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Turnaround Topics

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The Case for Independent Oversight in Municipal Restructurings

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Phrases like "financial control board," "fiscal board" and "emergency manager" send shivers through the spines of politicians and voters alike. Isn't democracy the absolute best form of government ever? Of course it is, but sometimes there are unintended consequences even of good things. For example, take borrowing money with full intentions of paying it back — be that a pension for a former municipal employee or a lender that helped finance a water treatment plant — and tax collections drop as people move away. Who is responsible then?

As citizens, we have promised to pay trillions of dollars more in future state, city and other municipal obligations than we have set aside, can expect to save over the coming years or can realistically earn through investments. These liabilities will result in many situations where the solutions will include higher taxes, less spending on government services or debt restructuring — and in many cases, it will include all three. It is no wonder that corporate insolvency professionals consider municipal distress a growth area for their industry.

Root Causes of Municipal Distress and the "Reelection Lens"

There are three main contributors to municipal distress: (1) unfunded pension obligations; (2) long-term debt that was issued to cover short-term deficits; and (3) lack of investment in — and maintenance of — infrastructure. Each factor is its own version of "kicking the can," which occurs when elected officials must make economic decisions when they are only a few months or few years away from reelection. Called "the reelection lens," it affects almost every decision that an elected body or individual makes during their tenure. Let's be clear: No one wakes up in the morning with the intent of making bad decisions (politicians included). It happens because tough decisions are going to impact some constituents unevenly, and those constituents vote. Even if the elected official courageously makes decisions without considering the reelection lens, situations change, and in municipal finance, these changes are almost always negative.

Municipal restructurings occur when it is no longer easy to ignore any of these root causes and when the capital markets will no longer lend on the municipality's promise to pay. There is much in common between municipal distress and typical corporate distress, including the need to address fundamental strategy, long-term viability and short-term cash flow. However, municipal restructurings have a level of complexity that makes them very different. Governments must provide for public safety, respond to natural emergencies and educate children, and there is no ability to opt out of those "businesses." Governments are intended to exist in perpetuity; they cannot liquidate and cannot be sold. They cannot turn their pension obligations over to the PBGC, and they do not have owners or creditors that can step in, infuse capital and force change.

Elusiveness of Accountability

We learned in high school government class that accountability is (at least on paper) a strong feature of democracy. If elected officials are not doing the right thing or meeting the will of the people, they are not reelected. However, the intersection of perpetual government operations and municipal finance allow for many decisions to be financed at a low cost over a long period of time. This is great for long-term capital needs, but it inadvertently allows for a mismatch between (a) short-term services and benefits and (b) who pays for them. Think of it as buying groceries on a credit card and not paying the credit card off every month or at any time in the next year. In the public sector, most residents do not know that the grocery bill is not being paid. Thus, many decisions lack a level of immediate accountability. The current taxpayers, citizens and visitors are receiving services and benefits but shifting the cost to future taxpayers.

Why Disrupt Democracy?

If an elected official or elected body makes poor decisions, it is often not evident for years. At a minimum, the decision-makers have long since been replaced or completed their terms of office. Herein lies the need for temporary disruption of our democratic process (gasp!).

Independent oversight can provide insulation against the whims of elected officials — not those who have served in the past, but those who serve presently or in the future. Independent oversight curtails decision-making through the lens of reelection. Outside oversight can ensure that constituents understand both the short- and long-term impacts of a decision. This means that stakeholders understand the assumptions that are being made to support a decision: whether these assumptions are reasonable or optimistic, and what the trade-offs are between difficult options. At a minimum, an outside authority will ensure that tough decisions are evaluated independent of any individual's next election options.

Apolitical, independent oversight, as an additional resource to elected officials, solves five problems better than democratically elected officials alone during times of severe municipal distress. These problems include (1) changing the dialogue from win/lose to win/win, (2) transparency of information and action, (3) inclusive problem-solving, (4) accountability and (5) long-term stability and economic development.

