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The Gordian Knot of a Project Revenue Bond Default

W. Bartley Hildreth

Wichita State University, Wichita, Kansas, U.S.A.

Revenue bonds finance projects that are designed to yield a specified revenue stream that will cover both operational expenses and periodic debt service. These bond deals involve complex arrangements regarding the generation and dispersal of project-related funds. To ensure that all parties understand these arrangements, the terms are written into the record through bond covenants that legally bind the parties. A project's financial viability is assessed through a reading of these (and other disclosure) documents. What happens when the assumptions upon which the financing is based do not materialize? What happens when the project turns into an unreliable facility with all parties contemplating legal action to minimize their respective liability? This case study is of one such situation. After reviewing the project's financing structure and the default that occurred, as well as the resulting dilemmas facing a new mayor, the case study of a waste-to-energy facility presents the workout as implemented in a financial reorganization.

DEBT AND DEFAULT

A wide array of parties are involved in debt creation and management. The participants include the issuer (or the ultimate risk bearer if different from the issuer), the investors with funds to loan for a price, investment bankers to buy the issuer's bonds and sell them to the investors, a bond counsel willing to issue an opinion on the legality of the debt instruments, a trustee to monitor the issuer on behalf of the bondholders, credit raters to assess the probability of default, and (very infrequently) state and federal government oversight agencies. The ability of the participants to work together in a complex market is not tested just during issuance of the securities but also later, in the course of operating the project which was financed by the bonds that still are being repaid through periodic debt service payments (Hildreth, 1987; 1993).

Debt creation imposes an explicit burden of debt repayment. Sometimes the debt repayment conditions fail to be honored, resulting in default. The general concept of default

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is a single, distinct occasion involving nonpayment of a financial obligation. Default is either failure to repay the principal amount borrowed or to pay scheduled interest payments on time. In both cases, a delay in payment by only a few days still meets the definition of a default even though the delay imposes a negligible economic impact on the bondholders. Continuing nonpayment of principal or interest imposes a much more significant burden.

Default is also defined by obligations, duties, and responsibilities that are more procedural than economic. The obligations are usually detailed in specific covenants that bind the debtor to particular practices and policies, and are combined into a document termed an indenture. Covenants include pledges to transfer and retain a specified stock of funds in certain restricted accounts; to maintain levels of property and casualty insurance; to revise rates to levels sufficient to cover all expenses and coverage requirements; and numerous other features designed to protect the assets covering the bondholders' claims. Violation of any single covenant results in an "event of default." According to Spiotto (1993: Section 13.43): "An 'Event of Default' is the agreed upon occurrence that allows the bondholders or their representative (indenture trustee) to take appropriate action, including the institution of the remedies set forth in the indenture." The trustee's remedies include a range of legal action to force the debtor to take the steps contained in the indenture; assert the trustee's control over the project to protect bondholders' interests; and/or accelerate as due and payable all outstanding bonds. As pointed out by a representative of Moody's Investors Service (Smith, 1979: 245-246), such obligations seek "to prevent default" rather than merely to enforce the payment of delinquencies. In other words, an issuer pledges to follow certain procedural terms and conditions; failure to follow the covenants (often termed a "technical" default) alerts the bondholders to the possibility of repayment problems. The indenture thus serves to anticipate repayment problems before the bondholders incur actual economic loss.

The municipal finance community asserts that a technical default is less significant than a default because of the distinction between the violation of procedural covenants and the nonpayment of principal and interest. (See Advisory Commission on Intergovernmental Relations, 1985; Feldstein, 1983.) While not necessarily differing on the apparent economic difference between the two, the law is more precise and less tied to economic calculations. Spiotto, perhaps the most prominent municipal default legal expert, clarifies that a "default ripens into an Event of Default after notice has been given to the issuer for the commencement of the grace period and, after a lapse of time, the default remains uncured" (Spiotto, 1993: Section 13.42).

While defaults may appear to be distinct and final, Spiotto (1993: Section 13.41) isolates three phases of default. The first phase involves gathering information on the reasons for the default and correcting any questions regarding the security for the debt. For example, if a revenue source appears ineffective, corrective action might be possible to preserve the probability of repayment. The second phase of a default is the workout, where the bondholders and the issuer attempt to resolve their differences. Failure in the second phase leads to what is generally considered the nature of a default. In the third phase of a default, bondholders assert their rights to obtain payment, including calling the bonds due and payable immediately (acceleration of payments) and using the full force of litigation to uphold their interests.

