings difference reflects a variety of influences, including variations in the distributions of union members and nonunion employees by occupation, industry, firm size, or geographic region.").
[196] Alicia H. Munnell & Rebecca Cannon Fraenkel, Ctr. for Ret. Research at Bos. Coll., Public Sector Workers and Job Security, STATE & LOC. PENSION PLANS, no. 31, 2013, at 3, *available at* http://crr.bc.edu/wp-content/uploads/2013/05/SLP31.pdf ("[B]eing employed by a state or local government reduces the probability of unemployment by 1.4 to 2.5 percentage points.").
[197] Paul M. Secunda, *Constitutional Contracts Clause Challenges in Public Pension Litigation*, 28 HOFSTRA LAB. & EMP. L.J. 263, 268–71 (2011) (distinguishing private pension plans that are "of the defined contribution variety" from public pension plans that are "defined benefit plans").

participation and coverage for certain workers, and, in some cases, earlier mandatory retirement ages.[198] In Detroit's case, for example, the Police and Fire Retirement System ("PFRS"), which administers the pension plan for the City's uniformed personnel, covers retirees who generally are not eligible for Social Security retirement benefits or disability benefits.[199] The legal and accounting regimes applicable to public and private pension plans also are different.[200] In Detroit's case, for example, the Pension Benefit Guarantee Corporation (which "protects the retirement incomes of more than forty million American workers in more than 26,000 private-sector defined benefit pension plans")[201] does not insure pension benefits under either PFRS or the City's General Retirement System ("GRS"), which administers the pension plan for the City's non-uniformed personnel.[202]

With respect to funding and benefits obligations, the prevalence of defined benefit (versus defined contribution) plans in the public sector merits attention.[203] In contrast to the private sector where defined contribution plans are the norm, public sector employers like Detroit are substantially more likely to offer defined benefit plans, according to BLS data.[204] With defined contribution

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[198] *Id.* at 270; PUB. PLANS PRACTICES TASK FORCE OF THE AM. ACAD. OF ACTUARIES, RISK MANAGEMENT AND PUBLIC PLAN RETIREMENT SYSTEMS 5 (2010), *available at* http://actuary.org/pdf/pension/PPPTF_Final_ Report_c.pdf ("State and local workers were excluded from Social Security, at its inception, and thus, subsequently, many states and local governments endeavored to establish plans.").

[199] *In re* City of Detroit, Mich., 504 B.R. 97, 114 (Bankr. E.D. Mich. 2013) (eligibility opinion) (citing Retirement Systems Br. at 5 (citing 20 C.F.R. §§ 404.1206(a)(8), 404.1212)).

[200] Secunda, *supra* note 197, at 263–71.

[201] *Who We Are*, PENSION BENEFIT GUAR. CORP., https://www.pbgc.gov/ about/who-we-are.html (last visited Apr. 16, 2014).

[202] *In re City of Detroit*, 504 B.R. at 114.

[203] Secunda, *supra* note 197, at 272–74.

[204] According to a BLS March 2013 National Compensation Survey, 89% of state and local government workers have access to retirement plans. THOMAS E. PEREZ & ERICA L. GROSHEN, U.S. BUREAU OF LABOR STATISTICS, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, MARCH 2013, at 366 (2013), *available at* http://bls.gov/ncs/ebs/benefits/2013/ebbl0052.pdf. Eighty-three percent of those with access have access to a defined benefit plan, while only 32% have access to a defined contribution plan. *Id.* By comparison, the survey revealed that only 64% of private sector workers have access to a retirement

plans, workers contribute to their own retirement through retirement savings accounts, such as a 401k.[205] Workers bear the risk of underfunding with defined contribution plans, because if a worker fails to contribute, contributes an insufficient amount, or if investment choices do not perform as well as the worker had hoped, the worker's retirement account value may suffer.[206] The employer has no direct obligation to help or otherwise "make up" for losses in retirement accounts.[207] With defined benefit plans, however, employees are promised a specific monthly benefit based upon a formula.[208] To fund promised benefits, employers and employees contribute to an investment pool.[209] The employer makes investment decisions on behalf of the pool, assumes market risk, and must make

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plan, and of those with access, only 19% have access to a defined benefit plan compared to 59% with access to a defined contribution plan. *Id.* at 177.

[205] Secunda, *supra* note 197, at 272–74.

[206] *Id.*

[207] *Id.* at 272 ("Of course . . . a larger percentage of these private-sector pension plans are now defined contribution plans, meaning that employers are generally not responsible for having sufficient funds on hand when employees retire. These employers simply make a one-time contribution (or none at all if the employer is dealing with a Section 401(k) deferral plan without a matching contribution) and there are no subsequent pension funding responsibilities. Simply put, employees in the defined benefit context are left with the responsibility of planning so that they have enough in their pension fund account when they retire.") (citations omitted).

[208] *Id.* at 268–69.

[209] *Id.* at 268–74. According to the Census Bureau's 2011 Annual Survey of Public Pensions, in 2011, employees contributed $40,298,909 to defined benefit plans whereas employers (state and local) contributed a total of $96,189,812. ERIKA BECKER-MEDINA, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE- AND LOCALLY-ADMINISTERED DEFINED BENEFIT DATA SUMMARY REPORT: 2011, at 11 (2013), *available at* http://www2.census.gov/govs/retire/2011summaryreport.pdf. For best practices respecting funding defined benefit plans, see GOV'T FIN. OFFICERS ASS'N, GUIDELINES FOR FUNDING DEFINED BENEFIT PENSIONS (2013) (COBRA) 1–2 (2013), *available at* http://www.gfoa.org/downloads/GFOABestPracticeGuidelinesforFundingDefinedBenefitPensions.pdf; GOV'T FIN. OFFICERS ASS'N, REVIEWING, UNDERSTANDING AND USING THE ACTUARIAL VALUATION REPORT AND ITS ROLE IN PLAN FUNDING (COBRA) 1–3 (2013), *available at* http://www.gfoa.org/downloads/GFOABestPracticeonActuarialValuationReports.pdf.

up the difference if the pool is insufficient to pay promised benefits.[210]

The public employer's obligation to "make up the difference" if plan assets fall short gives rise to the risk/problem of underfunding. Underfunding occurs when the defined benefit plan sponsor fails to make contributions (or sufficient contributions) to deal with accrued actuarial liabilities.[211] In Detroit's case, the pension systems for public workers have a substantial underfunding problem.[212] At the end of the City's 2012 fiscal year, Detroit's two retirement systems (GRS and PFRS) "together had over 20,000 retirees receiving benefits, . . . more than 2,400 former employees [who] were entitled to but were not yet receiving benefits, and more than 9,700 active employees . . . with an expectation of receiving benefits when they retire," according to the City's bankruptcy filings.[213] Using current valuation assumptions and methods, as of June 30, 2011, "the GRS had reported Unfunded Actuarial Accrued Liabilities ("UAAL") of approximately $639.9 million."[214] According to the City's bankruptcy papers, the actual amount of these liabilities is likely far higher, as current assumptions and valuation methodologies "serve to substantially understate the Systems' unfunded liabilities."[215] These legacy liabilities are a substantial drain on Detroit's resources: Judge Rhodes found that "38.6% of the City's revenue was consumed servicing legacy

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[210] Secunda, *supra* note 197, at 272–74.

[211] ROGER L. DAVIS, ORRICK, HERRINGTON & SUTCLIFFE LLP, AN INTRODUCTION TO PENSION OBLIGATION BONDS AND OTHER POST-EMPLOYMENT BENEFITS 3 (3d ed. 2006), *available at* http://www.orrick.com/Events-and-Publications/Documents/247.pdf ("The unfunded accrued actuarial liability ('UAAL') is determined by the actuary for the pension fund to be the amount by which the pension fund is short of the amount that will be necessary, without further payments from the state or local government, to pay benefits already earned by current and former employees . . . .").

[212] There has been considerable debate in the bankruptcy court about the degree of underfunding. *E.g.*, *In re* City of Detroit, Mich., 504 B.R. 97, 115 (Bankr. E.D. Mich. 2013).

[213] Declaration of Charles M. Moore in Support of City of Detroit, Mich.'s Statement of Qualifications Pursuant to Section 109(c) of the Bankr. Code at 4, *In re City of Detroit*, 504 B.R. 97 (No. 2:13-BK-53846).

[214] *Id.* at 5.

[215] *Id.*

liabilities" in 2012,[216] and that "forecasts for subsequent years, assuming no restructuring, are 42.5% for 2013, 54.3% for 2014, 59.5% for 2015, 63% for 2016, and 64.5% for 2017."[217]

As the Pew Center has observed, unfunded pension and retiree health care plans pose significant challenges for public workers, state and local governments, and citizens.[218] For public workers, underfunding (and the potential for associated loss or diminution of benefits, or impaired stability of the plan) can have a devastating impact on personal financial condition because, in the absence of social security, there is no safety net.[219] In Detroit's case, for example, where pensioners receive on average $18,000 per year, any diminution or loss of benefits would cut deep.[220] For cities, underfunding "limit[s] policymakers' ability to invest in other priorities because . . . [e]very dollar that goes to plug a hole in the city's retirement funds is a dollar that cannot be spent on [infrastructure] and other services."[221] In practical terms, this means that fewer dollars are available for public safety, education, and infrastructure, as municipalities are forced to allocate resources to pension and OPEB-related obligations.[222] Again, in Detroit's case, the City's inability to meet its obligations (including pension and OPEB) has made it impossible for public officials to invest in desperately needed services and infrastructure upgrades.[223] For

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[216] *In re City of Detroit*, 504 B.R. at 115.

[217] *Id.*; *accord* Memorandum in Support of Qualifications, *supra* note 2, at 3.

[218] PEW CTR., *supra* note 26, at 15–29.

[219] Objection of the Detroit Ret. Sys. to the Eligibility of the City of Detroit, Mich. to be a Debtor Under Chapter 9 of the Bankr. Code at 6, *In re City of Detroit*, 504 B.R. 97, No. 13-53846 ("As a result, a significant number of the City's retirees (in particular the police and firefighters) have no social security benefits to fall back on, because these City employees were never added as a 'covered group' and, therefore, have not accumulated SSA benefits.").

[220] *In re City of Detroit*, 504 B.R. at 114 ("The average annual benefit received by retired pensioners or their beneficiaries is about $18,000.").

[221] PEW CHARITABLE TRUSTS, *supra* note 27, at 1–2.

[222] *Id.* ("To shore up retirement funds, local officials may have to cut services, reduce the workforce, or raise taxes.").

[223] Orr Declaration, *supra* note 1, at 4 ("After decades of fiscal mismanagement, plummeting population, employment and revenues, decaying City infrastructure, deteriorating City services, and excessive borrowing that provided short term band-aids at the cost of deepening

taxpayers, "the longer unfunded [pension and OPEB] liabilities go unaddressed, the larger the bill facing future city budgets and taxpayers,"[224] such that municipalities may be forced to "cut services, reduce the workforce, or raise taxes" to buoy underfunded or unfunded retirement or OPEB-associated funds.[225] Cities and their taxpayers also "pay a price" for underfunded or unfunded pension and OPEB liabilities in the form of "higher borrowing costs" (assuming the City's finances are strong enough to access the municipal securities market on reasonable terms), "because credit rating agencies incorporate unfunded retirement costs into their analyses."[226] All of the negative consequences are manifest in Detroit.

Census Bureau data suggest that demographic trends may exacerbate the problem of underfunding, or (at a minimum) lead to increased demand on benefits pools.[227] When a workforce ages, the number of active participants paying into the system may decrease, even as benefit payments to retired workers increase. Over the past twenty years, the ratio of active members to beneficiaries of state and locally administered pension systems has changed, with the result that there are now fewer active members supporting a larger number of beneficiaries, as shown in Figure 2.[228]

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insolvency, the City of Detroit today is a shadow of the thriving metropolis that it once was.").

[224] PEW CHARITABLE TRUSTS, *supra* note 27, at 2.

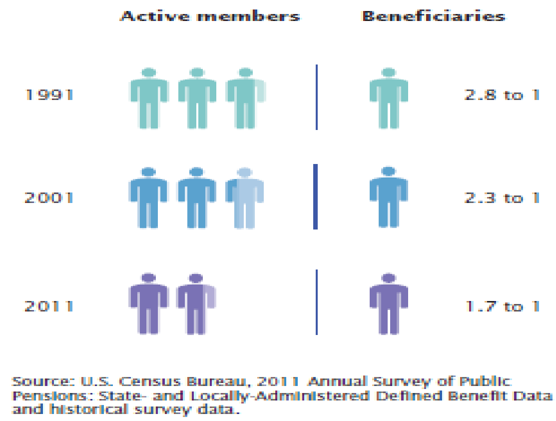
[225] *Id.* ("To shore up retirement funds, local officials may have to cut services, reduce the workforce, or raise taxes.").

[226] *Id.*; *accord* Memorandum in Support of Qualifications, *supra* note 2, at 28; Orr Declaration, *supra* note 1, at 38 ("[T]he City's ability to access the credit markets to satisfy its cash needs is compromised by its plummeting credit ratings. The City's credit ratings have reached historic lows and currently are below investment grade. No major U.S. city has a lower credit rating that Detroit. As of June 17, 2013, S&P and Moody's had lowered Detroit's credit ratings to CC and Caa3, respectively.").

[227] BECKER-MEDINA, *supra* note 209, at 1 (explaining that the ratio "active members to beneficiaries" has significantly declined from 1991 to 2011).

[228] *Id.*

Figure 2. Ratio of Active Members to Beneficiaries of State- and Locally-Administered Pension Systems: 1991, 2001, 2011[229]



These data mean "for every beneficiary receiving periodic benefit payments" under a public pension defined benefit plan, "there were less than two active members paying into [the] pension system[]."[230] As the number of active workers decreases and the number of retired workers increases (in 2011, the total number of beneficiaries eligible for periodic payments increased 4.4%), the demand for benefits increases.[231] As a result, even though pension plan revenues were up in 2011, due to the recovery of the stock market from lows experienced during 2008 and 2009, total payments for state and locally administered [plans] increased as well (they were 8.5% higher in 2011 compared to 2010, due primarily to a 7.6% increase in benefits payments).[232] A number of public officials have voiced concerns about the changing ratio of current versus former workers: Syracuse, New York Mayor Stephanie Miner, for example, has commented that "her city is 'upside down'" with respect to health care expenses, in that the City "pays more for health care of retired workers" than it does for those still working.[233] These data suggest

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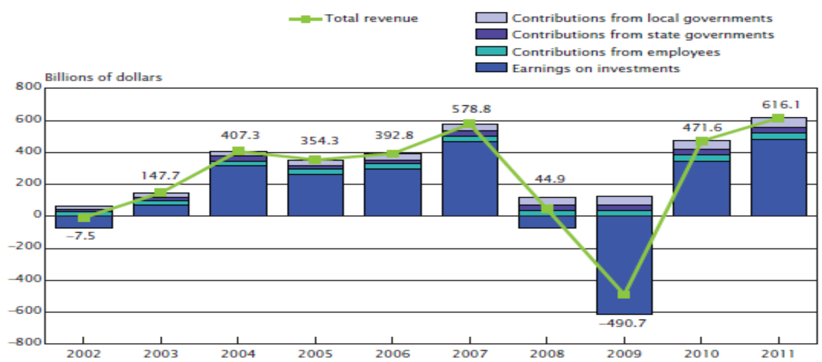
[229] *Id.* (graphic labeled Figure 1, based on data collected by the U.S. Census Bureau in its 2011 Annual Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data and historical survey data).
[230] *Id.* at 2.
[231] *Id.*
[232] *Id.*
[233] Jimmy Vielkind, *Is Detroit Bankruptcy Prelude to Upstate Crisis?*, TIMESUNION (July 24, 2013), http://timesunion.com/local/article/Is-Detroit-bankruptcy-prelude-to-upstate-crisis-4682870.php.

that reducing labor costs is not simply a matter of terminating current workers, or declining to fill positions, since this might exacerbate the "upside down" problem identified by Mayor Miner. Unless and until legacy obligations are addressed, cities like Detroit and Syracuse face a long-term, structural challenge to fiscal health.

Macroeconomic forces can intensify fiscal stress associated with defined benefit plan funding and benefit obligations. According to the Census Bureau, declines in the stock market during 2008 and 2009 (in particular) led to a decrease in total revenues:[234]

Figure 3. Components of Revenue for Public Pension Systems: 2002-2011



Source: U.S. Census Bureau, 2011 Annual Survey of Public Pensions: State- and Locally-Administered Defined Benefit Data and historical survey data.

Stock market declines during this period put additional pressure on public pension plans at the same time that "the recession . . . cut into state and local tax revenues, limiting the ability of governments to make up these shortfalls."[235]

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[234] BECKER-MEDINA, *supra* note 209, at 2.

