

Feeling the Pinch

Vallejo bankruptcy filing may be the tip of iceberg
by Aisha Jefferson

June 16, 2008 -- Encumbered with ballooning labor costs and years of recurring debt that led to a \$16 million budget shortfall amid a looming recession, the cash-strapped San Francisco Bay Area suburb of Vallejo sought shelter from its financial woes via a recent Chapter 9 bankruptcy filing. But some governmental experts worry that Vallejo's May 23 filing could be a more common option for local government bodies nationwide that struggle to maintain financial solvency.

"The fear is that Vallejo may be the tip of the iceberg, that Vallejo may not be the exception," says James E. Spiotto, a municipality bankruptcy specialist and partner at Chicago-based law firm Chapman and Cutler LLP. "Once you have a downturn in the economy, within a year to two afterward, you start to see reduced tax revenues from other local governments." Spiotto says whenever you have a downturn, specifically during a housing market slump, every house in foreclosure poses a challenge in getting taxes paid, and as property values decline, the tax rates are lowered, leading to less money in local government coffers to budget for infrastructure improvements, public safety, and schools.

A Chapter 9 filing provides a financially distressed municipality protection from its creditors as it develops and negotiates a plan for the adjustment of debts, according to the Administrative Office of the U.S. Courts Website.

Officials in north Alabama's Jefferson County are working to avoid filing for bankruptcy after becoming entangled in a series of exotic bonds, which were used for sewer system improvements. The bonds had decreased to junk status, leaving the county with interest rate payments that jumped from about \$130 million annually to about \$260 million. Orange County in southern California, the fifth most populous county in the nation, filed for bankruptcy in 1994 after \$1.6 billion in investment loss.

Since 1980, about 35 towns, villages, or counties filed for bankruptcy, Spiotto says. "That is nothing compared to Chapter 11s or Chapter 7s, which are really in the tens of thousands filed a year," he adds. "The bankruptcy of a municipality is a rare event. It's maybe done as a last resort."

Filing a bankruptcy petition was something newly elected Vallejo Mayor Osby Davis spent the first five of the past seven months in office to avoid.

Davis, Vallejo's first black mayor, says the city went through every reasonable option to evade filing, including negotiating with labor unions to find permanent solutions for lowering pay raises, but all options led to delaying "the inevitable" for a year or two. The city simply didn't have the ability to curb expenditures to make it financially solvent, he says, so filing a petition for bankruptcy was its best option. Spikes in the economy exasperated the problem, he adds. Vallejo is the largest city in California to file for bankruptcy.

Davis says three factors caused the city to file for bankruptcy. The first was its failure to heed the warning signs of impending financial crisis that the city was aware of since 1993, where its expenditures were growing faster than its revenue. Second, the city fell victim to the "put off till tomorrow what it could've done today syndrome" regarding expenditures and revenues issue. Last, bad management decisions were a factor.

"Our contracts are going up at such a rapid pace," says Davis, who explains that providing medical benefits for retirees has become too expensive since people are living longer. The city paid out \$5.4 million in

compensated absences for people who retired, and based upon current contracts, unions were entitled to a total of 13.7% in pay increases, making the city responsible for about \$5 million annually in raises added to the budget, Davis says.

"The relationship between the labor unions and the administration had become so strained that it was impossible to work through," he adds. In the meantime, the city awaits a federal judge's decision on whether it is insolvent and eligible for the bankruptcy filing.

It can take several years to come up with a plan to get it approved, with the city paying a certain amount of the debt owed to creditors over the next 10 to 20 years, Spiotto says. "There's no quick payment for pre-petitioned debt," Spiotto says.

He also says filing for bankruptcy could've been avoided if the city had an oversight or refinancing commission on the state level to review the city's financial process. He points out that refinancing and oversight authorities are created to help local governmental bodies resolve financial distress. There are two fundamental advantages: financial credibility and access to capital markets if the city has an assured source of revenue to pay debt service, which is isolated from bankruptcy and other credit risk; and access to a variety of fiscal tools to enforce fiscal discipline, since the commission would be an independent entity removed from the political pressure of the local government.

There is nothing legislated in California to allow the state to offer assistance to Vallejo, and "the state, to some degree, is the one who has to create the authority. It is difficult to do it on a local level," Spiotto says, adding that there are a number of states that have oversight authorities.

And given the stigma associated with bankruptcy, Spiotto says he was somewhat surprised with Vallejo's unanimous city council decision to file. "The pain is so much in a municipal market you have to pay more interest and cutting public services," he says. Vallejo is already bracing for the leper treatment. Two major redevelopment projects may be shelved indefinitely because it would need bonds issued to build the infrastructure, which would be too expensive now that the city's gone bankrupt.

"Not many people would want to take a chance on a community that filed for bankruptcy," Davis says, explaining that when you file for bankruptcy, it "really means that you have dishonored a promise you made to your employee contracts that you have."

Davis says the city still looks the same, other than the loss of some employees, and that, for the most part, some of Vallejo's 117,000 residents "are relieved we have done something to get a handle on the problem."

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