This case study examines a successful use of a workout to resolve a municipal default. This default was labeled technical since all principal and interest payments were made on time, albeit from sources unanticipated in the original financing. A case study

such as this one is important because the ability of public officials to resolve financial dilemmas such as a default is critical to governing in resource-scarce environments.

A DEFAULTED WASTE-TO-ENERGY SYSTEM

Communities face solid waste disposal problems due to landfill site and capacity constraints. One alternative embraced by many communities is to burn solid waste to generate energy (either steam or electricity) for sale to business, industry, and other customers. Currently, there are 142 waste-to-energy facilities in operation (Kiser, 1992). At the forefront of this movement was a midwestern city's recycle energy system (RES). The RES was designed to dispose of 1000 tons per day of garbage and trash by shredding, removing ferrous materials for sale, and burning the residue to produce steam for sale as a source of energy. This is termed a refuse-derived fuel facility since it processes and produces fuel on site. There are sixteen in operation throughout the country (Kiser, 1992). Further distinguishing itself, RES was one of the first (and last) strictly public refuse recovery facilities financed solely by revenues generated by the project itself, including fees for dumping garbage into the RES as well as the fees generated from selling the output steam.

The city turned to the RES option for dealing with a looming solid waste disposal problem given its diminishing landfill capacity and increasing environmental regulations. The event that accelerated public debate was a private utility firm's decision in 1971 to abandon its downtown steam system unless it could secure substantial steam rate increases. Steam customers joined the city in opposing the utility's abandonment request. As a result, the city was eventually deeded the physical assets for operation of the existing steam loop. Building on this opportunity, the city decided to build a modern resource recovery plant to dispose of municipal solid waste and generate the steam required for the loop.

The city demonstrated caution in entering into this new venture. It engaged a local engineering firm to conduct a preliminary feasibility study, and public officials conducted field trips to view operating facilities in the United States and Canada. There were even hints the facility might make a profit for use on public services. After inviting nationally known engineering firms to present design proposals, the city awarded a design contract to the same local firm that had prepared the earlier study. These actions solidified the city's May 1974 view that the RES was "an innovative, timely, and financially attractive step into the future for solving the area's solid waste disposal problems." Engineering plans and specifications for the RES were received and let out for bid in late 1974, with bids received in February 1975.

Only after deciding to proceed with the project in 1975 did the city and bond counsel begin to develop financing plans. The city's initial plan was to issue revenue bonds as it had done for its water and sewer systems. This path was squashed by New York City's 1975 fiscal crisis, the resulting calls for better bond disclosure practices, and the near default of a similar waste-to-energy system in another state. These events led the city to seek a state-local partnership with tax-exempt securities issued by a state financial intermediary (or conduit) with the proceeds loaned to the city for constructing the project. Under this arrangement, the city would contractually agree to repay the loan from project revenues, but it would own the facility without a mortgage on the facility securing the loan or the bonds. Unable to secure the conduit agency's bonds with the city's general fund, alternative security was required that included the negotiation of long-term steam contracts and waste disposal assurances.

As is too often found with public power projects (Jones, 1984; Feldstein, 1983), this one faced technological, economic, and operational risks. The technology was unproven, the economics were uncertain, and the managerial ability to deal with the complex system was questionable. On Standard & Poor's (1984) risk assessment scale, this resource recovery facility scored high. The eventual result was a waste-to-energy project that entered into technical default on its state agency-issued municipal securities.

The Project Financing Framework and the Technical Default

In December 1976, a state statutory authority—the state water development authority (WDA)—issued \$46 million of municipal bonds to help finance the city's RES. A series of legal agreements secured the bonds. Financing was made pursuant to a *trust indenture* between the WDA and a bank trustee named by WDA. The bank trustee's normal duty was ministerial, merely to process semiannual debt service payments to bondholders. A *cooperative agreement* by and among the WDA, the city, and the county specified that proceeds from the sale of the WDA bonds were loaned by the WDA to the city to construct and operate the RES. The RES was to generate revenues from a tipping fee charged to the city and other haulers to dump solid wastes into the RES and a fee charged to users of steam produced by the RES. The financing was thus premised on expected revenues on the inflow side (tipping fees) and the output side (steam user rates).