[235] Alicia H. Munnell, Ashby Monk, Jean-Pierre Aubry & Thad Calabrese, Ctr. for Ret. Research at Bos. Coll., *Pension Obligation Bonds: Financial Crisis Exposes Risks*, ST. & LOC. PENSION PLANS, no. 9, Jan. 2010, at 1 (citing proprietary data). As the Center for Retirement Research ("CCR") has observed, "the sharp decline in equity markets [during the economic crisis] . . . resulted in a large increase in underfunded liabilities among state and local pensions" while, at the same time, "the recession . . . cut into state and local tax revenues, limiting the ability of governments to make up these shortfalls." *Id.*

C. Contractual, Constitutional Constraints on Impairing Salary, Pension Benefits, and OPEB

As previously noted, apart from their sheer size, salary, pension, and OPEB benefits may challenge state and local government fiscal health for the additional and independent reason that these obligations cannot easily be adjusted or impaired outside of bankruptcy due to contract law and constitutional concerns.[236] As noted previously, unions and collective bargaining play a comparatively larger role in the public versus the private sector.[237] As a matter of contract law, where obligations derive from negotiated, contractual collective bargaining agreements, public employers cannot simply modify or repudiate obligations in response to economic strain.[238] Moreover, constitutional concerns come into play when a state or local government seeks to modify compensation contracts.[239] As Professor Secunda points out, "under a Contracts Clause claim under the federal or state constitution, [public worker] plaintiffs may obtain injunctive relief to bar the enforcement of pension reform which cuts back on already earned or vested pension rights or benefits."[240] In addition to contracts clauses, seven states also have constitutional provisions, which prohibit state and local governments from impairing accrued pension benefits.[241] Under these provisions, state and local governments cannot unilaterally impair accrued pension benefits without running afoul of state

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[236] *See supra* Part III.A–B.
[237] *See supra* Part III.B.
[238] Secunda, *supra* note 197, at 270–72 ("For instance, under a Contracts Clause claim under the federal or state constitution, plaintiffs may obtain injunctive relief to bar the enforcement of pension reform which cuts back on already earned or vested pension rights and benefits.").
[239] *Id.* ("Nevertheless, the Takings Clause of the Fifth and Fourteenth Amendments of the Constitution may provide 'just compensation,' because the cutting back of pensions may constitute an abridgement of a property right.").
[240] *Id.*
[241] Alicia Munnell & Laura Quinby, Ctr. for Ret. Res. at Bos. Coll., *Legal Constraints on Changes in State and Local Pensions*, ST. & LOC. PENSION PLANS, no. 25, Aug. 2012, at 2 (listing Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, and New York as states with constitutional restrictions on pension benefits).

constitutional norms.[242] For example, Michigan's Constitution states that "[t]he accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby."[243]

The scope and meaning of Michigan's non-impairment provision has been front and center in Detroit's bankruptcy ever since the summer of 2013, when Detroit's Emergency Manager Kevyn Orr published a proposal to the City's creditors (including pensioners which referenced impairment).[244] Orr's proposal outlined Detroit's dire financial condition and advocated for a thorough "overhaul and restructuring" of the City's obligations.[245] With respect to creditor recoveries, Orr proposed the following: (i) treatment of secured debt commensurate with the value of the collateral securing the debt, including the repayment or refinancing of the City's revenue bonds, secured unlimited and limited tax general obligation bonds, secured installment notes, and liabilities arising in connection with swap obligations;[246] (ii) pro rata distribution of $2 billion in principal amount of interest-only limited recourse participation notes to holders of unsecured claims, including holders of unsecured limited and unlimited tax general obligation bonds; the service corporations (based on the COPs); the pension systems (based on pension underfunding); and retirees (based on OPEB);[247] and (iii) a "Dutch Auction" process for the City to purchase the notes.[248] Also at a meeting respecting the June 14th

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[242] *E.g.*, *In re* City of Detroit, Mich., 504 B.R. 97, 151–52 (Bankr. E.D. Mich. 2013) (citing Kosa v. Treasurer of State of Mich., 292 N.W.2d 452, 455 (Mich. 1980)) (explaining how article 9 section 24 of Michigan's Constitution resulted from an effort by teachers to "lobb[y] for a constitutional amendment granting *contractual status* to retirement benefits"); *In re* Request for Advisory Op. Regarding Constitutionality of 2011 Pa 38, 806 N.W.2d 683, 694 (Mich. 2011) ("The obvious intent of section 24, however, was to ensure that public pensions be treated as contractual obligations that, once earned, could not be diminished.").

[243] MICH. CONST. art. IX, § 24.

[244] *In re City of Detroit*, 504 B.R. at 126.

[245] *Id.*; PROPOSAL FOR CREDITORS, *supra* note 3, at 43–52, 101–09.

[246] PROPOSAL FOR CREDITORS, *supra* note 3, at 101–09.

[247] *Id.* at 109.

[248] *Id.* at 108.

proposal, Orr announced his decision not to make the scheduled $39,700,000 in payments due on the COPs and swap transactions.[249]

With respect to claims for unfunded pension liabilities, Orr stated that "[b]ecause the amounts realized on the underfunding claims will be substantially less than the underfunding amount, there must be significant cuts in accrued, vested pension amounts for both active and currently retired persons."[250] In subsequent comments, Orr acknowledged the Pension Clause of the Michigan Constitution, but he reportedly suggested that neither it nor the Contracts Clause prevented a bankruptcy court from impairing pensions as part of a plan of adjustment under Chapter 9.[251]

On July 3, 2013, public worker stakeholders filed two separate lawsuits in state court seeking a declaratory judgment that Public Act 436 (the Act pursuant to which Orr was appointed) "violated the Michigan Constitution to the extent that it purported to authorize chapter 9 proceedings" without first carving out (or otherwise ring-fencing) accrued pension benefits to protect them from adjustment.[252] The petitioners "also sought an injunction preventing defendants from authorizing any chapter 9 proceeding for the City in which vested pension benefits might be impaired."[253] Shortly thereafter, the Detroit Pension Systems filed a similar lawsuit.[254] On July 18, 2013, the Ingham County Circuit Court found that Chapter 9 for Detroit would impair accrued financial benefits in violation of the Pension Clause. [255] The Court entered a preliminary injunction enjoining officials from taking further action on behalf of the City through a Chapter 9 proceeding where pension benefits

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[249] *In re City of Detroit*, 504 B.R. at 127.
[250] PROPOSAL FOR CREDITORS, *supra* note 3, at 109.
[251] *E.g.*, Ed White, *Detroit to Get Crucial Ruling in Bankruptcy Case*, ASSOCIATED PRESS (Dec. 3, 2013, 4:08 AM), http://news.yahoo.com/detroit-crucial-ruling-bankruptcy-case-061034373--finance.html ("The Michigan Constitution protects public pensions, but Orr believes bankruptcy law trumps that provision."); *Q&A with Kevyn Orr: Detroit's Emergency Manager Talks About City's Future*, DETROIT FREE PRESS (June 14, 2013), http://freep.com/article/20130616/OPINION05/306160052/kevyn-orr-detroit-emergency-manager-creditors-fiscal-crisis.
[252] *In re City of Detroit*, 504 B.R at 128.
[253] *Id.* (citing Flowers v. Snyder, No. 13-729-CZ (Mich. Cir. Ct. July 3, 2013); Webster v. Mich., No. 13-734-CZ (Mich. Cir. Ct. July 3, 2013)).
[254] *Id.* (citing Gen. Ret. Sys. of Detroit v. Orr, No. 13-768-CZ (Mich. Cir. Ct. July 17, 2013)).
[255] *Id.* at 163.

might be impaired.[256] One day later, the Court issued a declaratory judgment order which held that accrued pension benefits could not be impaired under the Michigan Constitution, and it also made the following rulings: (i) "P.A. 436 is unconstitutional and in violation of [the Pension Clause], to the extent it permits the Governor to authorize an emergency manager to proceed under Chapter 9 in any manner which threatens to impair or diminish accrued pension benefits;" (ii) "[t]he Governor is prohibited by [the Pension Clause] from authorizing an emergency manager under P.A. 436 to proceed under Chapter 9 in a manner which threatens to diminish or impair accrued pension benefits;" and (iii) the Governor acted without authority under Michigan law and in violation of the Pension Clause by authorizing Emergency Manager Orr to proceed under Chapter 9 to diminish or impair accrued pension benefits.[257]

This City's bankruptcy filing moved this debate to bankruptcy court. On July 16, 2013, Emergency Manager Orr recommended to Michigan governor Richard Snyder and to the state's treasurer that the City file for Chapter 9 relief.[258] On July 18, the same day the state court issued its judgment, Governor Snyder authorized the City to file a Chapter 9 petition.[259] Although M.C.L. section 141.15661(1) purports to permit the governor to "place contingencies on a local government in order to proceed under [C]hapter 9," Governor Snyder did not do so.[260] Instead, Governor Snyder explained that he was "choosing not to impose any such contingencies today. Federal law already contains the most important contingency—a requirement that the plan be legally executable [under] 11 U.S.C. [section] 943(b)(4)."[261] Orr filed the City's Chapter 9 petition that same day.[262] After the bankruptcy court

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[256] *Id.*
[257] *Id.* at 164; *accord* Webster v. Mich., No. 13-734-CZ (Mich. Cir. Ct. July 19, 2013), *available at* http://freep.com/assets/freep/pdf/C4208749719.PDF.
[258] Orr Declaration, *supra* note 1, at Exhibit J (Letter from Kevin D. Orr, Emergency Manager, City of Detroit Emergency Manager's Office, to Richard Snyder, Governor, Mich. Executive Office of the Governor & Andrew Dillon, State Treasurer, Mich. Dep't of Treasury (July 16, 2013)).
[259] Statement of Qualifications, *supra* note 4, at 11 (Exhibit A Letter from Richard Snyder, Governor, Mich. Exec. Office of the Governor, to Kevyn Orr, Emergency Manager, City of Detroit Emergency Manager's Office & Andrew Dillon, State Treasurer, Mich. Dep't of Treasury (July 18, 2013)).
[260] *Id.* at 14.
[261] *Id.*
[262] *Id.* at 9, 11.

entered an order staying pre-petition litigation (including the state court actions),[263] more than one hundred parties (including pensioners and other stakeholders) (hereinafter, collectively, "the Objectors") filed objections to Detroit's eligibility in the bankruptcy court action.[264]

Citing the Pension Clause, public worker stakeholders argued that Detroit is not eligible to be a Chapter 9 debtor because the State (and the City) failed explicitly to protect accrued pension benefits from impairment.[265] Among other arguments, these Objectors asserted that: (i) Chapter 9 is unconstitutional on its face under the Bankruptcy Clause of Article I, Section 8 of the United States Constitution because it violates the uniformity requirement, and under the Contracts Clause of Article I, Section 10 to the extent it would permit the impairment of contracts to which the state is a party; and (ii) Chapter 9 is unconstitutional as applied under the Tenth Amendment to the United States Constitution to the extent it does not prohibit the bankruptcy court from impairing vested pension benefits owed to Detroit's retired city workers.[266]

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[263] Order Pursuant to Section 105(a) of the Bankr. Code Confirming the Protections of Sections 362, 365 and 922 of the Bankr. Code, *In re* City of Detroit, Mich., 504 B.R. 97 (Bankr. E.D. Mich. 2013) (No. 13-53846), 2013 WL 4761053, at *1 ("It is hereby ordered that: . . . all other entities (and all those acting for or on their behalf) are hereby stayed, restrained and enjoyed from [commencing legal action against Detroit].").

[264] *In re City of Detroit*, 504 B.R. at 110. As to federalism issues associated with the state court rulings, Judge Rhodes held that the Ingham County court's judgment respecting was not binding under principles of res judicata or collateral estoppel, and also is not a persuasive indication of what the Michigan Supreme Court would hold. *Id.* at 164–65.

[265] Objection of the Official Comm. of Retirees to Eligibility of the City of Detroit, Mich. to Be a Debtor Under Chapter 9 of the Bankr. Code at 13–18, *In re City of Detroit*, 504 B.R. 97 (No. 13-53846).

[266] As summarized by the bankruptcy court, 110 separate creditors filed objections to Detroit's eligibility on various grounds, raising the following legal questions:

> (1) Does chapter 9 of the bankruptcy code violate the uniformity requirement of the bankruptcy clause of the United States Constitution?; (2) Does chapter 9 violate the contracts clause of the United States Constitution?; (3) Does chapter 9 violate the Tenth Amendment of the United States Constitution, as applied in this case?; (4) Does the bankruptcy court have the authority to determine the constitutionality of chapter 9 of the bankruptcy code

On December 5, 2013, following extensive briefing and hearings, Judge Rhodes issued a 143-page ruling respecting Detroit's eligibility for Chapter 9 relief.[267] After cataloging Detroit's debts and the impact of the City's financial crisis on the City's beleaguered

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> under *Stern v. Marshall*, 131 S. Ct. 2594 (2011)?; (5) Did the voters' rejection of Michigan Public Act 4 of 2011 in November 2012 constitutionally prohibit the Michigan Legislature from enacting Michigan Public Act 436 of 2012?; (6) Does Public Act 436 violate the Michigan Constitution because it included appropriations provisions for the purpose of evading the right of referendum?; (7) Does Public Act 436 violate the home rule provisions of the Michigan Constitution?; (8) Does Public Act 436 violate the pension clause of the Michigan Constitution?; (9) Does the pension clause of the Michigan Constitution establish protections for pension rights that are greater than contract rights?; (10) Does the bankruptcy court have the authority to determine the constitutionality of Public Act 436 under *Stern v. Marshall*?; (11) Did Detroit's emergency manager have valid authority to file this bankruptcy case even though he is not an elected official?; (12) Was the governor's authorization to file this bankruptcy case valid under the Michigan Constitution even though the authorization did not prohibit the City from impairing pension rights?; (13) Does the judgment in *Webster v. Michigan*, which was entered post-petition, preclude the City from asserting that the governor's authorization to file this bankruptcy case was valid?; (14) Was the City "insolvent" under 11 U.S.C. § 101(32)(C), as required by 11 U.S.C. § 109(c)(3)?; (15) Does the City desire to effect a plan to adjust its debts, as required by 11 U.S.C. § 109(c)(4)?; (16) Did the City negotiate with its creditors in good faith before filing its bankruptcy petition, as required (in the alternative) by 11 U.S.C. § 109(c)(5)(B)?; (17) Was the City unable to negotiate with creditors because such negotiation was impracticable, as required (in the alternative) by 11 U.S.C. § 109(c)(5)(C)?; and (18) Should the case be dismissed under 11 U.S.C. § 921(c) because the City of Detroit did not file its bankruptcy petition in good faith?

In re City of Detroit, 504 B.R. 191, 195–96 (Bankr. E.D. Mich. 2013) (opinion regarding certification and direct appeal).

[267] *In re City of Detroit*, 504 B.R. 97, 136–41.

residents, Judge Rhodes observed that a plan of adjustment may be Detroit's only hope for survival:

> The City of Detroit was once a hardworking, diverse, vital city, the home of the automobile industry, proud of its nickname—the "Motor City." It was rightfully known as the birthplace of the American automobile industry. In 1952, at the height of its prosperity and prestige, it had a population of approximately 1,850,000 residents. In 1950, Detroit was building half of the world's cars.
>
> The evidence before the Court establishes that for decades, however, the City of Detroit has experienced dwindling population, employment, and revenues. This has led to decaying infrastructure, excessive borrowing, mounting crime rates, spreading blight, and a deteriorating quality of life.
>
> The City no longer has the resources to provide its residents with the basic police, fire and emergency medical services that its residents need for their basic health and safety.
>
> Moreover, the City's governmental operations are wasteful and inefficient. Its equipment, especially its streetlights and its technology, and much of its fire and police equipment, is obsolete.
>
> To reverse this decline in basic services, to attract new residents and businesses, and to revitalize and reinvigorate itself, the City needs help.[268]

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[268] *Id.* at 112. Notably, during hearings on the Objections to Eligibility, Judge Rhodes said with respect to the Pensions Clause,

> [t]he question we all are struggling with is what is the meaning—the substantive meaning—of that provision in the context of a political subdivision that doesn't have the money to comply with it? What's the meaning of it? . . . [H]ow do we give meaning to non-impairment . . . if the city doesn't have the money to pay?

Oral Argument at 41:19, *In re City of Detroit*, 504 B.R. 97 (No. 13-53846), *available at* http://www.mieb.uscourts.gov/sites/default/files/detroit/docket 1199.pdf. Judge Rhodes raised this theme repeatedly during arguments, Having framed the case in this fashion, Judge Rhodes held that Detroit meets the criteria set forth in 11 U.S.C. § 109(c), and is eligible to be a Chapter 9 debtor, despite the fact that the City had not pledged to protect accrued pension benefits.[269] Public worker stakeholders have appealed this ruling, and the appeal is pending as of the date of publication.

IV. Non-Traditional Securities and Derivatives: A Tempting, But Risky, Way of Dealing with Pension, OBEP, and Other Debts

As discussed below—and as Detroit's struggle with its COPs and swaps suggests—non-traditional securities present challenges to municipal fiscal health[270] because state and local governments are ill-

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questioning lawyer after lawyer about what the Pension Clause guarantee means if Detroit does not have the money to meet its pension-related obligations in full, or if meeting those obligations in full (were it even possible) would mean the City was unable to make the kind of investments in infrastructure, services, and the living conditions generally necessary to put the City on a path towards recovery. *Id.* at 2:45:47–:48, 3:28:13.

[269] *In re City of Detroit*, 504 B.R. at 110. Judge Rhodes held that (i) Chapter 9 is not facially unconstitutional under the Bankruptcy Clause of Article I, Section 8 or the Contracts Clause of Article I, Section 10 of the United States Constitution; (ii) Chapter 9 does not violate the Tenth Amendment to the United States Constitution; and (iii) Chapter 9 is constitutional as applied in this case. *Id.* at 136–54. Other holdings not discussed here include the following: (i) the bankruptcy court has the authority to determine the constitutionality of Chapter 9 and Michigan Public Act 436; (ii) Michigan Public Act 436 does not violate the Michigan Constitution; (iii) Detroit's Emergency Manager had valid authority to file the bankruptcy case even though he is not an elected official; (iv) the Governor's authorization to file the bankruptcy case was valid under the Michigan Constitution even though the authorization did not prohibit the City from impairing pension rights; (v) the judgment in the *Webster* state court action does not preclude the City from asserting that the Governor's authorization to file the bankruptcy case was valid; (vi) Detroit was insolvent; (vii) the City desires to effect a plan to adjust its debts; (viii) the City did not negotiate in good faith with creditors; (ix) the City filed its bankruptcy petition in good faith; and (x) the Supreme Court's decision in *Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494 (1986) does not apply in this case. *Id.* at 129–35, 154–89.

[270] As the Government Finance Officers Association has commented,

equipped to deal with the interest rate risk, termination fees, and/or penalties that may be associated with these instruments.[271] As an initial matter, I note that it is hard to get a sense of the size of the market for complex instruments and derivatives in public finance due to a lack of available statistics. Available aggregate statistics reference general obligation and revenue bond offerings: these

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> [d]erivative products can be important interest rate management tools that, when used properly, can increase a governmental entity's financial flexibility, provide opportunities for interest rate savings, alter the pattern of debt service payments, create variable rate exposure, change variable rate payments to fixed rate and otherwise limit or hedge variable rate payments. Recent market experience has also shown, however, that derivatives, when used to hedge a particular bond issue, can limit an issuer's flexibility with respect to such bond issue.

GOV'T FIN. OFFICERS ASS'N, USE OF DEBT-RELATED DERIVATIVES PRODUCTS AND THE DEVELOPMENT OF A DERIVATIVES POLICY (2003, 2005, AND 2010) (DEBT) 1 (2010), *available at* http://www.gfoa.org/downloads/GFOA_usedebtderivativesBP.pdf; MOODY'S INVESTORS SERVS., *supra* note 102, at 2 ("State and local governments issue variable rate debt in order to achieve lower interests costs than those that are associated with fixed rate debt. Unlike fixed rate debt, however, variable rate debt is subject to interest rate risk. An issuer may face cash flow pressures if interest rates exceed those for which the issuer has budgeted. Furthermore, protracted periods of unbudgeted interest payments can drain an issuer's liquidity. To mitigate interest rate risk, most variable rate debt obligations are subject to interest rate ceilings, and state usury laws also limit interest rates. However, since these ceilings are usually quite high, issuers remain vulnerable to unexpected increases.").