First, oversight authority comes into existence through a process that is well-traveled, such as the processes in Pennsylvania and Michigan; through situation-specific state legislation, as is the case in New York and Massachusetts; or through some other regulatory or legal undertaking. Regardless of the manner of adoption, the introduction of an oversight authority results in a transition between rhetoric and heated debates among politicians and stakeholders — "I win, you lose" — to a quieter moment in which the parties take a step back while the authority gets up to speed and spends time listening to the constituencies. This breathing spell sets the tone for how the parties will move forward — "you win, I win" — and can ensure that the loudest voice is not the only voice heard.

Second, transparency is legitimized. Virtually every candidate runs on a "transparency" platform these days. But soon after an election, the deplorable information systems, antiquated business processes and quirky accounting methods become evident. Bad facts surface. It is virtually impossible to have immediate data transparency when you cannot even understand what you are reading and lack confidence in what you are seeing. Elected officials then struggle with what to share and what to keep close, and all too soon, the reelection lens comes into focus, and important facts and trends that appear in a push for transparency become inconvenient to winning reelection.

An outsider, who is not focused on winning the next election, can change the government's approach, narrow transparency to key data, and truncate the argument of "but we've always done it this way" to make sure that important information is visible to everyone. Independent authorities can expose contracting and procurement inefficiencies and conduct special-purpose audits if necessary. Stakeholders do not need 20 years of history to make decisions, but they do need to know that current key data and analyses are unbiased and dependable.

Third, boards can ensure that the elected officials work across political divides to solve problems and engage experts to bring new thinking to the situation. Inclusion of taxpayers, community activists, retirees and the corporate community in the information-gathering process often yields creative and transformative solutions to problems that previously appeared unsolvable. Such inclusion also helps stakeholders appreciate the difficulty of the decisions at hand, understand the reasons behind the choices that have been made and accept their roles in the implementing the solution.

Fourth, while lack of accountability strangely seems to be a part of our democratic process today, an external authority can instill true responsibility and accountability in elected officials (at least during the board's tenure). A well-operating oversight board should not focus on the past unless it is critically important to moving the revitalization forward. Rather, they should focus on bringing together the constituents to craft a better future. If — and only if — the elected officials cannot agree on the necessary plans, budgets and priorities should the board then step in to make decisions. None of the control boards or independent authorities with which the authors have worked ever sought to make decisions in lieu of the decisions that elected officials would make in the normal course. However, when it was clear that no responsible decision could be crafted because of partisan politics or special interests, the outside authorities fulfilled their appointed roles. Developing measurable outcomes and holding government employees and officials accountable for executing on those plans becomes the fiscal board's responsibility, which helps ensure that the parties accept long-overdue changes in service delivery and work together to make government as efficient as possible and accept long-overdue changes in service delivery.

Lastly, government entities need vision and long-term strategies, just like other enterprises. This vision is different from the dreams and platitudes that are heard on the campaign trail because this is "blocking and tackling" fundamental governance issues, such as the following: Which services are essential, and which ones are "nice to have"? Which functions are best performed by the government, and which ones are best performed by third parties? What about our community supports long-term economic growth? Independent oversight establishes a framework for responsible and balanced decision-making into the future.

Fiscal Oversight Works

The highest-profile municipal insolvency, at least historically, was New York. In October 1975, the city neared a bond default and had insufficient cash to meet its obligations. The New York State Financial Emergency Act created the Emergency Financial Control Board and instituted a control period to oversee virtually all financial matters of the city, including causing the city to adopt responsible accounting practices. The discipline instilled during these dark days remains, and New York has demonstrated stability and growth ever since.

Washington, D.C., also experienced a return to stability and economic development as a result of independent oversight, as has Detroit. This is not to say that fiscal control can or will solve every problem or that all stakeholders are thrilled with their individual outcomes. However, looking back over 40 years, it is encouraging to note that supplementing the traditional political roles with independent oversight — at least for a short period — can be successful.