Steam customers were classified into three classes: uninterruptible, interruptible, and surplus. Uninterruptible customers were those located on the old steam loop in the central business district (CBD); they had no alternative heating sources. Interruptible customers were a downtown state university and a large nonprofit hospital, each a large user with existing natural gas alternatives. The surplus, or third, class was composed of a single customer, a large international manufacturing firm headquartered in the city (but with little actual manufacturing at the site). A series of contracts entered into by these parties specified that the three classes of customers agreed to pay rates at a level sufficient to cover the operation and maintenance expenses and to provide 1.5 times coverage of annual debt service. The contracts included "take or pay" provisions specifying that the contract customers would pay for their contracted level of steam even if they did not use the steam.

The RES revenues, including tipping fees and steam fees, were earmarked for operational expenses and to make payments on the WDA-to-city loan, which in turn served as the security and funds for the WDA bonds. The city did not extend its full faith and credit guarantee to the WDA bonds; the WDA bonds were state agency-issued project revenue bonds.

To ensure an adequate supply of refuse, both the city and county agreed in the cooperative agreement to enact ordinances requiring all solid waste collected in their respective jurisdictions to be disposed of at the RES after payment of the required tipping fee. As required, the city enacted what is termed a "flow control" ordinance. It was challenged by several private landfill operators and private solid waste haulers as being in violation of federal antitrust laws, the "takings" clause of the 14th Amendment, and other laws. In spite of two appeals to the U.S. Supreme Court, the validity of the city's ordinance was ultimately upheld in 1985. In contrast to the city's affirmative stance in support of the flow control provisions of the cooperative agreement, the county resisted enacting a similar flow control ordinance.

Scheduled to begin operation in 1979, the RES was not totally operational until January 1983. During the delay, steam was generated, but the garbage handling operation

did not work as conceived. Major design and mechanical problems required extensive modification. Originally estimated to cost \$56,000,000, the financing package included \$46,000,000 from the WDA bonds and \$5 million each from the city and the county from separately issued general obligation securities. At completion, however, the cost had escalated to almost \$100 million.* To make up the difference, the city contributed the proceeds of \$8 million more of general obligation bonds, the WDA added \$16 million, and a congressionally mandated U.S. Environmental Protection Agency (EPA) grant to the city (a reallocation of an unused grant) added \$19.7 million.

The delay in achieving operating status, as well as other problems (some to be reviewed later), led to the situation in which the RES did not produce the revenues required to make all loan payments. This resulted in a continuing series of events of default under the cooperative agreement, triggering corresponding events of default under the indenture. There was no interruption of payments of principal and interest due to the bondholders, however. Instead of project revenues, the debt service reserve fund (stocked by some of the original WDA bond proceeds) was tapped to pay debt payments in 1980. City and WDA contributions made the difference in 1981 and 1982; the EPA grant was used for 1983 and set aside for 1984 payments. This left no clear special source of funds from which to make bond payments in 1985.

Technical default actually occurred in February 1981, when the RES did not have sufficient project funds to make the scheduled loan payment pursuant to the cooperative agreement, although the funds were made available from other sources, as outlined above. The event of default under the cooperative agreement and the event of default under the indenture gave rise to certain remedies under the indenture. During the summer of 1981, the bondholders' bank trustee asserted one remedy by assuming management of the RES in order to preserve the interests of the bondholders and to gain the \$16 million infusion from the WDA. In this pressure-packed period, a long-term *operating service agreement* was signed by the trustee, the city, and a private waste management company. The firm agreed to retrofit the RES by making its operations simpler, and once the RES passed a thirty-day performance test (which it did in January 1993), to operate the RES for ten years under a "cost plus fee" contract. The fee was set low in the initial years, but escalated at a rapid pace. An incentive fee also was included in the package.

To assist in its duties, the trustee engaged the services of legal counsel, a consulting engineering firm, and a national accounting firm. The fees for the trustee and this entourage, as well as the operator's fixed fee, received first claim over RES revenues. The costs for the trustee to assume active management and monitoring thus increased the cost structure of the RES. Although modifications to the RES were made and mechanical difficulties were significantly reduced, the system continued to incur operating deficits.