[271] *E.g.*, MOODY'S INVESTORS SERVS., *supra* note 102, at 6 ("The ability to quickly adjust revenues and expenditures is a valuable mitigant to the potential cash flow and liquidity impacts of variable rate debt and swaps. To measure an issuer's ability to generate additional revenues, we consider the nature of the revenue streams that are pledged or are available to support the issuer's variable rate debt and swaps, as well as any legal or procedural restrictions that would prevent the issuer from receiving sufficient revenues within the necessary timeframe. For example, Moody's considers whether levy limits or political reluctance may prevent an issuer from increasing property taxes or utility fees as needed. If the issuer is able and willing to raise revenues, we consider the timeframe in which the increased collections will be received, as delayed receipts may not help the issuer with immediate cost pressures."); *see also* Chung, *supra* note 33, at 1481–82.

resources do not aggregate, categorize, or quantify offerings of complex, non-traditional instruments such as certificates of participation like those used in Detroit.[272] While it is possible to get some information about individual deals through the Electronic Municipal Markets Access System, or EMMA (the data repository maintained by the Municipal Securities Rulemaking Board ("MSRB")),[273] the lack of aggregate, standardized reporting and data makes it difficult to get a sense of the size of the overall market or of trends in deal terms. Likewise, the lack of aggregate data and reporting for derivatives deals—individually and as components of larger financing plans—also makes it difficult to identify the size of the market or trends. As discussed below, this lack of transparency is one of the reasons why I am calling for national data clearing house and standardized reporting standards to collect and aggregate this data, and make it available for study.

But if aggregate data are lacking, there is anecdotal evidence that complex deals can be difficult, risky, and expensive for state and local governments to manage. At a minimum, the anecdotal evidence suggests that study is warranted. Consider Detroit. In 2005 and 2006, Detroit entered into a series of funding transactions to address accrued liabilities associated with the City's various pension systems "through arranging for the issuance of certificates of participation [COPs] supported by services contracts between the City and each of the General Retirement System Service Corporation and the Police and Fire Retirement System Service Corporation *i.e.*, specially created vehicles."[274] The City's goal was to "raise $1.4 billion for its underfunded pension funds, the GRS and the PFRS."[275] After creating a non-profit servicing corporation for each of the two pension funds to act as intermediary, the City entered into service

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[272] *Muni Swap Index Data*, SIFMA, http://www.sifma.org/research/item.aspx?id=19762 (last visited Apr. 16, 2014); *Statistics: Municipal: US Municipal Issuances*, *supra* note 101; *Statistics: Municipal: US Municipal Securities Holders*, SIFMA, http://www.sifma.org/research/statistics.aspx (last updated Mar. 6, 2014) (Excel spreadsheet); *Statistics: Municipal: US Municipal Trading*, SIFMA, http://www.sifma.org/research/statistics.aspx (last updated Apr. 1, 2014) (Excel spreadsheet).

[273] *About the Information Available on EMMA*, ELECTRONIC MUNICIPAL MARKETS ASSET SYSTEM, http://emma.msrb.org/Search/Search.aspx (last visited Apr. 16, 2014).

[274] Orr Declaration, *supra* note 1, at 33; *accord In re* City of Detroit, Mich., 504 B.R. 97, 115 (Bankr. E.D. Mich. 2013).

[275] *In re City of Detroit*, 504 B.R. at 115.

contracts with each of the corporations,[276] pursuant to which the City pledged to make payments to the service corporations.[277] Each COP represented "an undivided proportionate interest in the payments that the City would make to the Service Corporations under the Service Contracts."[278] The service corporations had created funding trusts, "which issued debt obligations to investors" (namely, the COPs).[279] To make the COP offerings more attractive to investors, the City purchased insurance from two bond insurers—XL Capital Assurance, Inc., now known as Syncora, and Financial Guarantee Insurance Company.[280] At the end of fiscal year 2012, the aggregate outstanding amount of these certificates was approximately $1.43 billion.[281]

Concurrently with the issuance of certain of these certificates, certain of these special entities also entered into various "pay-fixed, receive-variable interest rate swap contracts" in an aggregate notional amount of $800,000,000"[282] "to hedge cash flows related to interest on its [COP] debt obligations."[283] An interest rate swap is a contract between two parties to exchange a series of fixed rate and floating rate interest payments over a defined period of time, without exchanging the underlying principal amount, which is referred to as a "notional" principal amount.[284] Municipal securities

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[276] *Id.* ("The City then entered into Service Contracts with each of the Service Corporations.").
[277] *Id.* ("The City would make payments to the Service Corporations, which had created Funding Trusts and assigned their rights to those Funding Trusts.").
[278] *Id.*
[279] *Id.*
[280] *Id.*
[281] *Id.* at 114; Orr Declaration, *supra* note 1, at 33 (estimating debt at $1.45 billion).
[282] *In re City of Detroit*, 504 B.R. at 116; Orr Declaration, *supra* note 1, at 34.
[283] *In re City of Detroit*, 504 B.R. at 115–16; *accord* FIN. DEP'T, CITY OF DETROIT, MICH., COMPREHENSIVE ANNUAL FINANCIAL REPORT (CAFR) FOR THE FISCAL YEAR ENDED JUNE 30, 2012, at 33 (2012), *available at* http://emma.msrb.org/EP731053-EP567459-EP968879.pdf.
[284] The MSRB describes interest rate swaps (and their characteristics and uses) as follows:

> A specific derivative contract entered into by an issuer or obligor with a swap provider to exchange periodic interest payments. Typically, one party agrees to make

issuers use interest rate swaps to convert interest rate basis (e.g., from floating to fixed or fixed to floating) to manage liabilities, and (ideally) to enable issuers to lower their costs of borrowing.[285]

While swaps offer the potential for up-front cost savings and other benefits, they involve risks due to interest rate sensitivity and the possibility of termination fees.[286] Among other risks, swaps carry counterparty credit risk, interest rate risk, and basis risk. [287] According to a 2011 Report from the consulting firm National Economic Research Associates ("NERA"), "changes in reference

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> payments to the other based upon a fixed rate of interest in exchange for payments based upon a variable rate. The swap contract may provide that the issuer will pay to the swap counter-party a fixed rate of interest in exchange for the counter-party making variable payments equal to the amount payable on the variable rate debt.

Glossary of Municipal Securities Terms, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Glossary.aspx (last visited Apr. 16, 2014).

[285] Mary L. Schapiro, Chairman, SEC, as delivered by Andrew J. Donohue, Dir., Div. of Inv. Mgmt., SEC, Remarks at Investment Company Institute 2010 General Membership Meeting (May 7, 2010), *available at* http://sec.gov/news/speech/2010/spch050710mls.htm.

[286] MASSIMILIANO DE SANTIS, NAT'L ECON. RESEARCH ASSOCS., DEMYSTIFYING FINANCIAL DERIVATIVES: INTEREST RATE SWAPS AND MUNICIPAL DERIVATIVES 7 (2011); John Haupert, *Using Interest Rate Swaps as Part of an Overall Financing and Investment Strategy*, GOV'T FIN. REV., Oct. 1992, at 13–15; Phillip N. Shapiro & T. Spencer Wright, *An Issuer's Perspective on Interest Rate Swaps*, GOV'T FIN. REV., Oct. 1992, at 7–11.

[287] *See* SIFMA, *supra* note 90, at 249; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-265, MUNICIPAL SECURITIES: OVERVIEW OF MARKET STRUCTURE, PRICING AND REGULATION 51 (Jan. 2012) ("Termination risk is the risk that the swap may terminate or be terminated before its expiration. Swap agreements allow for termination of the swap by either party in the case of certain events, such as payment defaults on the swap or credit rating downgrades. For example, if the issuer triggers early termination, it could owe a termination payment reflecting the value of the swap under the market conditions at that time. If market rates have changed to the issuer's disadvantage (e.g., the issuer is a fixed-rate payer and interest rates have declined), the issuer will be 'out of the money' on the swap, that is, the fixed rate that the issuer is paying to the counterparty is higher than the current market rate . . . . A termination of a swap can result in a substantial unexpected payment obligation."); GOV'T FIN. OFFICERS ASS'N, USING VARIABLE RATE DEBT INSTRUMENTS 2 (2011) http://gfoa.org/downloads/GFOABPDEBTCCIUSINGVARIABLERATEDEBTINSTRUMENTS.pdf.

interest rates have caused losses in swap positions taken by hundreds of U.S. municipalities" in recent years.[288] NERA found that,

> [w]ith the fall in interest rates brought by the recent global financial crisis, the municipalities are losing money on floating-to-fixed swap agreements they made during the bull market to protect themselves against rising interest rates. In some cases, even with falling interest rates, municipalities have found that the floating payments they make on their debt have increased, due to downgrades to the credit companies insuring the debt.[289]

In Detroit's case, the service corporations agreed to convert the floating rate of interest on certain of the COPs into a fixed payment.[290] This was, according to Judge Rhodes, a wager by the City, because "if the floating interest rates exceeded a certain rate, the Swap Counterparties would make payments to the Service Corporations. But if the floating interest rates sank below a certain rate, the Service Corporations would make payments to the Swap Counterparties."[291] In addition to the risk that interest rate would move in a direction disadvantageous to the City, "the City was also at risk if there was an 'event of default' or 'termination event,'" according to Judge Rhodes.[292] Judge Rhodes found that if either event occurred, "the Swap Counterparties could terminate the swaps and demand a potentially enormous termination payment."[293]

Moreover, Judge Rhodes found that due to a dramatic decline in interest rates in 2008, the City "lost catastrophically on the swaps bet."[294] With respect to the COPs-related swaps, the City stated in its Comprehensive Annual Financial Report ("CAFR") for the fiscal year ended June 2012 that, "[a] total of $439.3 million of the negative fair value of derivatives are interest rate swaps

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[288] DE SANTIS, *supra* note 286, at 7.
[289] *Id.*
[290] *In re* City of Detroit, Mich., 504 B.R. 97, 116 (Bankr. E.D. Mich. 2013) ("Under the hedges, also known as 'swaps' (bets, really), the Service Corporations and the Swap Counterparties agreed to convert the floating interest rates into a fixed payment.").
[291] *Id.*
[292] *Id.*
[293] *Id.*
[294] *Id.*

associated with the City's [COPs]."[295] The CAFR also detailed consequences (termination fees, rating downgrades, etc.) that the City then was facing as a result of its difficulties meeting obligations associated with the COPs and swaps.[296] As reported by Judge

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[295] CAFR, *supra* note 283, at 14.

[296] According to the CAFR:

> On January 8, 2009, due to POC debt rating and Swap Insurer's rating declines, the City received formal notice from the Swap Counterparty to four of the eight Swap agreements stating that an event had occurred, which if not cured by the City, would constitute an Additional Termination Event. On January 14, 2009, the City also received formal notice from the Swap Counterparty to the four remaining Swap Agreements. In June 2009, the City and the Counterparties agreed to an amendment to the Swap Agreements, thereby eliminating the Additional Termination Event and the potential for an immediate demand for payment to the Swap Counterparties. As part of the amended Swap Agreements, the Counterparties waived their right to termination payments. Additionally, the City was required to direct its Wagering Tax Revenues to a Trust as collateral for the quarterly payment to the Counterparties and agreed to other new termination events. The termination events under the amended Swap Agreement include a provision for the Counterparties to terminate the amended Swap Agreement and demand a termination payment if POCs ratings are downgraded below "Ba3" or equivalent. In March 2012, the risk of the amended Swap Agreement termination arose with the credit rating downgrade below "Ba3." The amount of swap termination payments would be based upon a variety of factors such as the various Swap Counterparties' financial pricing models, underlying variable debt, index or reference rates, and the point of pricing. Any termination payments would be allocated based on the notional allocation percentage of the affected POCs, between the governmental and business-type activities as of the point of liability accrual. If the termination events are not cured, there presently exists significant risk in connection with the City's ability to meet the cash demands under the terms of the amended Swap Agreements. As of this report date, the City is negotiating with the counterparties to come up with an acceptable course of action due to the credit rating

Rhodes, "[t]he City estimates that the damage will be approximately $45,000,000 per year for the next ten years."[297]

There are other compelling examples of risks associated with complex instruments and derivatives. In 1994, for example, Orange County, California declared bankruptcy despite its relative wealth after a disastrous foray into the derivatives market.[298] As noted previously, Jefferson County's 2009 bankruptcy also involved swaps.[299] In 2010, a swaps deal involving the Denver Public Schools attracted press attention and criticism of local government officials.[300] According to one commentator, the "complex and risky" deal at issue exposed the school district to costs and risks that would not have been acceptable to savvy corporate issuers.[301] Oakland, California[302] and the State of New Jersey[303] (among others)[304] also reportedly have wrestled with swap-related obligations.[305]

> downgrade. At June 30, 2012, the negative fair value of the POC swap liabilities was $354.7 million for the governmental activities and totaled $439.3 million for the primary government.

Id. at 33.

[297] *In re City of Detroit*, 504 B.R. at 116.

[298] *See supra* note 31 and accompanying text.

[299] Walsh, *supra* note 128 (reporting that at $4 billion, Jefferson County's bankruptcy was then the largest in history, overtaking previous record (a $1.7 billion bankruptcy filing by Orange County, California in December 1994)); SEC Press Release, *supra* note 145.

[300] Gretchen Morgenson, *Exotic Deals Put Denver Schools Deeper in Debt*, N.Y. TIMES, Aug. 6, 2010, at A1 (detailing how and why the Denver School District entered into interest rate swap agreements and the eventual financial impact on the district). In April 2008, the Denver Public School System issued $750 million of thirty-year variable-rate amortizing bonds. Andrew Kalotay, Prepared Remarks at SEC Panel on Municipal Derivatives 2 (July 29, 2011), *available at* http://kalotay.com/sites/default/files/municipal-articles/Kalotay_SEC_July29_prepared_remarks.pdf. Because the school district's objective was to lock into a fixed rate over time, it also entered into a $750 million LIBOR-based interest rate swap whose amortization structure mirrored that of the bond issue. *Id.* at 4.

[301] Kalotay, *supra* note 300; *accord* Morgenson, *supra* note 300.

[302] In 1998, Oakland reportedly issued variable rate bonds in order to help the city finance its pension obligations. *Oaklanders Demand End to Swap Ripoff*, SEIU LOCAL 1021 (June 12, 2012), http://seiu1021.org/?s=Oakland's+Goldman+Sachs+Rate+Swap&submit-btn=Search. To protect against interest rate spikes, the city entered into an agreement with Goldman Sachs to swap its variable rate for a fixed rate obligation. *Id.*

A. Instruments Designed to Finance Pension and OPEB Obligations Merit Careful Scrutiny

Instruments designed to finance pension obligations may be a particular source of risk and instability for local government budgets. In addition to the COPs at issue in Detroit, pension obligation bonds ("POBs") also merit attention. POBs are "bonds issued by a state or local government to pay its obligation to the pension fund or system in which its employees (or others for whose

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Instead of spiking, however, "interest rates dropped to about half what the city was paying to Goldman Sachs." *Id.* Although the bonds were refunded for additional debt in 2005, the swap agreement was structured to continue until 2021, and requires the city to pay $5 million per year until that time. *Id.* Terminating the swap reportedly would cost Oakland $19 million. Aaron Lucchetti, *Interest Rate Deals Sting Cities, States*, WALL ST. J., Mar. 22, 2010, at C1.

[303] According to its annual financial statements, the State of New Jersey paid Goldman Sachs $122 million in one month partially to terminate certain swap arrangements. STATE OF N.J., COMPREHENSIVE ANNUAL FINANCIAL REPORT FOR THE YEAR ENDED JUNE 30, 2011, at 76 (2011), *available at* http://www.state.nj.us/treasury/omb/publications/11cafr/pdf/finstats.pdf.

[304] *E.g.*, Press Release, Penn. Dep't of the Auditor Gen., Philadelphia Derivatives Show Danger of Failure to Rein in Wall Street (Apr. 27, 2010), *available at* http://www.auditorgen.state.pa.us/department/press/phillyderivativesshowdangerfailreininwallstreet.html (detailing net negative values for interest rate swaps for the City of Philadelphia, the School District of Philadelphia, the Philadelphia Authority for Industrial Development, and the Philadelphia Intergovernmental Cooperation Authority). Note that the constitutionality of school financing systems, while beyond the scope of this Article, has been much litigated over the years. *See, e.g.*, Serrano v. Priest, 487 P.2d 1241, 1244 (Cal. 1971). In some cases, municipalities which have suffered losses due to swap agreements have sued their swap providers, often resulting in settlements or the restructuring of swap agreements. In 2009, for example, the Alabama Public School and College Authority ("APSCA") sued to void a swaption that it had sold to J.P. Morgan and refused to make payments on the swaption until a decision was rendered. Shelly Sigo, *Judge OKs Deal in Alabama, J.P. Morgan Swaption Suit*, BOND BUYER, Dec. 27, 2010, at 3. According to press reports, the APSCA agreed to pay a $19 million in settlement to J.P. Morgan to resolve the dispute. *Id.*

[305] For a discussion of the Jefferson County case, see *supra* Part II.E; Chung, *supra* note 33, at 1474–77.

pension benefits it is responsible) are members."[306] The use of POBs to manage pension-related obligations dates back to 1985, when the City of Oakland, California issued the first of this type of instrument.[307] Local governments issue POBs for a variety of reasons, including "interest rate savings" (when taxable bond rates are low, POBs can function like "a classic interest rate savings refunding"), to obtain discounts (by "negotiat[ing] discounts with the pension system for early payment of the normal annual contribution"), for arbitrage purposes (because "pension funds may invest in a much broader range of investments than state or local governments," and thus may be able to invest the proceeds of a POB offering at a higher rate of return), and budget relief (e.g., "reamortizing unfunded accrued actuarial liabilities by replacing the obligation to fund pensions with POBs").[308] According to the Center for Retirement Research, about ten states—most notably California and Illinois—have been active in the POB market.[309]

While POBs may be useful for some issuers, they too carry risks and costs not present in other forms of financing. For example, because POBs are sensitive to market conditions, returns can vary from year to year. When returns are robust, they may be sufficient to fund pension plans. If returns falter, however, they may not be sufficient to meet funding obligations, or even to meet borrowing costs.[310] If that happens, issuers have the potential to lose billions of dollars on POB deals.[311] The Center for Retirement Research at Boston College has argued that "governments that issue POBs are usually in a poor position to shoulder the investment risk," and thus, the Center counts the use of POBs as a measure of fiscal mismanagement.[312] POBs reportedly have contributed to financial

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[306] DAVIS, *supra* note 211, at 1.
[307] Munnell et al., *supra* note 235, at 1–2.
[308] DAVIS, *supra* note 211, at 5–7.
[309] Munnell et al., *supra* note 235, at 2.
[310] *Id.* at 3.
[311] *Id.* For a critical take on pension obligation bonds, see D. Roderick Kieweit, *The Day After Tomorrow: The Politics of Public Employee Retirement Benefits*, 2 CAL. J. POL. & POL'Y, no. 3, 2010, at 13–14; Joe Mysak, *Don't Buy into Pension Obligation Bond Plans*, BLOOMBERG (Jan. 23, 2004), http://bloomberg.com/apps/news?pid=newsarchive&sid=a55YHbUZvMmQ; Popper, *supra* note 87.
[312] ALICIA H. MUNNELL, JEAN-PIERRE AUBRY, JOSH HURWITZ & MARK CAFARELLI, CTR. FOR STATE & LOCAL GOV'T EXCELLENCE, ARE CITY FISCAL WOES WIDESPREAD? ARE PENSIONS THE CAUSE? 5 (2013),

difficulties in a number of communities, including Stockton, California[313] and New Orleans, Louisiana.[314]

So-called capital appreciation bonds ("CABs") also merit further scrutiny. Capital appreciation bonds are municipal securities for "which the investment return on an initial principal amount is reinvested at a stated compounded rate until maturity" such that "[a]t maturity the investor receives a single payment (the 'maturity value') representing both the initial principal amount and the total investment return."[315] According to the MSRB, "CABs are distinct from traditional zero coupon bonds because the investment return is considered to be in the form of compounded interest rather than accreted original issue discount."[316] Accordingly, "only the initial principal amount of a CAB would be counted against a municipal issuer's statutory debt limit, rather than the total par value, as in the case of a traditional zero coupon bond."[317] In plain English, this means that issuers may borrow today, but push repayment obligations into the future, potentially without running afoul of limits on debt.