Today, all eyes are focused on the unprecedented Puerto Rico crisis, whose predicament is made more complex by its misunderstood relationship with the U.S. Each of the three causes for municipal distress previously discussed have flourished in the Commonwealth for more than a decade. No doubt there are (and were) elected officials who intended to make the best decisions that they could at the time, but they were mesmerized by the light of the "reelection lens" and believed that Puerto Rico's future would be brighter. (For reasons beyond the scope of this article, the U.S. government — through action and inaction — exacerbated just about every bad decision.) However, when the taxpayers determined that the future was brighter elsewhere, they voted by moving off the island, which ensured that the future could not be bright enough to make good on the government's promises. Now, Puerto Rico is on the cusp of working with an independent oversight board to transform and revitalize itself.[1]

Parameters for Municipal Restructuring

Once the realization occurs that past practices cannot sustain the future, the difficult work of balancing the interests of all the stakeholders begins. Ideally, a restructuring would be accomplished under the guidance and oversight of a control board through negotiations with creditors and stakeholders. This would occur after the municipality has developed a clear plan and understanding of its mission, service delivery and financial condition. During this process, parties would have access to the same information and could participate in the constructive development of these plans and solutions to problems. A municipal restructuring either under chapter 9 of the U.S. Bankruptcy Code, or one that will follow these general parameters, may ultimately be required to ensure that dissenting parties are bound by the decisions of the board and the stakeholders.

Regardless of how the restructuring is accomplished, the restructuring should satisfy two key tests that are drawn from bankruptcy law: the best-interest-of-creditors test and the feasibility test. While balancing the best interest of creditors, the plan must also be feasible today — and for the foreseeable future. In the City of Detroit bankruptcy proceeding, the authors were asked to evaluate whether the city's adjustment plan was feasible. This work led to the following test being developed:

> *Is it likely that the city, after confirmation of its plan, will be able to sustainably provide municipal services to its citizens, and make payments contemplated without the significant probability of default?*[2]

Working from the end of the restructuring process backward, this test can be used to guide the oversight board. When implemented correctly, a fiscal board should act as a mirror to the elected officials, ensuring that the analysis for decision-making uses proper assumptions and balances short-term impact with long-term feasibility. At a philosophical level, fiscal boards should provide guideposts and guardrails for the elected officials. At times, the board will take the heat for politically difficult decisions. Fiscal boards should avoid focusing on the past, as focus on blame does little to ensure a positive future. Finally, a fiscal board's oversight should be as apolitical as possible; its only agenda should be to support full transparency, good decision-making and solutions that are fair and sustainable.

Without independent oversight, there is a "natural" tendency for elected decision-makers to be guided by special interests and view challenging issues through the focus of the reelection lens, which will undermine the hard work that has been done.

At a tactical level, fiscal boards — at a minimum — should ensure that elected officials establish long-term fiscal plans that balance the needs of prior creditors with the need to invest in the stabilization of the municipality and attract outside investments. This will include ensuring that delivery of essential services (not the "nice-to-haves") is focused and efficient. Fiscal boards must also ensure that the public understands the totality of the municipality's obligations, including those that are off-balance sheet and contingent. In addition, the fiscal board must also ensure that the assumptions used throughout the process are reasonable and are not designed to shift current obligations to future generations.

Independent oversight, including the difficult idea that democracy must be interrupted or at least supplemented for a period, is a tool to stop the intergenerational shift of government obligations. The feasibility test not only provides guidance during the restructuring process, it can also serve as a framework for oversight. Any entity that has restructured must fundamentally reconnect with its purpose and change its practices. A fiscal board that continues to provide some limited oversight beyond the initial restructuring will readily return to this framework time and again to ensure that decisions are made holistically. Without independent oversight, there is a "natural" tendency for elected decision-makers to be guided by special interests and view challenging issues through the focus of the reelection lens, which will undermine the hard work that has been done. **abi**

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1 For more information on Puerto Rico's oversight board, *see* Sonia Colón, "ABI Exclusive: The Ins and Outs of the House-Passed PROMESA Bill," XXXV *ABI Journal* 7, 8, 54-57, July 2016, *available at* abi.org/abi-journal. Stay current on the latest news from the Commonwealth by visiting ABI's "Puerto Rico in Distress" webpage at abi.org/PR-crisis.

2 Exerted and abridged from M. Kopacz Expert Report (July 18, 2014), *available at* detroitmi.gov/portals/0/docs/em/bankruptcy%20information/m.%20kopacz%20expert%20report%20to%20judge%20rhodes%20071814.pdf.