The City's RES Dilemma

In late 1983, a newly elected mayor assessed the realities of the RES. While the RES was an ongoing question in the mayoral campaign, it was not a decisive matter in the voters' rejection of the incumbent. Early in the transition period, the following facts of the city's dilemma were outlined.

* A rule of thumb used "within the industry to 'ballpark' the construction cost of waste-to-energy facilities is \$100,000 for each ton of daily processing capacity" (National League of Cities, 1986: 59). The RES was designed to handle 1000 tons per day.

The cooperative agreement among the city, county, and WDA required project revenues to provide 150% coverage of WDA debt service. At the time, however, achieving just 100% coverage of the debt service would require steam rate increases of approximately 40% for the uninterruptible customers, 103% for the interruptible customers, and 153% for the surplus sales customer. Even these rate levels assumed that a stock of funds remaining from the special EPA grant would be used to pay all debt service obligations during 1984 since the RES could not generate sufficient funds on its own.

The trustee proposed to force the city to impose rate increases on January 1, 1984—the first day of a new mayoral term. While not sufficient to meet debt service coverage requirements, the proposed rate increases were set at approximately 13% for the uninterruptible customers, 51% for the interruptible customers, and 137% for the surplus sales customer. Tipping fees—the fees paid by both the city and private garbage haulers to dump their loads into the RES—were to increase 10%. This schedule of rate increase also assumed that the remaining federal grant proceeds would cover the year's debt service requirements. The trustee projected that the rate increases were sufficient to get the RES through 1984, given the assumption that all users would continue the current level of services, but at the higher rates—thus assuming no price inelasticity of demand and no flight to substitute energy sources. A further assumption in the scenario was that the RES operation would meet its budget estimates, including no fires or unexpected operational problems (both high-risk assumptions, given past history).

In pursuit of revenue maximization, the RES sought to maximize the composition of the refuse supply. A basic flow of refuse was required to run the plant at the desired level of capacity. By the original financing agreement, the city had to use the facility for its collected garbage and pay a tipping fee to the RES. The city paid the RES the tipping fees for residential garbage collected by the city. Pending final resolution of litigation, the city was not enforcing the flow control ordinance, which required private haulers of commercial wastes to also use the RES and pay the tipping fee. A continuous flow of garbage into the RES was required also to generate an uninterrupted flow of steam. Any break in the garbage flow or any downtime due to mechanical problems resulted in the burning of gas to produce steam—a wasteful and uneconomical energy conversion. The RES reverted to this costly step many times due to mechanical problems.

Given these constraints, the RES had an incentive to attract premium-paying waste dumpers. Accepting out-of-state wastes arranged through brokers was one result. Despite local newspaper headlines, the RES accepted New Jersey waste that did not meet New Jersey disposal laws but complied with state laws governing the RES. A form of such waste was saw-oil, or sawdust laced with certain kinds of oils (including flavors and fragrances, ball bearing and grinding oils, synthetic and organic lubricants, and waste oil bottom sludges). There was a twofold advantage in accepting this waste: it generated a premium payment for the right to dump the waste into the RES, and the oil-based product had a high burning yield—it generated more energy than regular wastes.

Despite the planned rate increases and the attempt to attract high-paying waste, regular and periodic rate increases would be necessary to produce net operating income (operating revenues less operating expenses). Part of the problem was the expense structure. A major RES cost was the contract operator's fixed fee: \$130,000 in 1983, \$550,000 in 1984, \$1 million in 1985, and \$1.5 million in 1986. The fixed fee levels agreed to in the long-term operating service agreement were purported to give the private operator a return for assuming the business risk of making the RES operationally viable. Even with

modest price increases on utilities and other expenses, the fixed fee levels would require significant increases in operating revenues each year to cover escalating cost factors.

Even if achieved, a positive net operating income was not sufficient to ensure the financial viability of the RES. The loan repayments to WDA and the required stocking of both an equipment and replacement fund and a debt service reserve account constituted additional expenses *not* included within the net operating income calculation. The 1984 debt service on WDA bonds was \$4.266 million; stocking the other accounts required more funds.