Since 2007, hundreds of school districts and community colleges in California reportedly have used CABs to raise nearly $7 billion for construction projects.[318] As the true cost of these instruments has become known, however, CABs have met with controversy.[319] In May 2011, the Office of the Los Angeles County

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available at http://slge.org/wp-content/uploads/2013/12/City_Fiscal_Woes_14-358.pdf.

[313] Mary Williams Walsh, *How Plan to Help City Pay Pensions Backfired*, N.Y. TIMES (Sept. 3, 2012), http://nytimes.com/2012/09/04/business/how-a-plan-to-help-stockton-calif-pay-pensions-backfired.html.

[314] Bruce Eggler, *New Orleans Sells $200 Million in Bonds to Refinance Firefighter Pensions*, NOLA (Oct. 12, 2012), http://nola.com/politics/index.ssf/ 2012/10/new_orleans_sells_200_million.html (referring to New Orleans' earlier issuance of pension obligation bonds as a "disastrous gambit" to deal with firefighter pension obligations).

[315] MUN. SEC. RULEMAKING BD., *supra* note 284.

[316] *Id.*

[317] *Id.*

[318] Ian Lovett, *California Schools Finance Upgrades by Making the Next Generation Pay*, N.Y. TIMES, Feb. 10, 2013, at 25N.

[319] Letter from Mark J. Saladino, Treasurer & Tax Collector, Cnty. of L.A., to School Finance Professionals, on County of Los Angeles School District General Obligation Bonds 2 (May 16, 2011), *available at* http://kcttc.co.kern.ca.us/forms/School%20Bonds%20White%20Paper.pdf;

Treasurer and Tax Collector ("LA Treasurer") issued a white paper on the use of CABs by Los Angeles County school districts,[320] which characterized CABs as "exceedingly costly for both school districts and for taxpayers."[321] In 2012, California State Attorney General Bill Lockyer and State Superintendent of Public Instruction Chief Tom Torlakson issued a news release, which called for a moratorium on the issuance of CABs, citing risks and costs.[322] In late 2013, the California state legislature passed, and Governor Brown signed into law, a bill that places limits on the use of CABs and CAB terms.[323] The new "legislation reduces the maximum maturity of [CABs], from 40 years to 25 and limits a school district's repayment ratio to no more than $4 in interest and principal for every $1 dollar borrowed."[324] School districts also must provide their school boards with public reports that explain why and how the district intends to use CABs.[325] The analysis is supposed to "include the cost of the bond issue, a comparison with conventional forms of financing, the reason for using capital appreciation bonds and disclosures by brokerages hired as underwriters."[326]

V. The (Municipal Securities) Regulatory Regime

As an initial matter, I acknowledge that the federal securities laws are only part of the picture when it comes to state and local

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Petersen, *The Bank, the School and the 38-year Loan*, ORANGE CNTY. REG. (Mar. 4, 2014), http://ocregister.com/articles/bonds-496091-school-bank.html.

320 Letter from Mark J. Saladino, *supra* note 319, at 1.

321 *Id.* at 2.

322 News Release, Cal. Dep't of Educ., State Schools Chief Tom Torlakson, State Treasurer Bill Lockyer Caution School Districts Against Issuance of Capital Appreciation Bonds (Jan. 17, 2013), *available at* http://www.cde.ca.gov/nr/ne/yr13/yr13rel12.asp.

323 2013 Cal. Legis. Serv. 447 (West) (codified at CAL. EDUC. CODE §§ 15140.5–15146; CAL. GOV'T CODE §§ 53508.5–.6).

324 Dan Weikel, *Gov. Brown Signs Law Limiting Risky Capital Appreciation School Bonds*, L.A. TIMES (Oct. 2, 2013), http://articles.latimes.com/2013/oct/02/local/la-me-ln-school-bonds-20131002.

325 2013 Cal. Legis. Serv. 477 ("This bill would require . . . . board of the school district or community college district to be presented with specified information concerning the bonds ."); Weikel, *supra* note 324.

326 Weikel, *supra* note 324; *accord* CAL. EDUC. CODE §§ 15144.3(b), 15146(b)–(c) (West, Westlaw through Ch. 3 of 2014 Reg. Sess.).

government fiscal health. As noted throughout this article, state and federal constitutional law and bankruptcy law (among many other disciplines) play an important role in the conversation. I think there is a role for the federal securities laws, however, particularly with regard to financial reporting standards, the collection, aggregation, and reporting of transaction data, and the fiduciary standard, and these are the issues discussed below. In a nutshell, the following section argues that with its focus on investor disclosure and investor risk of loss, the regulatory regime applicable to municipal securities and related instruments fits uneasily, and imperfectly, with questions respecting state and local government fiscal health. As I explain below, even as amended by Dodd-Frank, the current regime does not adequately address risks and costs that cities and taxpayers face when public officials rely upon Wall Street to meet funding needs.

A. Municipal Securities: Brief Background

Almost eighty years ago, when Congress enacted section 3(a)(2) of the Securities Act of 1933 ("'33 Act"), it exempted municipal securities issuers and their securities from the registration, disclosure, and periodic reporting requirements applicable to registrants and publicly-traded corporate securities.[327] As a historical matter, this exemption has been attributed to principles of comity, the power of the local government and Wall Street lobbies, concerns about the cost of a more robust regulatory regime, perceptions regarding the financial expertise of the institutional investors who then dominated the ranks of municipal securities purchasers, and the lack of perceived abuses in the municipal securities market.[328] As a

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[327] *See* 15 U.S.C. § 77c(a)(2) (2012). The statute provides, in relevant part, that:

> [e]xcept as hereinafter expressly provided, the provisions of this subchapter shall not apply to . . . [a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

Id. § 77c(a).

[328] *See* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 187 (1982) ("During the Roosevelt administration, no business lobby proved

practical matter, the registration and disclosure exemptions meant that the distribution of municipal securities was largely unregulated for almost fifty years, save for the antifraud provisions of the federal securities laws.[329]

It was not until 1975, after New York City nearly defaulted on $600 billion of bonds,[330] that Congress took its first steps towards

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nearly as effective against the SEC as the nation's municipal securities issuers and municipal securities dealers. Strengthened by the appearance of defending local government, not big business, with political allies in both parties and almost every state, the municipal securities lobby was able to wrest exemption from the 1933 Securities Act and the 1934 Securities [Exchange] Act . . . ."). According to Seligman, James Landis noted in a letter written several years later that "the mayors of our various cities rose up en masse when we tried to bring the issuance of municipal securities under the 1933 Act." *Id.* at 65; *accord Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the S. Comm. on Banking and Currency*, 73d Cong. 7443 (1934). For additional discussions of the history of the exemptions for municipal securities, see Note, *Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation*, 28 VAND. L. REV. 561, 582–86 (1975); James M. Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 46 (1959). For a critical examination of the justification for the exemption, see Gellis, *supra* note 95, at 25–39.

[329] Prior to 1975, the '34 Act did not include within the term "person" municipal corporations. As a result, it was thought that municipal corporations could not be held liable under section 10(b) of the '34 Act and Rule 10b-5 promulgated thereunder. *See, e.g.*, Brown v. City of Covington, 805 F.2d 1266, 1268–71 (6th Cir. 1986) (citing pre-1975 version of section 3(a)(9) of the '34 Act, which defined person to include "an individual, a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated association"). In 1975, however, the definition of person was amended to include "a government, or political subdivision, agency, or instrumentality of a government." Pub. L. No. 94-29, § 3(2)(9), 89 Stat. 97 (1975) (codified as amended at 15 U.S.C.§ 78c(a)(9) (2012)) (amending the Securities Exchange Act of 1934).

[330] In 1975, New York City nearly defaulted on $14 billion of outstanding debt, including $600 million of bonds. Gellis, *supra* note 95, at 18. Though the city ultimately was saved by the combined effort of unions and the state and federal government, investigations into the crisis raised significant questions about regulatory regimes applicable to municipal securities. *Id*. at 18–19. The New York City debt crisis and its consequences are discussed in detail in numerous reports and publications. *See* JOINT ECON. COMM., 94TH CONG., NEW YORK CITY'S FINANCIAL CRISIS, AN EVALUATION OF ITS ECONOMIC IMPACT AND OF PROPOSED POLICY SOLUTIONS (Comm. Print

federal regulation of the municipal securities market, and regulatory reform in this market has been largely crisis-driven ever sense.[331] Through a series of reforms to the federal securities laws, Congress created the MSRB, a self-regulatory organization charged with establishing fair practices and conduct rules for firms and individuals involved in the underwriting, trading, and selling of municipal securities.[332] Congress also required the SEC to provide for the

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1975); SUBCOMM. ON ECON. STABILIZATION, H. COMM. ON BANKING, FIN. & URBAN AFFAIRS, 95TH CONG., SECURITIES AND EXCHANGE COMMISSION STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1997). *See generally* CONG. BUDGET OFFICE, BACKGROUND PAPER NO. 1, NEW YORK CITY'S FISCAL PROBLEM: IT'S ORIGINS, POTENTIAL REPERCUSSIONS, AND SOME ALTERNATIVE POLICY RESPONSES (1975), *reprinted in Hearings on S. 1833, S. 1862, S. 2514 and S. 2523 Before the S. Comm. on Banking, Hous. and Urban Affairs*, 94th Cong. (1975). For a discussion of conditions and developments in the bond market during this period, see generally J. PETERSEN, CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT (1976) (prepared for Joint Economic Committee, 94th Cong., 2d Session). As Petersen notes, in addition to the New York City bond crisis, the municipal securities market was unsettled during this period due to a variety of factors, including declining economic and fiscal circumstances in a number of cities and states, questions about the enforceability/sanctity of municipal debt contracts, changes to the bankruptcy code, declining institutional demand for municipal securities, and the institution of the 1975 regulatory regime. *Id.*

[331] As Professor Gellis notes, "[d]espite a tremendous increase in the amount of state and local borrowing after World War II, accompanied by an increasing reliance on revenue bond financing rather than general obligation bond financing, the decision not to require disclosure of information by municipal issuers went unquestioned" until the New York City bond crisis of the mid-1970s. Gellis, *supra* note 95, at 17–18 (internal citations and quotations omitted).

[332] *See* 15 U.S.C. § 78o-4(b)(1) (2012); *see also* Ann J. Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 66–67 (1987) (describing creation, structure, and regulatory role of the MSRB). Since its establishment, the MSRB has adopted rules concerning standards of professional conduct and fair practice, record keeping, securities quotations, the sale of new issuers, and other topics. U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-265, MUNICIPAL SECURITIES: OVERVIEW OF MARKET STRUCTURE, PRICING AND REGULATION 6, 9–10 (2012) (describing complex relationship among the SEC, the MSRB, and FINRA, whereby the MSRB "develops rules for broker-dealers engaged in underwriting, trading and selling municipal securities," FINRA is

registration of municipal securities brokers and dealers. In deference to the exempt status of municipal securities (and to protect issuers from direct regulation under principles of comity),[333] Congress also enacted the Tower Amendment at this time.[334]The Tower Amendment, which still exists today, prohibits the Commission and the MSRB from requiring municipal securities issuers to make any disclosure filings with the Commission or the MSRB prior to the sale of securities, and also prohibits the MSRB from requiring any municipal issuer to provide pre-issuance disclosure documents to purchasers and prospective purchasers.[335]

The issue of investor disclosure was not addressed until 1989, after the Washington Public Power Supply System ("WPPSS") defaulted on $2.25 billion of revenue bonds issued to fund the construction of nuclear power plants.[336] Investigations into this crisis raised significant questions about the quality of financial reporting and investor disclosure in the municipal securities market and the conduct of market professionals.[337] Mindful of section 3(a)(2) and

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responsible for conducting surveillance of trade data, taking action against member firms found to have engaged in rule violations, referring evidence of potential violations involving bank dealers to appropriate federal banking regulators and conducting periodic examinations of member firms, and the SEC is responsible for promulgating and/or approving rules relevant to municipal securities, overseeing the activities of self-regulatory organizations like the MSRB and FINRA, conducting its own examinations and inspections of broker-dealers, and investigating and bringing enforcement based on alleged securities law violations).

[333] During the New York City bond crisis, two bills were introduced in Congress that would have imposed disclosure requirements directly upon issuers. S. 2574, 94th Cong. (1975); S. 2969, 94th Cong. (1976). For a discussion of these bills, see Gellis, *supra* note 95, at 65, 75–77. Neither passed. *Id.* According to a 1975 Senate report, Congress maintained the prohibition against direct issuer regulation when the 1975 amendments were enacted for a number of reasons, including comity principles and respect for the ability of state governments to access capital markets, concerns about the costs of regulation for state and local government issuers, and perceived lack of abuses in the municipal market sufficient to justify incursions on state prerogatives. *See* S. REP. NO. 94-75 (1975).

[334] *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o-4(d) (2012).

[335] *See* 15 U.S.C. § 78o-4(d)(1).

[336] *See* Municipal Securities Disclosure, 17 C.F.R. § 240.15c2-12 (2014); *see also* Municipal Securities Disclosure, Exchange Act Release No. 26,985, Fed. Sec. L. Rep. (CCH) ¶ 25,098 (June 28, 1989).

[337] *See generally* DIV. OF ENFORCEMENT, SEC, STAFF REPORT ON THE

the Tower Amendment's proscriptions, neither Congress nor the Commission imposed disclosure obligations directly upon municipal securities issuers in the wake of the WPPSS default.[338] Instead, the Commission adopted Rule 15c2-12 pursuant to its authority to adopt rules to deter fraud and manipulation in the municipal securities market.[339] As originally adopted, Rule 15c2-12 required underwriters participating in primary offerings of municipal securities to obtain, review, and distribute to investors copies of issuers' official statements (a type of disclosure document).[340] In a companion

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INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES (1988).

[338] Together with the section 3(a)(2) exemption, the Tower Amendment forms the basis of the regulatory regime applicable to municipal securities. *See* Securities Exchange Act of 1934, 15 U.S.C. § 78o-4(d) (2012). Based upon these provisions, the Commission has imposed disclosure obligations (and other obligations concerning market practices and procedures) upon municipal securities dealers rather than directly upon issuers. *E.g.*, Exchange Act Release No. 26,985, *supra* note 336. To the extent municipal securities issuers have any disclosure obligations, such obligations are indirect and derive from the Commission's authority under the antifraud provisions of the federal securities laws. *See, e.g.*, *id*.; Municipal Securities Disclosure, Exchange Act Release No. 33,742, 56 SEC Docket 546 (Mar. 9, 1994). These releases, which were issued simultaneously with the adoption and (later) reform of Rule 15c2-12, reflect the SEC's views with respect to the disclosure obligations of participants in the municipal securities market. As these releases reflect, the SEC has expressed the view that issuers are subject to the antifraud provisions of the federal securities laws, including sections 10(b) and 15(c) of the '34 Act. *See* 15 U.S.C. §§ 78(b)–(c).

[339] The SEC adopted Rule 15c2-12 pursuant to its authority under section 15(c)(2) of the '34 Act to enact rules designed to deter fraud and manipulation in the municipal securities market. Municipal Securities Disclosure, Exchange Act Release No. 26,985, *supra* note 336.

[340] Rule 15c2-12 required underwriters in a primary offering of municipal securities to:

> (1) obtain and review a copy of an official statement deemed final by an issuer of securities, except for the omission of specified information; (2) in non-competitively bid offerings, to make available, upon request, the most recent preliminary official statement, if any; (3) to contract with the issuer of the securities, or its agent, to receive, within specified time periods, sufficient copies of the issuer's final official statement, both to comply with [Rule 15c2-12] and any rules of the [MSRB]; and (4) to provide, for a specified period of

statement issued with Rule 15c2-12, the Commission discussed the due diligence obligations of municipal underwriters, including the obligation to review the issuer's official statement.[341]

It took still another crisis—Orange County, California's bankruptcy[342]—for the Commission to address post-offering disclosure.[343] Through amendments to Rule 15c2-12, the Commission prohibited underwriters from participating in a municipal offering unless the underwriter reasonably determined that the issuer (or an obligated person) had agreed to provide specified annual information and notices of certain events to then-existing information repositories.[344] Amendments also prohibited a broker,

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> time, copies of final official statements to any potential customer upon request.

Exchange Act Release No. 26,985, *supra* note 336; *accord* 17 C.F.R. § 240.15c2-12 (2013).

[341] *See* Municipal Securities Disclosure, Exchange Act Release No. 26,100, Fed. Sec. L. Rep. (CCH) ¶ 25,097 (Sept. 22, 1988).

[342] As noted above, for discussion of Orange County's bankruptcy and threatened default, see In the Matter of County of Orange, California, Exchange Act Release No. 36,761, *supra* note 31; Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. CORP. L. 427, 454 (1996) (describing Orange County crisis and losses); Merton H. Miller & David J. Ross, *The Orange County Bankruptcy and Its Aftermath: Some New Evidence*, J. DERIVATIVES 51, 51–60 (Summer 1997). For a brief discussion of market risk control failure and the Orange County situation, see Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 27–28 (1997).

[343] The 1994 amendments were proposed in Municipal Securities Disclosure, Exchange Act Release No. 33,742 [1993–1994 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,324 (Mar. 9, 1994). At the same time, the Commission also published a statement outlining its views as to the application of the antifraud provisions to disclosure in both the distribution and trading of municipal securities. Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33,741, 56 SEC Docket 479 (Mar. 9, 1994). The Commission announced the adoption of the final rule in Exchange Act Release No. 34,961, 57 SEC Docket 2641 (Nov. 10, 1999).