Under the operator's contract, if the operator budgeted an upcoming year's positive net operating income (NOI) that exceeded the forecasted NOI figure contained in the operating service agreement, the operator would receive an incentive fee set at 60% of the difference between the forecasted NOI and the budgeted NOI. The probability of such an incentive payment was remote, given the financial problems besetting the RES.

Under the contract the operator prepared a budget, formally called an "annual forecast of costs," for submission to the city and the trustee by October 1 of each year. Both the city and the trustee had to give the operator written notice of any budget disputes by November 1—a one-month review period. The contract specified that when the parties could not amicably resolve the dispute by December 1 the monthly payment to the operator "shall, until the dispute is resolved, be prepared, submitted and paid on the basis of the Annual Forecast of Costs as submitted by the Operator." The operator did not have an obligation to submit a budget generating a net operating income or one that necessarily covered debt service. In fact, the operator had no control over setting RES rates, yet the trustee sought to pressure the city to set higher rates to cover budget shortfalls and debt service requirements. The trustee's form of pressure was a threat to call all bonds due and payable immediately if rate increases were not imposed, an act surely to set off all types of legal warfare.

The mayor had no effective budgetary control over the RES budget because of the trustee's assumption of management responsibility. In this strong mayor-council city, neither the mayor nor his appointed finance director were able to monitor costs and, if necessary, make day-to-day, week-to-week, or month-to-month budget cuts to offset revenue shortfalls or expense overruns, neither did the city have control over the RES accounting system, bank accounts, or billing system. All of these controls were taken over by the trustee when the bonds went into technical default. In fact, the city only received monthly variance reports on expected versus actual costs for the preceding month. Since all steam users paid their bills directly to a trustee-controlled bank account, the city did not know the cash flow position of project funds until reported later by the operator and the trustee's financial advisor.

The operator submitted a monthly invoice to the trustee (with a copy to the city) for payment of costs to be incurred in the *ensuing* calendar month, as estimated in the annual forecast of costs. As a result, scarce project funds were used to pay for utility fees (a large monthly cost item) before the service was actually used, billed, or paid. For example, the operator would submit the December invoice by November 15, with the invoice paid from project funds by December 1. The RES would use the gas in December, but the operator would not be billed until January 10, with payment due on February 10. The operator thus enjoyed the cash float from December 1 to February 10. This was during a time when interest rates were in the double digits.

Enterprise operations such as the RES are sensitive to rate and usage changes. If users face RES rates exceeding the cost of alternative energy, the economic signal to them

is clear. While many steam users lacked boilers or existing alternative energy sources, the return on a capital investment is justified under certain pricing scenarios. Instead of making the investment, the business might just move from the central business district, striking another blow to a struggling downtown. If the RES closed down, similar hardships would occur. Furthermore, the city could face possible liability to customers under the concept of utility service abandonment.

As originally envisioned, the demand-side risk of the RES was reduced through "take-or-pay" contracts. Major users entered into contracts specifying their agreement to use the allotted share of RES steam or pay in lieu thereof. For example, a major international manufacturing firm headquartered in the city had a twenty-five-year contract to buy all the excess steam of the RES. Instead of being a captured buyer, however, this user (and others) considered its obligation as one tied to a gas equivalent rate, that pricing of one energy source could lead to a substitution of energy sources. As shown by the experiences of the Washington Public Power Supply System, as economics clash with take-or-pay contracts, litigation ensues (Jones, 1984). Major RES users had quietly put the city and the trustee on notice that they would legally challenge the validity of the contracts if pressed on the point.

Despite the fact that the WDA bonds did not involve the city's full faith and credit guarantee, the city's taxing power supported part of the total cost of the RES. A long-term city cost was debt service on \$13,640,000 in unvoted general obligation bonds—\$5 million for the original financial commitment and the rest for subsequent capital repair contributions. The city also paid tipping fees to dispose of city-collected residential solid wastes, the cost of hauling the ash generated by burning waste in the RES, and expenses associated with general city "overhead" (supervisory and monitoring time and expense—not an insignificant amount, given the problems imposed on the city by the RES's financial quagmire).