[344] 17 C.F.R. §§ 240.15c2-12(b)(5)(i)(A)–(C) (2013); Municipal Securities Disclosure, Exchange Act Release No. 33,742, *supra* note 343 (proposing release); Municipal Securities Disclosure, Exchange Act Release No. 34,961, *supra* note 343 (adopting release). Under the 1994 amendments, disclosure was required in twelve situations, if material:

dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it had procedures in place providing that it would promptly receive any event notices with respect to that security.[345]

In May 2010, in response to continuing concerns about the quality and timeliness of disclosure, the Commission adopted amendments to Rule 15c-12 requiring broker-dealers and municipal securities dealers to provide additional disclosure with respect to certain issuer events.[346] The 2010 Amendments also eliminated the materiality determination for certain reportable events,[347] expanded

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> (1) Principal and interest payment delinquencies; (2) Non-payment related defaults . . . ; (3) Unscheduled draws on debt service reserves reflecting financial difficulties; (4) Unscheduled draws on credit enhancements reflecting financial difficulties; (5) Substitution of credit or liquidity providers, or their failure to perform; (6) Adverse tax opinions [or events affecting the tax-exempt status of security] . . . ; (7) Modifications to rights of security holders . . . ; (8) Bond calls . . . ; (9) Defeasances; (10) Release, substitution, or sale of property securing repayment of securities . . . ; (11) Rating changes; (12) Bankruptcy, insolvency, receivership or similar event . . . .

§ 240.15c2-12(b)(5)(i)(C). That same year, the SEC also issued interpretive guidance concerning the disclosure obligations of municipal bond market participants under the antifraud provisions of the '33 and '34 Act. Exchange Act Release No. 33,741, *supra* note 343.

[345] *See* 17 C.F.R. § 240.15c2-12(c) (2013). In 2008, the SEC further amended Rule 15c2-12 to require the "broker, dealer, or municipal securities dealer to reasonably determine that the issuer or obligated person has agreed to provide" specified information to the MSRB—through a centralized repository system now known as EMMA, or Electronic Municipal Market Access. Amendment to Municipal Securities Disclosure, Exchange Act Release No. 64,184A, 98 SEC Docket 1908 (May 26, 2010).

[346] Specifically, the 2010 amendments require a "broker, dealer, or municipal securities dealer" to reasonably determine that an issuer or obligated person has agreed to provide notice of specified events in a "timely manner not in excess of ten business days after the event's occurrence." Amendment to Municipal Securities Disclosure, Exchange Act Release No. 62,184A, *supra* note 345; *accord* 17 C.F.R. § 240.15c2-12(c).

[347] Under the 2010 Amendments, the following events must be reported in all instances, even if arguably not material:

> (1) Principal and interest payment delinquencies; . . . (3)

the number and type of reportable events,[348] and imposed time limits for reporting events.[349] The amendments also revised (and largely eliminated) an exemption from Rule 15c2-12's continuing disclosure requirements for municipal securities with put features, such as VRDOs.[350] In conjunction with these amendments, the Commission issued interpretive guidance reminding underwriters of their obligations under antifraud provisions, particularly in cases where a municipal issuer fails to comply with agreements to provide continuing disclosure documents.[351] In commenting on these and

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> Unscheduled draws on debt service reserves reflecting financial difficulties; (4) Unscheduled draws on credit enhancements reflecting financial difficulties; (5) Substitution of credit or liquidity providers, or their failure to perform; (6) Adverse tax opinions . . . [and] (11) Rating changes . . . .

Amendment to Municipal Securities Disclosure, Exchange Act Release No. 62,184A, *supra* note 346; *accord* 17 C.F.R. § 240.15c2-12(c).

[348] The 2010 Amendments added the following new events which must be reported: (1) "issuance by the [IRS] of proposed or final determinations of taxability, Notices of Proposed Issue . . . or other material notices or determinations with respect to the tax status of the security . . ."; (2) "tender offers"; (3) "Bankruptcy, insolvency, receivership, or similar event of the obligated person"; (4) "consummation of a merger, consolidation, or acquisition," or certain asset sales involving the obligated person, or entry into or termination of a definitive agreement related to the foregoing, if material; and (5) the "[a]ppointment of a successor or additional trustee or the change of name of a trustee, if material." 17 C.F.R. § 240.15c2-12(c). *See generally* Amendment to Municipal Securities Disclosure, Exchange Act Release No. 62,184A, *supra* note 346.

[349] *See* 17 C.F.R. § 240.15c2-12(d)(5).

[350] Amendment to Municipal Securities Disclosure, Exchange Act Release No. 62,184A, *supra* note 346.

[351] The interpretive guidance provides, in relevant part, that,

> [t]he Commission believes that if the underwriter finds that the issuer or obligated person has on multiple occasions during the previous five years failed to provide on a timely basis continuing disclosure documents, including event notices and failure to file notices, as required in continuing disclosure agreement for prior offering, it would be very difficult for the underwriter to make a reasonable determination that the issuer or obligated person would provide such information under a continuing disclosure agreement in connection with a

other reforms over the years, Commission staff have expressed the view that the Commission had reached at the outer reaches of its rulemaking authority under 15c2-12.[352]

B. Dodd-Frank Reforms Likely Helpful, But Do Not Go Far Enough

Although Rule 15c2-12 and the antifraud provisions of the federal securities law remain key regulatory and enforcement tools for the Commission, they are limited in important respects relevant to this discussion. First, as mandated by the section 3(2)(a) exemption and the Tower Amendment, Rule 15c2-12 does not impose registration or disclosure obligations directly upon municipal issuers.[353] As a result, unless an issuer or public official engages in fraud in connection with a bond offering or related transaction, it/he/she likely will not face liability under the federal securities laws.[354] Moreover, Rule 15c2-12 and the antifraud provisions remain investor-focused in that they are principally concerned with the timeliness and quality of investor disclosure and with investors' risk

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> subsequent offering. In the Commission's view, it is also doubtful that an underwriter could meet the reasonable belief standard without the underwriter affirmatively inquiring as to that filing history.

See Exchange Act Release No. 62,184A, *supra* note 346 (footnotes omitted).

[352] *See, e.g.*, SEC, DISCLOSURE AND ACCOUNTING PRACTICES IN THE MUNICIPAL SECURITIES MARKET 3 (2007). Thus, while the Commission has reminded issuers that they are "primarily responsible for the content of their disclosure documents, and may be held liable under the federal securities laws for misleading disclosure," liability is based on antifraud principles. Municipal Securities Disclosure, SEC Release No. 26,985, *supra* note 336.

[353] Naomi Jagoda, *State Budget Crisis Task Force: Revisit the Tower Amendment*, BOND BUYER, Jan. 15, 2014, at 1 ("The SEC and MSRB place disclosure requirements on underwriters of munis rather than issuers.").

[354] John W. Schoen, *Shady Finance Deals Put Cities in Regulatory Spotlight*, CNBC (Nov. 20, 2013), http://www.cnbc.com/id/101194543 ("But the rules for such disclosures are much more lax than regulations for public companies, which must provide timely financial disclosures of any 'material' information . . . . Investors in municipal bonds, on the other hand, must wait more than ten months after the end of a local government's fiscal year to get their hands on its audited financial statement.").

of loss due to default.[355] As I have argued in earlier work, Rule 15c2-12 does not address—or really even speak to—systemic risks and costs that cities and taxpayers incur when municipal issuers rely upon public markets for financing—including the risk of tax increases and spending and budget cuts enacted to meet debt service obligations.[356] As I discuss in the next section, while Dodd-Frank speaks to some of these limitations, current reforms do not go far enough to incent and support the type of diligent, disinterested decision-making needed for state and local government fiscal health.

1. Municipal Advisors: New Registration, Fiduciary Duty Requirements

One of Dodd-Frank's most important reforms relating to the municipal securities market relates to municipal advisors, a type of financial intermediary that municipal entities[357] retain for advice regarding the timing and terms of securities offering and related transactions.[358] While many municipal advisors are skilled,

[355] *Id.*

[356] Chung, *supra* note 33, at 1500–07.

[357] Section 975 of Dodd-Frank amended section 15B(e)(8) of the '34 Act to define the term "municipal entity" as

> any State, political subdivision of a State, or municipal corporate instrumentality of a State, including—(A) any agency, authority, or [municipal corporate instrumentality]; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities.

15 U.S.C. § 78o-4(e)(8) (2012).

[358] *See* Registration of Municipal Advisors, Release No. 63,576, *supra* note 103, at 6–8, for a discussion of a range of municipal advisory services provided by municipal advisors. As the SEC noted in its adopting release respecting its final municipal advisor rule,

> [w]ith respect to the issuance of municipal securities, municipal advisors (which may include entities registered as brokers, dealers, municipal securities dealers, or investment advisers acting as municipal advisors), among other things, may assist municipal entities in developing a financing plan, assist municipal entities in evaluating different financing options and structures, assist in the

competent professionals, staff at the SEC, and others have long expressed concern about unethical, incompetent, and unregistered advisors.[359] With these concerns in mind, Dodd-Frank makes two important changes to the regulatory regime.

First, Dodd-Frank provides that anyone who acts as a municipal advisor must register with the Commission.[360] The Act defines municipal advisors to include persons who

> provide[] advice to or on behalf of a municipal entity . . . with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues, or undertakes solicitation of a municipal entity.[361]

> selection of other parties to the financing (such as bond counsel and underwriters), coordinate the rating process, ensure adequate disclosure, and/or evaluate and negotiate the financing terms.

Registration of Municipal Advisors, Exchange Act Release No. 70,462, 2013 WL 6021683 (Sept. 20, 2013) (codified at 17 C.F.R. pts. 200, 240, 249).

[359] *See, e.g.*, *Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 9–11 (2009) (statement of Martha Mahan Haines, Assistant Director, Division of Trading and Markets, SEC). Similarly, a Senate Report related to Dodd-Frank observed that "[d]uring the [financial] crisis, a number of municipalities suffered losses from complex derivatives products that were marketed by unregulated financial intermediaries." S. REP. NO. 111-176, at 38 (2010).

[360] *See* 15 U.S.C. § 78o-4(a)(1)(B). Prior to Dodd-Frank, municipal advisors were not required to register with the SEC so long as they limited their activities "to providing advice as to whether and how a municipality should issue debt securities, including advice with respect to the structuring, timing and terms concerning such issue or issues." SEC Staff Legal Bulletin No. 11, Fed. Sec. L. Rep. P 60011 (C.C.H.) (2012).

[361] Specifically, Dodd-Frank defines municipal advisor to include a person (who is not a municipal entity or an employee of a municipal entity)

> (i) that provides advice to or on behalf of a municipal entity . . . with respect to municipal financial products [including municipal derivatives] or the issuance of municipal securities, including advice with respect to the structure, timing, terms, and other similar matters

Under the Act, this definition includes financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors,[362] but not underwriters.[363] In 2012, after a lengthy rulemaking and comment period, the Commission adopted definitions and promulgated guidance

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> concerning such financial products or issues, or (ii) undertakes a solicitation of a municipal entity.

15 U.S.C. § 78o-4(e)(4)(A). While there is some evidence that using a municipal advisor can reduce issuer costs, the empirical evidence is mixed. *Compare* Ronald W. Forbes, Paul A. Leonard & Craig L. Johnson, *The Role of Financial Advisors in the Negotiated Sale of Tax-Exempt Securities*, 8 J. APPLIED BUS. RES. 7, 7 (1992) ("[C]osts of contracting with financial advisors are not significantly offset by corresponding benefits in the form of lower borrowing costs."), *with* Jayaraman Vijayakumar & Kenneth N. Daniels, *The Role and Impact of Financial Advisors in the Market for Municipal Bonds*, 30 J. FIN. SERVS. RES. 43, 47–48 (2006) ("[U]sing financial advisors results in significantly lower true interest costs, reoffering yields, and underwriter gross spreads for revenue issues.").

362 *See* 15 U.S.C. § 78o-4(e)(4)(B).

363 15 U.S.C. § 78o-4(e)(4)(C) (stating the term municipal advisor, "does not include a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in section 77b(a)(11) of this title), any investment adviser registered under the Investment Advisers Act of 1940 [15 U.S.C. 80b-1 *et seq*.], or persons associated with such investment advisers who are providing investment advice, any commodity trading advisor registered under the Commodity Exchange Act [7 U.S.C. 1 et seq.] or persons associated with a commodity trading advisor who are providing advice related to swaps, attorneys offering legal advice or providing services that are of a traditional legal nature, or engineers providing engineering advice.") (alteration in original). Section 77b(a)(11) of the '33 Act defines "underwriter" as follows:

> [a]ny person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has participated in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customer distributors' or sellers' commission.

15 U.S.C. § 77b(a)(11).

regarding the meaning and scope of the term municipal advisor, established a permanent registration regime for municipal advisors, and imposed certain recordkeeping requirements on advisors subject to the rule.[364]

Second, Dodd-Frank provides that municipal advisors and their associated persons "shall be deemed to have a fiduciary duty" to any advised municipal client.[365] Under this standard, municipal advisors may not engage "in any act, practice, or course of business which is not consistent with the municipal advisor's fiduciary duty or that is in contravention of any rule of the Board [MSRB]."[366] Dodd-Frank directed the MSRB to promulgate rules governing advice provided to or on behalf of municipal entities relating to municipal financial products, and to set professional standards for municipal advisors and test individuals associated with municipal advisors on their proficiency and competency.[367]

The MSRB initially proposed a rule respecting the fiduciary obligations of municipal advisors in 2011, but it withdrew its proposal until such time as the Commission engaged in additional rulemaking respecting the definition municipal advisor and related terms.[368] The Commission adopted a final rule relating to municipal

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[364] The SEC's initial proposal respecting the definition of municipal advisors is set forth in Registration of Municipal Advisors. Exchange Act Release No. 63,576, *supra* note 103. The SEC's proposal was controversial, causing the SEC to promulgate temporary rules respecting the registration of municipal advisors to comply with Dodd-Frank. *See* Temporary Registration of Municipal Advisors, Exchange Act Release No. 62,824, 99 SEC Docket 812 (Sept. 1, 2010) (codified at 17 C.F.R. pts. 240, 249). The temporary registration rules were supposed to last until Dec. 31, 2011; however, the SEC extended the effective date of the temporary rules until September 30, 2012 and later December 2014. Extension of Temporary Registration of Municipal Advisors, Exchange Act Release No. 70,468, 2013 WL 5320964 (Sept. 23, 2013); Extension of Temporary Registration of Municipal Advisors, Exchange Act Release No. 66,020, 102 SEC Docket 2494 (Dec. 21, 2011). The Commission then proposed a permanent rule, s*ee* Exchange Act Release No. 63,576, *supra* note 103, and adopted a permanent rule on September 30, 2013 which is scheduled to become effective on January 14, 2014. *See* Exchange Act Release No. 70,462, *supra* note 358.

[365] 15 U.S.C. § 78-o4.

[366] *Id.*

[367] *See id.* § 975(b)(2)(L)(iii).

[368] Notice of Withdrawal of Proposed Interpretive Notice Concerning the Application of Rule G-17 to Municipal Advisors, Exchange Act Release

advisors in September 2013.[369] Subsequently, on January 9, 2014, the MSRB released the Request for Comment on Draft MSRB Rule G-42, on Duties of Non-Solicitor Municipal Advisors.[370] With respect to the duty of care, the draft materials state that a municipal advisor must:

> (a) exercise due care in performing its municipal advisory activities; (b) possess the degree of knowledge and expertise needed to provide the client with informed advice; (c) make a reasonable inquiry as to the facts that are relevant to a client's determination as to whether to proceed with a course of action or that form the basis for any advice provided to the client; and (d) undertake a reasonable investigation to determine that the municipal advisor is not basing any recommendation on materially inaccurate or incomplete information.[371]

Moreover, the materials provided that

> a municipal advisor that is engaged by a client in connection with . . . an issuance of municipal securities or a municipal financial product that is related to an issuance of municipal securities . . . must also undertake a thorough review of the official

No. 34-65398, 2011 WL 4454537 (Sept. 26, 2011); *MSRB Withdraws Pending Municipal Advisor Rule Proposals*, MUN. SEC. RULEMAKING BD. (Sept. 9, 2011), http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2011/2011-51.aspx.

369 MUN. SEC. RULEMAKING BD., REQUEST FOR COMMENT ON DRAFT MSRB RULE G-42, ON DUTIES OF NON-SOLICITOR MUNICIPAL ADVISORS 4 (2014), *available at* http://msrb.org/~/media/Files/Regulatory-Notices/RFCs/2014-01.ashx?n=1 ("Recently, on September 18, 2013, the SEC acted on that proposal and adopted final rules to, among other things, define who is a municipal advisor, establish a permanent registration regime for that defined set of persons, and establish basic recordkeeping requirements for such advisors.").

370 *Id.* at 1.

371 *Id.* at 7.

> statement for that issue unless otherwise directed by the client and so documented in writing.[372]

With respect to the duty of loyalty, the draft states that loyalty "requires, without limitation, a municipal advisor to deal honestly and with the utmost good faith with a municipal entity client and act in the client's best interests without regard to the financial or other interests of the municipal advisor."[373]

Draft Rule G-42(b) also "requires municipal advisors to fully and fairly disclose to its client in writing all material conflicts of interest, and to do so at or prior to the inception of a municipal advisory relationship."[374] To this end, the draft includes a non-exhaustive list of items requiring disclosure, including:

> [T]he provision by any affiliate of certain advice, services, or products to or on behalf of the client; payments to obtain or retain the client's municipal advisory business; payments received from third parties to enlist the municipal advisor's recommendations; any fee-splitting arrangements with any provider of investments or services to the client; conflicts that may arise from the use of the form of compensation under consideration or selected by the client; and any other engagements or relationships of the municipal advisor or any affiliate that might impair the advisor's ability either to render unbiased and competent advice to or on behalf of the client or to fulfill its fiduciary duty to the client, as applicable.[375]

2. MSRB and G-17: Additional Disclosures for Underwriters, But No Fiduciary Standard

Dodd-Frank also contains important language relating to the issuer/underwriter relationship. Section 975 of the Act obligates the MSRB to propose and adopt rules respecting advice provided to or

[372] *Id.*
[373] *Id.* at 7–8.
[374] *Id.* at 8.
[375] *Id.*

on behalf of municipal entities in connection with municipal securities transactions.[376] Citing section 975, the MSRB has engaged in rulemaking post Dodd-Frank designed to flesh out underwriters' obligations to issuers under MSRB Rule G-17,[377] a rule which

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[376] 15 U.S.C. § 78o-4(b)(2) (2012) ("The Board shall propose and adopt rules to effect the purposes of this chapter with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors."); *Expanded MSRB Mission; Rulemaking for Municipal Advisors*, MUN. SEC. RULEMAKING BD. (Oct. 1, 2010), http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-42.aspx. The term "municipal entity" is defined by section 15B(e)(8) of the '34 Act as follows:

> [A]ny State, political subdivision of a State, or municipal corporate instrumentality of a State, including—(A) any agency, authority, or instrumentality of the State, political subdivision, or municipal corporate instrumentality; (B) any plan, program, or pool of assets sponsored or established by the State, political subdivision, or municipal corporate instrumentality or any agency, authority, or instrumentality thereof; and (C) any other issuer of municipal securities.