Under one scenario, the city could become the ultimate risk bearer for the WDA bonds. Under the cooperative agreement (among the city, the county and WDA), the city agreed to pay tipping fees to the RES for disposal of the city's residential solid wastes. Assuming the flow control ordinance and steam contracts were all ultimately held invalid and unenforceable, the city would remain its sole user. This "put-or-pay" feature was designed to ensure an adequate supply of refuse. Under such a scenario, the city would have an obligation to charge residential collection customers a rate necessary to offset the tipping fee, up to the contractually agreed to limit of fees "comparable with competitive charges for such services" (surely a phrase worthy of debate, and litigation, if necessary). In such a worst case scenario, the city had the equally unacceptable option of offsetting the necessary residential fee increases with diverted general tax receipts, a pathway to the city's operating budget.

Still, the city had to have a way to dispose of its garbage. The existing city landfill was projected to reach its limit in approximately five to seven years without the RES; it could last twenty to thirty years with the RES. No other landfill site was programmed and it would take three to five years to conduct all the required tests and acquire the necessary permits to site a new landfill. In addition, the state government was intensifying its regulatory powers over landfill activities. The costs to upgrade the landfill escalated yearly. All of these factors pointed to the need to examine the RES as part of the city's entire solid waste collection and disposal system, and not just a subsystem—albeit a costly and troubled one.

Looming over the city was a state law mandating state supervision over municipalities that failed specific fiscal emergency tests. Default on a debt obligation was one fiscal test, so an argument could be made that the city's failure to make the loan payments to WDA in accordance with the cooperative agreement constituted a fiscal emergency condition. The state auditor had the responsibility to issue the determination, but he had not done so; nor did he during the period covered by this case. Had the state auditor acted, a state-created board would have been appointed to oversee the city's entire financial agenda, not just the RES. To some, the city's financial reputation was at greater risk with a financial emergency declaration (see Advisory Commission on Intergovernmental Relations, 1985) than with a long-term default on RES bonds, since those bonds were clearly project revenue bonds, issued by a state agency, not the city.

The city's general financial condition was improving after an economic restructuring that saw many of the major manufacturing facilities close their doors in the preceding decade with a concomitant loss in the city's population. A city income tax provided the bulk of the tax revenue, with collections reflecting anemic local economic conditions. Significant budget reductions were in force for several years. The city's general obligation bond ratings were downgraded in 1980–1981 to an AA by Standard & Poor's Corporation and an A by Moody's Investors Service, Inc. The city was a yearly borrower of funds to finance a systematic and aggressive capital improvements program for which a share of the local income tax was dedicated. The city's finances were in strong shape, given its economic environment, but it had little room to maneuver. Any attempt to bail out the RES at the expense of general services would be a budget-busting exercise that would be both politically unacceptable and likely to erode the city's general bond ratings.

Shortly after being briefed on these legal, financial, and operational aspects of the RES, the newly elected mayor was called to a city hall meeting. This late November meeting was instigated by the trustee and included the trustee's legal entourage as well as the current (outgoing) mayor and key members of his staff, the private RES contractor, the WDA executive director accompanied by the agency's legal advisor, and the city's bond counsel. With the threat of possibly calling the bonds due and payable as of January 1 the trustee sought a commitment from the new mayor to commit to solving the RES financial predicament within a month. With a term of office not to start until January 1 the not-yet-sworn-in mayor could make no such assurances, even if a decision to avoid default had been decided. Interestingly, the trustee offered to serve as a foil if that would help provide local political cover for a difficult decision. The end result of the meeting was to let the crisis roll into the new year—and a new mayoral term—with a new trustee-imposed deadline of January 31. Adding further drama to the situation, a series of fires and explosions rocked the RES facility just days before the mayor took the oath of office.

A Default Workout

As demonstrated by the structure of the financial dilemma, the city had to balance the risk of a default on state-agency bonds for a city-owned project against the risk of opening the city's treasury to a troubled enterprise operation. Befitting its complexity, the default workout dominated the city's fiscal agenda for over a year.

The goal of the workout was to reorient the RES from its myopic attempt to maximize revenues in the face of significant fixed-cost escalations brought on by the trustee's management of the RES, to a substitute premise of viewing the RES as part of a local solid waste collection and disposal system judged by cost-effective standards. This required

developing a solid waste collection and disposal system that would accomplish its responsibilities in a safe manner, and at minimum costs, given local needs. A movement to local control would allow city policymakers (the administration and city council working together) to decide what wastes should be processed into the plant, the price citizens should pay for solid waste handling and disposal, and the price steam customers should pay for access to a dependable energy system.

Politically, the newly elected mayor could have let a financial default occur, and probably successfully placed the blame on the prior political regime. After reviewing the likely impact on the community, however, he proceeded to fashion a resolution to the problem, despite the risk of gaining political ownership over the results if he failed. The newly elected mayor came to view the RES as the city's most troubled fiscal problem and if the bank trustee's fee increase plan was implemented, the legal battles pitting local economic interests against one another was sure to harm the good of the community. The short-term financial focus of the trustee had to be replaced by a long-term solution good for the community, and the bondholders, too. His plan was simple at its core—keep the parties talking, in a status quo manner, until he could build consensus around a financial reorganization that would slice through the complexity of the financial, operational, and legal knot. An atmosphere of cooperation among the major players was needed to replace the prevailing one of adversity.

A drift in policy direction by the thirteen-member city council provided an opportunity for the new mayor. For the first time in over a decade and a half, the mayor and a majority of council members were of the same political party. A signal of cooperation was expressed with one key appointment. The council president was selected to serve as the city's public works director (the office responsible for a city-run RES). He was a fifteen-year veteran council member whose private job was as a manager of facilities support services at the local headquarters of a major international manufacturing firm. Not only was this person well qualified for the job, council members trusted his political instincts. This was important because the council felt they had been led astray by past RES votes for short-term "solutions" that never endured for very long. They thus had to be convinced that a financial reorganization would work for the long term and meet the city's competing needs. The new mayor knew that he could not confront the council; it had to be part of the solution. In fact, early in the first days of the new administration, the trustee pressured for a city council vote on bailing out the RES's 1984 operating deficit with city funds. An agreed-upon script was played out with the council expressing strong objections to a city bailout. The "no" vote was coupled with a demand for a long-term solution, not just an operating subsidy that left the debt (and its structures) overhanging the RES.

During the workout, the contending positions of steam customers and the trustee were used by the city as leverage. The point was to keep the customers from going to court too soon or the trustee from pushing steam rates higher than market rates. A variety of standstill arrangements was employed to freeze each position pending a long-term solution.

To build a consensus that the local community had to resolve the default, the newly elected mayor resurrected an idea previously offered by the council but vetoed by the prior mayor. A nine-member "blue ribbon" commission was appointed, comprising major corporate chief executives, local business leaders, representatives of the major customers, and the top city and county elected officials. The commission brought financial, legal, and political expertise to the table, both through the members themselves and the tasking of their corporate staff experts to serve on special subcommittees. Operational experts

identified efficient management procedures while a subcommittee of financial experts worked on both the liquidity problems and the needed financial reorganization. A major result of the commission was the consensus call for a long-term solution. In fact, in its May 1984 report, the commission concluded that the RES was a valuable community investment that provided the only feasible solid waste disposal system available to the area. It also found that the RES could not realistically expect to sustain any debt service. In the short run, the commission kept the major steam customers aware of the RES and its problems and the damage that a single lawsuit could do to a lasting solution. In fact, the interruptible and surplus steam customers agreed to modest (18%) price increases and advanced their payments in some cases to help ease the RES's severe cash flow problems as the workout took shape.

Gaining the confidence of bondholders was important, partly to calm the trustee bank. The WDA bonds were held by about 200 bondholders, with several institutional investors holding about 50% of the outstanding bonds. Any steps taken to increase the probability of repayment is welcomed by bondholders, and this was especially true for RES bondholders who were left holding near-default-rated bonds (with a CC speculative rating by Standard & Poor's Corporation). Their trustee bank was afraid of incurring bondholders' wrath if the bonds were not repaid and the trustee's actions (or lack thereof) became the subject of legal challenge.