15 U.S.C. § 78o-4(e)(8).

[377] *E.g.*, Mun. Sec. Rulemaking Bd., Proposed Rule Change (Form 19b-4) (Aug. 22, 2011), *available at* http://www.msrb.org/Rules-and-Interpretations/SEC-Filings/~/media/Files/SEC-Filings/2011/SR-MSRB-2011-09-R-2.ashx ("More recently, with the passage of the Dodd-Frank Act, the MSRB was expressly directed by Congress to protect municipal entities. Accordingly, the MRSB is providing additional interpretive guidance that addresses how Rule G-17 applies to dealers in municipal securities transactions described below."); *see also* Amendment No. 2., Proposed Interpretive Notice Concerning MSRB Rule G-17, Exchange Act Release No. 65,749 (Nov. 15, 2011) [hereinafter Rule G-17 Amendment No. 2] ("With the passage of the Dodd-Frank Act, the MSRB was expressly directed by Congress to protect municipal entities."); Notice of Filing of Proposed Rule Change Consisting of Proposed Interpretive Notice Concerning the Application of MSRB Rule G-17, Exchange Act Release No. 65,263, 101 SEC Docket 3662 (Sept. 6, 2011). Prior to Dodd-Frank, the MSRB had issued interpretive notices reminding issuers of their good faith and fair dealing obligations. Fair Practice Duties to Issuers of Municipal

requires brokers, dealers, and municipal securities dealers to deal fairly with municipal securities issuers and prohibits brokers, dealers, and municipal securities dealers from using any deceptive, dishonest, or unfair practices.[378] On August 22, 2011, the MSRB filed a proposed rule change with the Commission consisting of a proposed interpretive notice concerning the application of G-17 to underwriting activities.[379] The proposal, as modified by Amendment No. 2 to the MSRB's initial filing, requires a variety of disclosures relating to the role of underwriters[380] and risks and conflicts of

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Securities, MSRB Reminder Notice (Sept. 29, 2009) [hereinafter MSRB Reminder Notice], *available at* http://www.msrb.org/msrb1/pdfs/MSRB-Rule-Book-2013.pdf, *reprinted in* MSRB RULE BOOK 168 (2013); Purchase of New Issue from Issuer, MSRB Interpretive Letter (Dec. 1, 1997) [hereinafter 1997 Interpretive Letter], *reprinted in* MSRB RULE BOOK, *supra*, at 183.

[378] MSRB Reminder Notice, *supra* note 377, at 168 ("In the conduct of its municipal securities business, each broker, dealer and municipal securities dealer shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."); *see also* Dealer Payments in Connection with the Municipal Securities Issuance Process, MSRB Interpretive Notice (Jan. 29, 2007), *reprinted in* MSRB RULE BOOK, *supra* note 377, at 194 ("remind[ing] brokers, dealers and municipal securities dealers . . . of the application of Rule G-20, on gifts, gratuities and non-cash compensation, and Rule G-17, on fair dealing, in connection with payments made and expenses reimbursed during the municipal bond issuance process").

[379] Exchange Act Release No. 65,263, *supra* note 377, at 1; Proposed Rule Change (Form 19b-4), *supra* note 377.

[380] Exchange Act Release No. 65,263, *supra* note 377, at 1. Among other proposals, the interpretive notice as amended (and subsequently approved) sought to require underwriters to disclose the following information to issuers:

> (A) MSRB Rule G17 requires an underwriter to deal fairly at all times with both municipal issuers and investors; (B) the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer; (C) unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is not required . . . to act in the best interest of the issuer without regard to the underwriter's own financial or other interests; (D) the underwriter has a duty to purchase securities from the

interests, including an obligation that certain underwriters disclose all material risks, characteristics, incentives, and conflicts of interest to issuers when recommending complex municipal securities financing (e.g., VRDOs with a swap).[381]

> issuer at a fair and reasonable price, but must balance that duty with its duty to sell municipal securities to investors prices that are fair and reasonable; and (E) the underwriter will review the official statement for the issuer's securities in accordance with, and as part of, its responsibilities to investors under the federal securities laws, as applied to the facts and circumstances of the transaction.

Order Approving Proposed Rule Change, as Modified by Amendment No. 2, Consisting of Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities, Exchange Act Release No. 66,927, 2012 WL 1572504 (May 4, 2012); *see also* Application of MSRB Rule G-17 to Underwriters of Municipal Securities, MSRB Interpretive Notice (Aug. 2, 2012) [hereinafter MSRB Interpretive Notice], *reprinted in* MSRB RULE BOOK, *supra* note 377, at 178.

[381] MSRB Interpretive Notice, *supra* note 380, at 177–78. With respect to the timing of disclosure, the proposed as amended stated as follows:

> All of the foregoing disclosures must be made in writing to an official of the issuer that the underwriter reasonably believes has the authority to bind the issuer by contract with the underwriter and that, to the knowledge of the underwriter, is not a party to a disclosed conflict. Disclosures must be made in a manner designed to make clear to such official the subject matter of such disclosures and their implications for the issuer. The disclosure concerning the arm's-length nature of the underwriter-issuer relationship must be made in the earliest stages of the underwriter's relationship with the issuer with respect to an issue (*e.g.*, in a response to a request for proposals or in promotional materials provided to an issuer). Other disclosures concerning the role of the underwriter and the underwriter's compensation generally must be made when the underwriter is engaged to perform underwriting services (*e.g.*, in an engagement letter), not solely in a bond purchase agreement. Other conflicts disclosures must be made at the same time, except with regard to conflicts discovered or arising after the underwriter has been engaged. For example, a conflict may not be present until an underwriter has recommended a particular financing. In that case, the disclosure must be

With respect to complex financings, the interpretive notice states as follows:

> An underwriter in a negotiated offering that recommends a complex municipal securities financing to an issuer has an obligation under Rule G-17 to make more particularized disclosures than those that may be required in the case of routine financing structures. The underwriter must disclose the material financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure. It must also disclose any incentives for the underwriter to recommend the financing and other associated conflicts of interest. Such disclosures must be made in a fair and balanced manner based on principles of fair dealing and good faith.[382]

Consistent with Dodd-Frank, the MSRB's proposal states (and requires underwriters to disclose) that underwriters do not owe fiduciary duties to issuers.[383] The notice further states that while underwriters' obligations are, "based on the suitability analysis required by the Financial Industry Regulatory Authority ('FINRA') of dealers selling complex products, such as options and securities futures," the notice does not impose suitability requirements upon underwriters in their dealings with issuers.[384] Instead, the interpretive

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> provided in sufficient time before the execution of a contract with the underwriter to allow the official to evaluate the recommendation, as described below under "Required Disclosures to Issuers."

Id. at 178.

[382] *Id.* at 179 (internal citations omitted).

[383] *Id.* at 178 (stating underwriters must disclose that "(ii) the underwriter's primary role is to purchase securities with a view to distribution in an arm's-length commercial transaction with the issuer and it has financial and other interests that differ from those of the issuer; (iii) unlike a municipal advisor, the underwriter does not have a fiduciary duty to the issuer under the federal securities laws and is, therefore, not required to act in the best interests of the issuer without regard to its own financial or other interests").

[384] Proposed Rule Change (Form 19b-4), *supra* note 377, at 16 (citing

notice reminds underwriters that:

> [t]he level of disclosure required may vary according to the issuer's knowledge or experience with the proposed financing structure or similar structures, capability of evaluating the risks of the recommended financing, and financial ability to bear the risks of the recommended financing, in each case based on the reasonable belief of the underwriter.[385]

In 2011, the Commission instituted proceedings to determine whether to disapprove this proposed rule change[386] and on May 4, 2012, in a split vote, the Commission approved the proposed changes to Rule G-17, as modified by Amendment No. 2, with the new rules having gone into effect on August 2, 2012.[387] In anticipation of the effective date, the MSRB issued guidance respecting the interpretation and implementation of the new rule, including guidance with respect to disclosure obligations.[388]

FINRA Rules 2360 and 2370). The suitability or know your customer standard is reflected in regulatory guidance including FINRA Rules 2090 and 2111, entitled "Know Your Customer" and "Suitability," respectively. FINRA Rule 2090 (July 9, 2012), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858 ("Know Your Customer"); FINRA Rule 2111 (Feb. 4, 2013), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859 ("Suitability").

[385] Proposed Rule Change (Form 19b-4), *supra* note 377, at 16.

[386] Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Change, Exchange Act Release No. 65,918, 102 SEC Docket 2142 (Dec. 8, 2011).

[387] Exchange Act Release No. 66,927, *supra* note 380; Press Release, Mun. Sec. Rulemaking Bd., MSRB Establishes New Protections for State and Local Governments That Issue Bonds (May 7, 2012), *available at* http://www.msrb.org/News-and-Events/Press-Releases/2012/MSRB-Creates-New-Protections-for-State-and-Local-Governments.aspx ("[U]nderwriters of municipal securities will be required to disclose to their state and local government clients risks about complex financial transactions, potential conflicts of interest, and compensation received from third-party providers of derivatives and investments, among other new requirements. The new rules include explicit and expanded requirements for underwriters aimed at protecting state and local governments that issue municipal bonds.").

[388] MSRB Interpretive Notice, *supra* note 380, at 177–78.

3. Swaps: Suitability-Style Rules Swaps Stakeholders When Making Recommendations

In addition to reforms relating to municipal advisors and underwriters, Dodd-Frank also makes important reforms to swap regulation. Specifically, subtitle B of Title VII of the Dodd Frank Act ("Title VII") amended the '33 Act and the Securities Exchange Act of 1934 ("'34 Act") to expand the regulation of the swaps market.[389] Under Dodd-Frank,

> regulatory authority over derivatives is divided between the Commission and the [Commodities Future Trading Commission ("CFTC")], with the Commission having authority over [security-based] swaps, the CFTC having authority over swaps, which represent the overwhelming majority of the overall market for derivatives subject to the Dodd-Frank Act, and the Commission and the CFTC jointly regulating mixed swaps.[390]

Focusing first on swaps, Title VII of Dodd-Frank amended the Commodity Exchange Act ("CEA") to provide the CFTC with authority to regulate swaps in ways relevant to the municipal securities market.[391] Specifically, section 731 of Dodd-Frank amended the CEA to give the CFTC rulemaking authority to impose business conduct requirements on swap dealers and major swap participants in their dealings with municipal issuers, which are

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[389] Dodd-Frank Act, Pub. L. No. 111-203, §§ 763–68, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 15 U.S.C.).

[390] Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps, Exchange Act Release No. 69,491, 2013 WL 1835417 (May 1, 2013) (providing background information on proposed amendments to the '33 Act and the '34 Act to "substantially expand the regulation of the SB swap market with a new goal of establishing a new regulatory framework within which this market can evolve").

[391] Dodd-Frank Act § 731. Under Dodd-Frank, the SEC has the authority to regulate security-based swaps, security-based swaps dealers, and major security-based swap participants. *Id.* § 731(a).

among so-called "special entities" covered by recent rulemaking.[392] Earlier this year, the CFTC adopted final rules implementing this authority under the CEA and Dodd-Frank.[393] In a nutshell, the CFTC's business conduct standards require swap dealers to: (i) know your counterparty; (ii) verify counter-party eligibility; and (iii) satisfy disclosure obligations.

With respect to the know your counterparty requirement, the CFTC's new rules establish a suitability standard[394] and related rules

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[392] Section 731 of Dodd-Frank amends the CEA by adding section 4s(h) to the CEA, providing the CFTC with both mandatory and discretionary rulemaking authority to impose business conduct standards on swap dealers and major swap participants in their dealings with counterparties, including so-called "special entities." 77 Fed. Reg. 9734, 9735 (Feb. 17, 2012) (codified at 17 C.F.R. pts. 4, 23). 7 U.S.C. § 6s(h)(2)(c) and newly-enacted Rule 23.401(c) define special entity as follows:

> (i) a Federal agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); (iv) any governmental plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); or (v) any endowment, including an endowment that is an organization described in section 501(c)(3) of [the Internal Revenue Code].

Dodd-Frank Act § 731(h), 7 U.S.C. § 6s(h)(2)(c); *see also* Business Conduct Standards for Swap Dealers and Major Swap Participants Dealing with Counterparties, Including Special Entities, 17 C.F.R. § 23.401(c) (2014) (defining a special entity in the same terms). In addition to adding section 4s(h) to the CEA, Dodd-Frank (through section 764 of the Act) added virtually identical business conduct standards provisions to section 15F(h) of the '34 Act providing the Commission with authority to impose business conduct standards on security-based swap dealers and major security-based swap participants in their dealings with counterparties, including Special Entities. Dodd-Frank Act § 764, 15 U.S.C. § 78o-10.

[393] *See* Swap Dealers and Major Swap Participants, 17 C.F.R. § 23 (describing final rules adopted to prescribe external business conduct standards for swap dealers and major swap participants). According to the CFTC, "[t]he proposing release [for these rules] included rules mandated by Section 4s(h) as well as discretionary rules that the [CFTC] determined were appropriate in the public interest, for the protection of investors and in furtherance of the purposes of the CEA." 77 Fed. Reg. at 9735.

[394] *See, e.g.*, 17 C.F.R. § 23.402(b).

which require swap dealers (but not major swap participants)[395] that act as advisors to special entities[396] (i) "to make a reasonable determination that any swap that they recommended to a Special Entity is in the Special Entity's best interest," and (ii) to use reasonable efforts to obtain information required to make a reasonable determination that the recommended swap is in the entity's best interest.[397] The CFTC stated in its implementing release "that the final 'know your counterparty' rule does not, by itself, create an 'advisor' status or impose a fiduciary duty on a swap dealer."[398]

Under the CFTC's rules, "a swap dealer 'acts as an advisor to a Special Entity' when the swap dealer recommends a swap or trading strategy involving a swap that is tailored to the needs or characteristics of the Special Entity."[399] A "swap dealer that acts as an advisor to a Special Entity" has "a duty to make a reasonable determination that any swap or trading strategy involving a swap recommended by the swap dealer is in the best interests of the Special Entity"[400]:

> Any swap dealer that acts as an advisor to a Special Entity shall make reasonable efforts to obtain such information as is necessary to make a reasonable determination that any swap or trading strategy involving a swap recommended by a swap dealer is in the best interest of the Special Entity, including information relating to: (i) The [Special Entity's] financial status . . . [and] future funding needs; (ii) The tax status . . . ; (iii) The hedging, investment, financing, or other objectives of the Special Entity; (iv) The experience of the Special Entity with respect to entering into swaps, generally, and swaps of the type and complexity being recommended; (v)

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[395] As set forth in the implementing release for these rules, "[t]he final rules for major swap participants do not include the suitability duty, pay-to-play, "know your counterparty" and scenario analysis provisions." 77 Fed. Reg. at 9742.
[396] *Id*. at 9783.
[397] *See, e.g.*, *id.* at 9770–74 (establishing institutional suitability rules concerning recommendations to counterparties).
[398] *Id.* at 9747.
[399] 17 C.F.R. § 23.440(a).
[400] *Id*. § 23.440(c)(1).

> Whether the Special Entity has the financial capability to withstand changes in market conditions . . . ; and (vi) Such other information as is relevant to the particular facts and circumstances of the Special Entity . . . .[401]

Notably, the "best interest" standard is not a fiduciary duty.[402] A swap dealer must do the following to satisfy the "best interest" standard: (i) "[m]ake[] a reasonable effort to obtain necessary information;" (ii) "[a]ct[] in good faith and make[] full and fair disclosure of [any] material facts and conflicts of interest" relating to the swap; and (iii) "[e]mploy[] reasonable care that any recommendation made to a Special Entity is designed to further the Special Entity's stated objectives."[403]

Moreover, the CFTC's new rules include safe harbors from the definition of "acts as an advisor" for swaps dealers that "do[] not express an opinion as to whether the Special Entity should enter into a recommended swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity."[404] Swaps dealers that fall within this safe harbor are not subject to the best interest rules cited above.[405] As the CFTC's implementing release points out, "a swap dealer that wishes to avoid engaging in activities that trigger a 'best interests' duty must [do so by] appropriately manag[ing] its communications" with Special

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[401] *Id*. § 23.440(c)(2).

[402] CFTC, Q&A—BUSINESS CONDUCT STANDARDS FOR SWAP DEALERS AND MAJOR SWAP PARTICIPANTS WITH COUNTERPARTIES FINAL RULEMAKING, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/bcs_qa_final.pdf (last visited Apr. 16, 2014) ("'Best interests' is not a fiduciary duty under this rule.").

[403] David Taub, *Implications of the CFTC Business Conduct Rules*, *in* MUNICIPAL SWAPS: UNDERSTANDING THE NEW WORLD OF REGULATION 3, 13 (SIFMA & Gov't Fin. Officers Ass'n 2013), *available at* http://www.sifma.org/uploadedfiles/events/2013/municipal_swaps_-_understanding_the_new_world_of_regulation/understanding-muni-swaps-march-11-2013.pdf.

[404] *See, e.g.*, 17 C.F.R. § 23.440(b); 77 Fed. Reg. 9734, 9783–85 (Feb. 17, 2012) (codified at 17 C.F.R. pts. 4, 23) (citing Appendix A to subpart H for additional guidance respecting the safe harbor); 77 Fed. Reg. at 9825 (discussing suitability standards applicable to recommendations generally); 77 Fed. Reg. at 9786–87 (discussing the duty to make reasonable efforts).

[405] 77 Fed. Reg. at 9818.

Entities.[406] A swap dealer also does not "act as an advisor" to a Special Entity (and thus, is not subject to the best interest rule cited above) (i) if the Special Entity represents in writing that it "will not rely upon recommendations provided by the swap dealer and will instead rely on advice from a qualified representative," or (ii) "if the swap dealer discloses to the Special Entity that it is not undertaking to act in the best interests of the Special Entity."[407]

The CFTC's rules also require swap dealers and major swap participants to disclose to counterparties material information about swaps, including material risks, characteristics, incentives, and conflicts of interest.[408] In addition, the CFTC's rules require "swap dealer[s] or major swap participant[s] that offer[] to enter or enter[] into a swap with a Special Entity . . . [to] have a reasonable basis [for] believ[ing] that the Special Entity [counterparty] has a representative that" meets the following standards and criteria:

> (i) [Is] sufficient[ly] knowledge[able] to evaluate the transaction and its risks; (ii) Is not subject to a statutory disqualification; (iii) Is independent of the swap dealer or major swap participant; (iv) Undertakes a duty to act in the best interests of the Special Entity it represents; (v) Makes appropriate and timely disclosures to the Special Entity; (vi) Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; and (vii) [where the special entity is a municipal entity], is subject to restrictions on certain political contributions [to certain public officials of the municipal entity].[409]

With respect to security-based swaps, the SEC proposed business conduct standards in 2011 that were intended to coordinate with

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[406] *Id.* at 9784.
[407] Taub, *supra* note 403, at 14.
[408] 77 Fed. Reg. at 9824.
[409] *Id.* at 9826. On February 17, 2012, the CFTC adopted new "pay-to-play" rules for swaps dealers. Among other rules and prohibitions, the CFTC's new rule bars swaps dealers from entering into a swap or a trading strategy involving a swap with a state or local government entity for two years if either the swap dealer or certain of its officers and employees make certain political contributions to certain candidates or officeholders associated with the government entity. *Id.* at 9827.

CFTC rulemaking.[410] The SEC reopened the comment period on these regulations this past summer, with final comments due on or before July 22, 2013.[411] Finally, the SEC has proposed, and in a number of cases adopted, rules that track the CFTC's rules with respect to definitions and other matters.[412]

VI. A Framework For Reform

In light of this regulatory background, and mindful of the challenges that local governments face in meeting obligations to citizens in the face of fiscal strain, the next section of this Article proposes reforms to the federal securities laws intended to increase transparency and oversight, and to incent and support better financial decision-making by state and local governments and their financial intermediaries. These reforms include: (i) compliance with a uniform accounting regime; (ii) the creation of a national public pension monitoring agency; (iii) enhanced collection and aggregation of data respecting complex instruments, including derivatives such as interest rate swaps; and (iv) a mandatory fiduciary standard for state and local government officials, underwriters, and derivatives counterparties in public finance deals.

A. Uniform Standards

As a first step toward greater transparency and better decision-making around public finance, I would require state and local governments to comply with uniform regulatory and accounting standards respecting public sector compensation plans,

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410 Taub, *supra* note 403, at 5.

411 Exchange Act Release No. 69,491, *supra* note 390.

412 *Id.* and rules cited therein. The SEC's final municipal advisor rule (discussed above):

> exempt[s] any registered swap dealer [from the definition of municipal advisor] to the extent that such dealer recommends a municipal derivative or a trading strategy that involves a municipal derivative, so long as such dealer or associated person is not 'acting as an advisor' to the municipal entity or obligated person, applying the standards applicable to the parties to such transactions under the existing regulatory regime of the CFTC.

Exchange Act Release No. 70,462, *supra* note 358.

including pension and OPEB plans. Rules for reporting and funding public pension plans are set forth in GASB Statements Nos. 25 and 27,[413] and GASB has proposed and enacted reforms over the years to increase transparency and the usefulness of financial information relating to pension reporting.[414] But, while many states' laws require compliance with GASB standards, compliance is not mandatory in all jurisdictions.[415] As a result, depending on state law, individual

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413 *See generally* GOV'T ACCOUNTABILITY STANDARDS BD., STATEMENT NO. 25: FINANCIAL REPORTING OF DEFINED BENEFIT PENSION PLANS AND NOTE DISCLOSURES FOR DEFINED CONTRIBUTION PLANS (1994) (establishing financial reporting standards for public defined benefit pension plans, but note that GASB approved an exposure draft on June 27, 2011 which would amend GASB Statement No. 25); GOV'T ACCOUNTABILITY STANDARDS BD., STATEMENT NO. 27, ACCOUNTING FOR PENSIONS BY STATE AND LOCAL GOVERNMENT EMPLOYERS (1994) (establishing standards for pension information in the financial reports of state and local government employers, but note that GASB approved an Exposure Draft on June 27, 2011 which would amend GASB Statement No. 27); GOV'T ACCOUNTABILITY STANDARDS BD., STATEMENT NO. 50, PENSION DISCLOSURES (2007) (amending GASB Statement Nos. 25 and 27); GOV'T ACCOUNTABILITY STANDARDS BD., STATEMENT NO. 67, FINANCIAL REPORTING FOR PENSION PLANS: AN AMENDMENT OF GASB STATEMENT NO. 25 (2012); GOV'T ACCOUNTABILITY STANDARDS BD., STATEMENT NO. 68, ACCOUNTING AND FINANCIAL REPORTING FOR PENSIONS: AN AMENDMENT OF GASB STATEMENT NO. 27 (2012).

414 *Summary of Statement No. 67: Financial Reporting for Pension Plans—An Amendment of GASB Statement No. 25*, GOV'T ACCOUNTABILITY STANDARDS BD. (June 2012), http://www.gasb.org/cs/ContentServer?site=GASB&c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176160219444; *Summary of Statement No. 68: Financial Reporting for Pensions—An Amendment of GASB Statement No. 2*, GOV'T ACCOUNTABILITY STANDARDS BD. (June 2012), http://www.gasb.org/cs/ContentServer?site=GASB&c=Pronouncement_C&pagename=GASB%2FPronouncement_C%2FGASBSummaryPage&cid=1176160219492.

415 For example, the Texas legislature enacted a law, which requires the state and permits local governments, not to use GASB Statement No. 45, which requires the governmental entities that provide health care, life insurance, and other post-employment benefits to retirees to report the estimated accrued cost of the benefits. TEX. GOV'T CODE ANN. §§ 2266.051–.052, 2266.102 (West, Westlaw through end of 2013 Third Called Sess. of the 83rd Legislature); *Summary of Statement No. 45: Accounting and Financial Reporting by Employees for Postemployment*

issuers may or may not comply with them when reporting on financial obligations in this area, as dictated by state law.

There are undoubtedly reasons for not requiring compliance with uniform standards—differences in state law driven by local conditions, the cost of compliance especially for small governmental units, and the difficulty of finding qualified personnel to prepare and manage financial statements all probably figure into the calculus. Moreover, standards such as those promulgated by GASB may require tweaking. But while existing standards are not perfect, there are costs to having no standards and/or to non-compliance as well. Non-compliance and the lack of uniformity can make it difficult to detect risks and to understand the nature and extent of liabilities. This, in turn, can make it difficult to determine when and whether a local government is in fiscal distress, when and whether intervention is warranted (and what kind of intervention is warranted), and whether risks at the local level are creating systemic risks and instability in our larger system of public finance. In addition, underwriters may consider whether an issuer follows GASB standards when assessing credit-worthiness and setting deal terms, suggesting that issuers that do not comply may have higher borrowing costs.[416] Caution respecting costs is unquestionably warranted—and a "one size fits all" set of standards for issuers without regard to size does not make sense. Accordingly, I would require compliance with a uniform set of accounting standards tailored to meet the needs of different issuers. Similar to a 2012 SEC recommendation,[417] I would also require states to provide advice and technical assistance to local governments to ease the burden of compliance.

Benefits Other than Pensions, GOV'T ACCOUNTABILITY STANDARDS BD. (June 2004), http://www.gasb.org/st/summary/gstsm45.html.

[416] U.S. GOV'T ACCOUNTABILITY OFFICE, STATE AND LOCAL GOVERNMENT RETIREE BENEFITS: CURRENT FUNDED STATUS OF PENSION AND HEALTH BENEFITS 7 (2008), *available at* http://www.gao.gov/assets/280/271576.pdf.

[417] In its 2012 report on the state of the municipal securities market, the SEC recommended reforms of this sort. This 2012 report recommends that Congress "authorize the Commission to establish the form and content of financial statements for municipal issuers who issue municipal securities . . . [and also to recognize] a designated private-sector body" as the standard setter for generally accepted for federal securities law purposes. SEC REPORT, *supra* note 107, at viii, 136.

B. National Oversight Body for Public Pensions

I also recommend a federal oversight regime for public pensions. As noted, public pensions exist outside the regulatory regime applicable to private sector pensions.[418] As long-time public finance expert James Spiotto has argued, a public pension funding authority could provide technical assistance in the form of standards and best practices to address critical issues of risk and underfunding.[419] As Spiotto suggests, this might include standards and advice regarding: (i) "[w]hat contribution increases are necessary by both public employers and employees" to ensure the health and stability of pension systems; (ii) "[c]an taxes be raised"—as a legal and/or practical matter—"to fund pensions"; (iii) "[a]re intercepts of state revenue necessary to provide . . . source[s] of funding"; (iv) can required annual contributions be made, or are required contributions "unreasonable, unaffordable [or] otherwise not sustainable"; (v) "[w]ill continued funding of" pension obligations cause the state or local "government to be unable to fund the costs of essential government services"; (vi) "[w]hat cost-cutting measures are required to achieve affordable benefits"; (vii) "[w]hat past employment benefits are affordable and what ones, if any, or not"; (viii) "[w]hat adjustments to past employment benefits are mandated to avoid a . . . meltdown"; and (ix) "what is the minimum acceptable funding percentage for funding pension benefit [sic]."[420]

This type of information and advice could force stakeholders to engage in politically difficult conversations and help financial decision-making at governmental units—particularly smaller units with fewer resources to devote to pension monitoring.[421] It also could give public officials and citizens access to better data regarding national trends, allowing state and federal regulators to identify systemic risks more proactively and earlier on. Better and timelier information and advice could incent and support better decision-making by government officials, citizens, public workers, and regulators on issues critical to state and local government fiscal health.

Finally, a public pension authority could develop model workout and restructuring plans for governments with persistent

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[418] *See supra* Part III.B.
[419] SPIOTTO, *supra* note 177, 31–32.
[420] *Id.*
[421] *See id.* at 33.

underfunding problems. As Detroit's example suggests, state and local governments "with unsustainable debt burdens and a diffuse group of creditors" can find it difficult to get creditors to agree to restructuring plans.[422] In such circumstances,

> [i]t may be difficult to secure high participation by creditors . . . as a group, as individual creditors may consider that their best interests would be served by trying to free ride in the hope of ultimately receiving payments in line with their original contracts. Both fears of free riding and other issues of inter-creditor equity may inhibit creditors from accepting a proposed debt restructuring, prolonging the restructuring process and making it less likely that a deal will achieve the objective of restoring sustainability.[423]

For example, bondholders may hold out for payment, believing that they may be first in line for the issuer's limited assets. Likewise, public worker stakeholders may be disinclined to consider voluntary adjustments to salary, pension, and OBEP promises, especially in states with non-impairment provisions.[424] In the absence of work-out mechanisms, crises may erupt, linger, and get solved (if at all) in an ad-hoc fashion.[425] A more orderly restructuring of unsustainable debt—perhaps through a statutory regime and/or control board-style mechanisms that include support from a public pension authority—could reduce loss and speed return to fiscal stability.

C. Greater Transparency, Oversight Respecting the Use of Complex Instruments and Derivatives

I also recommend establishing an information clearinghouse and oversight mechanisms (perhaps leveraging existing assets at the MSRB and the SEC and new clearing rules/platforms called for

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[422] ANNE O. KRUEGER, A NEW APPROACH TO SOVEREIGN DEBT RESTRUCTURING 7 (Int'l Monetary Fund 2002).
[423] *Id.*
[424] *See* SPIOTTO, *supra* note 177, at 4, 14.
[425] *See* KRUEGER, *supra* note 422, at 7–9 (describing difficulties in facilitating restructuring). *See generally* SPIOTTO, *supra* note 177.

under Dodd-Frank) respecting the use of complex instruments and derivatives by state and local governments. For example, an oversight body could require parties to disclose deal terms—including costs and risks associated with complex instruments—to a central, publicly-accessible clearinghouse in standardized form. This clearinghouse could include not just information regarding the particular instrument at issue; instead, it also could include disclosure respecting a state or local government's overall funding plan, financial condition, and debt profile. This would allow stakeholders to understand how a particular issuance fits into a state or local government's overall financial condition. In Detroit's case, for example, a clearinghouse could have put the COP and related swap transactions in proper context—i.e., as part of a larger mix of funding obligations and debt burdens, perhaps shining a light on risks and dangers associated with these transactions. The GFOA has developed a checklist respecting the use of derivatives by state and local governments; the categories of risk and cost identified in this checklist would be a good place to start in developing disclosure norms.[426]

Of course, any such reforms would need to be harmonized with Dodd-Frank rules, especially those relating to the clearing, trading, and reporting of derivatives transactions. For example, Dodd-Frank requires the clearing of all swaps that the CFTC and SEC determine should be cleared.[427] My proposal would add to these and related requirements by requiring disclosure of swaps and other non-traditional instruments, including instruments such as COPs, CABs, and POBs, along with information about how the instrument at issue fits into the municipal entity's overall financial condition. In this way, investors, taxpayers, regulators, and other stakeholders could consider how Detroit's COPs and associated swaps fit into Detroit's overall indebtedness and plan for funding pension obligations. Similarly, taxpayers, investors, and regulators could have seen how Jefferson County's swaps fit into the county's associated municipal bond offerings for water and sewer improvements. My goal is not simply to enhance transparency with

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426 GOV'T FIN. OFFICERS ASS'N, DERIVATIVES CHECKLIST 2–4 (2010), *available at* http://www.gfoa.org/downloads/GFOA_debtderivschecklistf2010.pdf.

427 Dodd-Frank § 723(h), 7 U.S.C. § 2(h) (2012) ("It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization . . . .").

respect to particular standardized derivative transactions, but also to put transactions in a larger context of state and local government debt levels and funding strategies. This would allow regulators, public officials, citizens, and other stakeholders to identify trends and to see how individual financing plans stack up against regional and national norms.

D. (Another) Call for the Fiduciary Standard

My final proposed reform relates to obligations owed to state and local governments and their taxpayers. In earlier work, I have called for an expansion of the fiduciary standard in the municipal space—specifically, for reforms to the federal securities laws which would apply a fiduciary standard to the following stakeholders (in addition to municipal advisors) when they provide advice to state and local governments respecting the structure, timing, and/or terms of municipal securities offerings or related transactions: (i) underwriters; (ii) derivatives counterparties (at the structuring phase); and (iii) state and local government officials and board members of public authorities, special districts, and other issuing instrumentalities.[428] Under my proposed rule, underwriters and derivatives counterparties would owe fiduciary duties to issuers, while public officials would owe fiduciary duties to taxpayers at the structuring phase—i.e., when they are negotiating respecting the terms of offerings and providing advice respecting funding plans. I recommended defining "advice" broadly to include a wide range of services provided by stakeholders, and I also argued against permitting stakeholders to "contract out" of the fiduciary standard via private-ordering. I discussed the nature and scope of this proposed obligation in detail in earlier work, along with objections to a fiduciary standard for these stakeholders, and I incorporate my earlier arguments here,[429] highlighting a few key points below.

First, I recommend a fiduciary standard at the structuring phase, when stakeholders are providing advice respecting the structure, timing, and terms of offerings and derivatives transactions, because raising standards of care and loyalty at this point (given that these are negotiated transactions) has the potential to mitigate conflicts of interest that pervade public finance.[430] For example,

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[428] Chung, *supra* note 33, at 1519–35.
[429] *Id.*
[430] A number of commentators have raised concerns about conflicts of

underwriters' interest in obtaining lucrative swaps business for affiliated individuals and corporations can lead to questionable conduct, recommendations, and/or deal terms, as the Jefferson County case suggests.[431] Likewise, politicians' interest in not offending key voting constituencies can lead to transactions (like the Detroit COPs and swaps), which "kick the can down the road" and only deepen financial distress. While existing rules may be sufficient with respect to fraud of the sort seen in Jefferson County, they do not speak to the pervasive, subtle conflicts of interest that permeate public finance. As one commentator argued in testimony before the SEC, municipalities may overpay in swaps transactions because the "municipality's grossly overcompensated hired guns—swap advisors, lawyers and such—provide inadequate protection and are conflicted by self-interest" and "skewed incentives."[432] While the fiduciary standard would not prevent every instance of wrongdoing, it might cause dealers to institute more robust internal controls designed to detect and prevent corrupt and/or unduly expensive deals[433] and/or impact fee structures in ways which would incent better oversight and better align economic incentives.[434]

Second, I have argued that a fiduciary standard is particularly important with respect to complex, non-traditional instruments involving interest rate risk and the possibility of termination fees and other penalties because state and local

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interest in public finance. *E.g.*, Kalotay, *supra* note 300.

[431] Chung, *supra* note 33, at 1523.

[432] Kalotay, *supra* note 300, at 1 (quoting Andrew Kalotay, *What Makes Muni Swaps So Special? Nothing, Actually*, BOND BUYER, Feb. 7, 2011, at 27).

[433] In *Kahn v. Lynch Communication Systems, Inc.*, the Delaware Supreme Court held that, while controlling stockholders can never escape entire fairness review, they may shift the burden of persuasion by showing that the transaction was approved either by an independent board majority (or in the alternative, a special committee of independent directors), or, if certain conditions are met, by an informed vote of the majority of the minority shareholders. 638 A.2d 1110, 1117 (Del. 1994). I would not permit burden-shifting in the municipal context, largely because I do not think that issuers and their public officials and citizens are well-positioned to assess and/or demonstrate fairness/unfairness.

[434] *See In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 441–48 (Del. Ch. 2012) (discussing "perverse incentives" created by fee arrangement involving investment bank with conflict and investment bank hired to cleanse conflict); Chung, *supra* note 33, at 1520–26.

governments are particularly vulnerable to spikes in payment obligations, penalties, and fees. Derivatives involve costs and risks that may not be immediately apparent to all stakeholders, and even under the best of circumstances, smart people make mistakes. These mistakes are not limited to the municipal market, of course—consider J.P. Morgan's recent experience with the "London Whale."[435] But because municipal issuers cannot easily generate additional revenues, should payment obligations spike or termination fees arise due to revenue constraints, they are particularly vulnerable to risks associated with derivatives that have interest rate risk and/or the possibility of termination fees. While I would not ban derivatives in the municipal securities market outright,[436] I would require counterparties to comply with fiduciary duties of care and loyalty when structuring or recommending these transactions. For example, under a fiduciary standard, both public officials and derivatives counterparties ought to be required to take a hard look at the following issues before structuring or recommending a transaction involving complex instruments: (i) material financial characteristics and material risks of the proposed financing, including any market, credit, operational and/or liquidity risks; (ii) fees charged by the swaps provider as well any incentive fees paid to the provider in exchange for recommending the financing; (iii) the impact of termination, including any termination fees; and (iv) the potential impact of the transaction on the municipal issuer's overall economic condition, defined broadly to include an analysis of the likelihood that the issuer will meet its financial obligations to creditors, consumers, employees, taxpayers, suppliers, constituents, and others as they become due and its service obligations to constituents both currently and in the future.[437]

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[435] See Heidi N. Moore, *JP Morgan's Loss: The Explainer*, MARKETPLACE (May 11, 2012), http://www.marketplace.org/topics/business/easy-street/jp-morgans-loss-explainer, for a relatively "plain English" description of J.P. Morgan's difficulties.

[436] It is worth noting, however, that "[m]istakes with regard to unhedged derivatives transactions have been . . . described as imprudent and lethal to the fiscal health of a municipality." Spiotto, *supra* note 78, at 3.

[437] In proposed interpretive guidance, the MSRB suggested that questions such as these may be relevant to disclosure obligations. *See, e.g.*, Exchange Act Release No. 65,918, *supra* note 386. In a similar vein, the Government Finance Officers Association has proposed that state and local governments consider the following risks, among others, when using derivative products: (i) basis risk; (ii) tax risk; (iii) interest rate risk; (iv) collateralization risk;

In earlier work, I acknowledged that the fiduciary standard is not a cure-all.[438] I acknowledge this reality again, here. Fiduciary obligations cannot insulate municipal issuers and their stakeholders from every challenge to fiscal well-being, and well-intentioned stakeholders acting diligently and loyally may still make decisions that do not turn out well in the end. Moreover, legal standards cannot prevent human beings from falling prey to corruption and/or self-interested behavior. Still, a fiduciary standard has the potential to improve the quality of deliberations associated with municipal funding plans, or to (at least) reduce the frequency and severity of harms associated with fiduciary breaches. Certain relationships might be probed in greater depth. Certain agreements and transactions might not pass muster. This could improve outcomes for state and local governments, and thus indirectly for taxpayers responsible for paying back municipal bond debts.

I also have acknowledged objections to a fiduciary rule for underwriters and derivatives counterparties[439] (again, only at the structuring phase) in earlier work, and I acknowledge those objections again, here. For example, underwriters have argued that a fiduciary standard is inappropriate in other contexts on the grounds that the issuer-underwriter relationship is adversarial rather than fiduciary in nature, and they likely would raise this objection to my proposal of an expanded fiduciary duty in public finance.[440] While there is force to this argument, there are reasons why municipal securities underwriters ought to be subject to a fiduciary standard at the negotiation/structuring phase. By their own account, underwriters provide advice to issuers respecting the merits and wisdom of entering into particular transactions, including advice with respect to structure, timing, and terms.[441] Municipal issuers rely upon this

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(v) counterparty risk; (vi) termination risk; (vii) market-access risk; (viii) rollover risk; and (ix) credit risk. GOV'T FIN. OFFICERS ASS'N, DERIVATIVES CHECKLIST, *supra* note 426, at 3.

[438] Chung, *supra* note 33, at 1524–26.

[439] *Id.* at 1526–35.

[440] *E.g.*, HF Mgmt. Servs. v. Pistone, 818 N.Y.S.2d 40, 42 (N.Y. App. Div. 2006) ("New York law . . . does not recognize the existence of a fiduciary obligation that is based solely on the relationship between an underwriter and issuer. . . .").

[441] *See Rule G-23: Activities of Financial Advisors*, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-23.aspx (last visited Apr. 16, 2014) (stating that a financial advisory relationship "shall not be deemed to exist when, in the

advice (or at least take it seriously), not only because they depend on underwriters to access to capital markets, but also because there are likely to be power imbalances and information asymmetries between underwriters on one hand and issuers on the other.[442] Issuers are

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course of acting as an underwriter and not as a financial advisor, a broker, dealer or municipal securities dealer renders advice to the issuer, including advice with respect to the structure, timing, terms and other similar matters concerning the issuance of municipal securities"). Under the current regime, underwriters providing this sort of advice are able to avoid the fiduciary standard: MSRB Rule G-23, as amended, states that a financial advisory relationship:

> [s]hall not be deemed to exist when, in the course of acting as an underwriter and not as a financial advisor, a broker, dealer or municipal securities dealer renders advice to the issuer, including advice with respect to the structure, timing, terms and other similar matters concerning the issuance of municipal securities.

Id. To deal with potential conflicts of interest between the role of the financial advisor and the role of underwriter, Rule G-23, as amended, prohibits a broker, dealer, or municipal securities dealer that served as a financial advisor to an issuer for a particular issue sold on either a negotiated or competitive bid basis from switching roles and underwriting the same issue. *Id.* In its model disclosures, SIFMA comments that

> [m]arketing materials and other documents that precede an official engagement, such as pitch books, responses to requires for proposals, term sheets, requested analyses and other materials used in the course of marketing or performing municipal bond banking services all may contain information that could the misconstrued as "advice" within the meaning of the Act [Dodd-Frank].

SIFMA, MODEL CLARIFYING STATEMENTS FOR MUNICIPAL SECURITIES UNDERWRITERS 2 (2011), *available at* http://www.sifma.org/issues/capital-markets/municipal-securities/g-17-model-disclosures/resources. To deal with this possibility, SIFMA suggests that its member firms include a disclosure statement in all such materials stating that materials do not contain advice within the meaning of the securities laws, and further stating that the member firm "has financial and other interests that differ from those of the [Issuer]" and is not a fiduciary. *Id.*

[442] As the Commission has argued in the context of municipal advisors,

> [t]he availability of . . . a variety of financing options has led to an increasing reliance on external advisors by municipal entities that issue municipal securities to assist them in deciding among the multiplying array of

simply less likely to have the expertise, experience, and/or knowledge of current market conditions that underwriters claim to possess when they market their services to public officials.[443] In other contexts, where experienced stakeholders provide advice in exchange for a fee—most notably, investment advisors—a fiduciary standard applies.[444] A fiduciary standard for underwriters and derivatives counterparties at the structuring phase would recognize the advice-focused realities of the issuer-underwriter and issuer-derivatives counterparty relationships. It also would support public confidence in the integrity and utility of the capital markets in its dealings with public funds.[445]

> structural choices for their debt and to help them negotiate with the multiplying number of intermediaries.

Registration of Municipal Advisors, Exchange Act Release No. 63,576, *supra* note 103, at 15 (citing Jayaraman Vijayakumar & Kenneth N. Daniels, *The Role and Impact of Financial Advisors in the Market for Municipal Bonds*, 30 J. FIN. SERVS. RES. 43, 46 (2006)).

[443] As the Delaware Supreme Court has recognized, "even good faith fiduciaries" can fall prey to a controlled mindset when dealing with an experienced, powerful controlling party. *In re* Southern Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 763 (Del. Ch. 2011), *vacated on other grounds*, No. 961-CS, 2011 WL 6382006 (2011) (holding special committee convened to consider proposals from controlling shareholder fell prey to "mindset that too often afflicts even good faith fiduciaries trying to address a controller" when it only considered strategic option presented by controller).

[444] *See* Arthur B. Laby, *SEC v. Capital Gains Research Bureau and the Investment Advisors Act of 1940*, 91 B.U. L. REV. 1051, 1078 (2011) (noting that federal fiduciary duty for investment advisors [a category of financial intermediary generally understood to provide advice in exchange for a fee] "has become firmly entrenched in the law"). As Laby notes, in proposing its pay-to-play rules, which prohibit an advisor from providing advice to a government client for two years after the advisor has made a contribution to covered elected officials and/or candidates, the Commission stated that the "Supreme Court has construed Section 206 [of the Investment Advisors Act] as establishing a federal fiduciary standard governing the conduct of advisors." *Id.* at 1079 (citing Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41,018, 41,022 (July 10, 2010) (codified at 17 C.F.R. §§ 275.206(4)–5, 275.204-2, 275.206(4)-3).

[445] As Professor Tuch argues in the context of IPOs, "[t]o permit it [the underwriter] to act in self-interest or third-party interest in such a transaction would be to damage community confidence in the integrity and

I also recognize that critics of a fiduciary standard also might argue that new obligations are unnecessary, since underwriters are already subject to good faith and fair dealing rules under MSRB Rule G-17 and certain derivatives providers are subject to the above-mentioned CFTC rules. While I do not object to efforts to require additional disclosure respecting obligations owed (or not owed, as the case may be), I am not convinced that a non-fiduciary fair dealing standard plus disclosure will have a meaningful effect on the behavior of financial institutions, issuer decision-making, or taxpayer outcomes. A growing body of research has questioned the effectiveness of the "empower and educate" approach,[446] with researchers finding that disclosure of conflicts of interest can make things worse because (i) people fail to discount advice from biased advisors as much as they should, and (ii) disclosure can increase the

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utility of the role and in capital markets generally." Andrew Tuch, *Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts*, 7 J. CORP. L. STUD. 51, 76 (2007).

[446] There is a growing body of literature which suggests that education and disclosure may not lead to better decision-making or improved outcomes. *See, e.g.*, Daylian M. Cain, George Loewenstein & Don Moore, *Coming Clean but Playing Dirtier: The Shortcomings of Disclosure as a Solution to Conflicts of Interest*, *in* CONFLICT OF INTEREST: CHALLENGES AND SOLUTIONS IN BUSINESS, LAW, MEDICINE AND PUBLIC POLICY 104–121 (Don A. Moore, Daylian Cain, George Loewenstein & Max H. Bazerman eds., 2005) [hereinafter Cain et. al., *Coming Clean but Playing Dirtier*]; Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1 (2005) [hereinafter Cain et. al., *The Dirt on Coming Clean*]; Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197, 197 (2008); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 813 (2006); John Beshears, James J. Choi, David Laibson & Brigitte C. Madrian, *How Does Simplified Disclosure Affect Individuals' Mutual Fund Choices?* 1 (Harvard Kennedy School, Working Paper No. RWP09_16, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1400943 (finding no evidence that Summary Prospectus disclosure, which was designed to simplify mutual fund disclosure, affected portfolio choices). *See generally* James J. Choi, David Laibson & Brigitte C. Madrian, *Are Empowerment and Education Enough? Underdiversification in 401(k) Plans*, BROOKINGS PAPERS ON ECON. ACTIVITY, no. 2, 2005, at 151, *available at* http://www.brookings.edu/~/media/projects/bpea/fall%202005/2005b_bpea_choi.pdf.

bias in advice because advisors feel morally licensed and strategically encouraged to exaggerate their advice even further.[447] Research also suggests that customers of financial institutions are not aware, and may not understand, legal distinctions between fiduciary and non-fiduciary relationships, and thus may be unknowingly vulnerable to opportunistic behavior by those not subject to fiduciary standards.[448] For all of these reasons, the disclosure of non-fiduciary status plus good faith and fair dealing rules may not offer powerful enough incentives to alter behaviors which have caused harm.[449]

I acknowledge that public officials also might argue that a fiduciary standard is unnecessarily duplicative of state law.[450] While

[447] *See, e.g.*, Daylian M. Cain, George Loewenstein & Don A. Moore, *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosure of Conflicts of Interest*, 37 J. CONSUMER RES. 836, 836 (2010); Cain et. al., *Coming Clean but Playing Dirtier*, *supra* note 446, at 104; Cain et. al., *The Dirt on Coming Clean*, *supra* note 446.

[448] In its 2008 report for the SEC, Rand Corporation found that investors are unaware of the basic different legal requirements of brokers [traditionally not subject to a fiduciary standard] and investment advisors [subject to a fiduciary standard]. *See* ANGELA A. HUNG, NOREEN CLANCY, JEFF DOMINITZ, ERIC TALLEY, CLAUDE BERREBI & FARRUKH SUVANKULOV, RAND INST. FOR CIVIL JUSTICE, INVESTOR AND INDUSTRY PERSPECTIVES ON INVESTMENT ADVISORS AND BROKER-DEALERS 71 (2008), *available at* http://www.sec.gov/news/press/2008/2008-1_randiabdreport.pdf.

[449] Because of problems with the "educate and empower" approach, I am inclined not to let underwriters and derivatives providers contract out of fiduciary obligations when they provide advice to municipal entities.

[450] For example, board members of public authorities in New York State are already subject to fiduciary duties. In 2004, citing concerns about the size and impact of public authorities, then New York State Governor George Pataki created the New York State Commission on Public Authority Reform. N.Y. STATE COMM'N PUB. AUTH. REFORM, REPORT i (2006). In 2005, after the Commission issued a report respecting the importance and level of oversight of public authorities, the Public Authorities Accountability Act was enacted into law. *Id.*; N.Y. PUB. AUTH. LAW § 2 (McKinney 2011); Press Release, Governor's Task Force on Implementation of 2009 Public Authorities Reform Act, Public Authorities Reform Act Takes Effect Today (Mar. 1, 2010). This law strengthened the role of the Authorities Budget Office, imposed additional public authority reporting requirements, and established fiduciary duty requirements for members of public authority boards, along with other whistleblowing and operational requirements. N.Y. CONST. art. VIII, § 3; N.Y. PUB. AUTH. LAW §§ 6, 2800; *id.* § 2824 (stating board members must "perform each of their duties as board members, including but not limited to those imposed by this

it is true that other bodies of substantive law may be implicated, there are benefits to standardizing and formalizing a fiduciary standard via the federal securities law. A uniform fiduciary standard would encourage public officials across jurisdictions to exercise a consistent level care and loyalty[451]—something that has not always happened, despite best intentions.[452] A federal standard (enforced by

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section, in good faith and with that degree of diligence, care and skill which an ordinarily prudent person in like position would use under similar circumstances, and may take into consideration the views and policies of any elected official or body, or other person and ultimately apply independent judgment in the best interest of the authority, its mission and the public"); AUTH. BUDGET OFF., NEW PROVISIONS OF THE PUBLIC AUTHORITIES REFORM ACT OF 2009 (2009), *available at* http://www.abo.ny.gov/abo/ProvisionsPARA2009.pdf; Lynn Wilson & Clayton Eichelberger, *New York State Public Authority Reform: Where We Have Come From and Where We Need To Go*, 11 N.Y. ST. B. ASS'N GOV'T LAW & POL'Y J. 15, 20 (2009). New York State law also requires local governments to adopt comprehensive investment policies respecting the investing, monitoring, and reporting of the funds of local governments, including policies respecting permitted types of investments of the local government. *See* N.Y. GEN. MUN. LAW § 39.

[451] *See, e.g.*, *Code of Professional Ethics*, GOV'T FIN. OFF. ASS'N, http://www.gfoa.org/index.php?option=com_content&task=view&id=98&Itemid=108 (last visited Apr. 16, 2014) ("[Government finance officers] shall recognize and be accountable for their responsibilities as officials in the public sector. They shall be sensitive and responsive to the rights of the public and its changing needs. They shall strive to provide the highest quality of performance and counsel. They shall exercise prudence and integrity in the management of funds in their custody and in all financial transactions. They shall uphold both the letter and the spirit of the constitution, legislation, and regulations governing their actions and report violations of the law to the appropriate authorities."). For a discussion of ethics in public administration, see generally Carol W. Lewis & Bayard L. Catron, *Professional Standards and Ethics*, *in* HANDBOOK OF PUBLIC ADMINISTRATION 699 (James L. Parry ed., 1996).

[452] For example, Commission staff have observed that public officials have on occasion failed to act with a high degree of diligence with respect to the disclosure of issuer financial information. *See* In the Matter of County of Orange, California, Exchange Act Release No. 36,761, *supra* note 31 ("The Supervisors . . . had a duty to take steps appropriate under the circumstances to ensure accurate disclosure was made to investors regarding . . . material information. The Supervisors, however, failed to take appropriate steps. For example, while the Supervisors believed that they could rely on the County's officials, employees or other agents with respect to these

federal regulators) also would reduce the likelihood that state enforcement actions would proceed—or not proceed—for political reasons.

Finally, I have acknowledged that cost is a key consideration, and I reiterate my concern about costs here. That said, it is not clear that applying a fiduciary standard would increase costs or reduce the type or quality of investment opportunities available. Whereas industry-sponsored research suggests that these are potential downsides to a uniform fiduciary regime,[453] other researchers have found that the fiduciary standard does not increase costs or reduce investor choice.[454]

VII. Conclusion

At the end of the day, addressing fiscal distress at the state and local government levels requires an enormous amount of

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offerings, they never questioned these officials, employees or other agents regarding the disclosure of this information; nor did they become familiar with the disclosure regarding the County's financial condition. Had they taken such or similar steps . . . in light of his or her knowledge, that the disclosure regarding the County's financial condition may have been materially false or misleading."); *see also* In the Matter of the City of Miami, Exchange Act Release No. 47,552, 79 SEC Docket 2580 (Mar. 21, 2003) (Commission opinion).

[453] *See* SIFMA, STANDARD OF CARE HARMONIZATION: IMPACT ASSESSMENT FOR SEC 3 (2010), *available at* http://www.sifma.org/issues/item.aspx?id=21999 (concluding that "[w]holesale adoption of the Investment Advisers Act of 1940 for all brokerage activity is likely to have a negative impact on consumers (particularly smaller investors)" with respect to investment "[c]hoice, [p]roduct access, and [a]ffordability of advisory services").

[454] *See* Michael S. Finke & Thomas P. Langdon, The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice 20–21 (Mar. 9, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019090 (finding (i) the number of registered representatives doing business within a state as a percentage of total households does not vary significantly among states with stricter fiduciary standards and (ii) that there is no statistically significant difference between advisers in states that have a strict fiduciary standard versus states with no fiduciary standard in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance).

political courage and hard work—both of which inevitably are in short supply. Public officials must be prepared to have honest conversations about what cities and towns need, and what they can afford, and they must be willing to advance cost-saving measures, even if particular constituencies might object. Citizens must speak openly and honestly about how governmental resources ought to be allocated, particularly when economic circumstances mean that hard choices will have to be made. Conflicts of interest are always a danger. For all of these reasons, I have argued here and elsewhere that better information collection, more uniform standards, and a mandatory, non-waivable fiduciary standard for public officials, financial institutions, and financial professionals involved in public finance could help to ensure that those in a position to advise and/or bind government make well-informed decisions.[455] The data repositories and oversight bodies that I suggest here could support these stakeholders' financial decision-making while also permitting regulators, taxpayers, and public workers to measure and assess community-funding plans against national norms. These reforms will not guarantee success—but they might give state and local governments a fighting chance. In these difficult times, for cities like Detroit, perhaps that is all we can ask.

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[455] In a forthcoming work examining the fiduciary standard, Sitkoff explains that a "mandatory fiduciary core serves a cautionary and protective function within the fiduciary relationship . . . that clarifies rights [and obligations] for third parties," and thus is "reconcilable with an economic theory of fiduciary law." Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW (Andrew Gold & Paul Miller eds., forthcoming 2014).