A meeting of bondholders was called by the trustee and held late in the first month of the new mayor's term. In the call for the meeting, the trustee concluded, "It is very possible [the plant's] viability cannot be achieved." The purported purpose of the bondholders meeting was to put pressure on the mayor to agree to steam rate increases by the end-of-month deadline imposed by the trustee. As a fallback position, the trustee wanted explicit bondholder permission not to have to raise rates to those levels. In the meeting, the attending bondholders gave strong support to the workout efforts outlined by the new mayor in his address to the group. Bondholders dismissed the city council's negative vote (of the prior evening) on the trustee's bailout proposal as understandable since it was not a long-term solution. The institutional investors at the meeting were supportive of the mayor's early initiatives, especially the blue ribbon commission and his pledge to make a good faith effort to have a long-term solution in place by year's end. Importantly, the mayor noted that default would not serve the interests of anyone, a calming note to bondholders. In no uncertain terms, the institutional investors instructed the bondholders' trustee to be more cooperative with the mayor's agenda for a long-term solution, not a piecemeal solution. Even when the workout took longer than planned, a private meeting of major institutional investors and bond insurance guarantors assured the mayor of their continued support and pledged to monitor the trustee's increasingly noncooperative stance. Furthermore, the trustee bank was part of a larger regional bank holding company whose leadership had expressed confidence in the mayor's efforts and offered comfort that the trustee bank would not take any precipitous actions.

The WDA was at risk also. The WDA actually issued the bonds that were in technical default, so its credit reputation was at risk. As with any conduit financing agency, the WDA's future was tied to its continued market access. It was thus willing to work with the city as long as the city had a feasible workout plan. Later it helped fund the final workout with a major financial contribution.

The mayor enlisted the city's long-serving (for over thirty years) bond counsel firm to help in the workout. This same firm served as the bond counsel and general legal advisor to the WDA. According to some observers, this legal firm faced a potential conflict

of interest charge over the dual representation on the basis that it would be hard for the firm to have maximized the competing interests of both the city and the WDA. At a minimum, the firm stood to have its reputation tarnished if the RES failed and the bonds went into actual default, with all the legal claims that would ensue. As one of the most prominent law firms in the state, its influence in state policy making was widely recognized. In private, one of the firm's senior partners made it clear that it was in the interest of the state, the city, and his law firm to solve the problem, and the firm would help design a financial reorganization. In the end, the law firm was of significant help in clarifying the state's interest in a viable local solid waste disposal solution and the risks to the state from an actual monetary default on the WDA bonds.

The mayor refrained from a public recitation of precise strategies and planned actions. This annoyed the local newspaper but it prevented the various parties from taking hard stances that later would be difficult to reverse. This preserved everyone's flexibility as the fluid negotiations took shape. Furthermore, the outstanding bonds would gain in value as a solution emerged, and as "live securities," insider trader laws were in effect. United States securities laws view insider trading as that based on material information not yet made public if the person has a responsibility to keep the information confidential. All parties to the workout were placed on notice about the personal liability of insider trading.

Financial Reorganization

A financial reorganization of the RES was required to advance the goals embodied in the planned operating premise of a cost-effective solid waste system run by the city. Defeasance of the outstanding WDA bonds was at first dismissed as financially impossible, at least by the original RES investment banking advisor. This led to a quickly examined, but dismissed, look at an open-market purchase of all outstanding bonds. This method was discarded as unlikely to be successful enough to totally remove all the legal baggage of the bonds. Defeasance then emerged as the preferred solution, spurred in part by the bond lawyers settling on this method as the cleanest way to remove the bond indenture and therefore the trustee.

Defeasance is a voluntary financial organization to adjust the pattern of debt service payments and to gain release from the original bond indenture. The concept of defeasing a bond series is to structure a portfolio of government securities, the principal and interest of which is sufficient to meet all future principal and interest payments on the refunded outstanding bonds (Feldstein and Fabozzi, 1987). Through defeasance, the bondholders achieve certainty that their interest and principal payments will be paid on time and in full. Bondholders and their trustee thus have no further interest in the project and its operations. Upon successful defeasance of the outstanding bonds, the trust indenture is removed, as is the need for an active trustee. In fact, the trustee reverts to the traditional role of a paying agent of coupons and maturities.

In the RES situation, defeasance would remove the trust indenture for the WDA bonds, but the cooperative agreement would remain in effect. This results from the state's continuing interest in the project and WDA's prior advances to the system. While the RES would remain responsible for repayment of the WDA advances, those obligations are due at such time as the plant generates excess revenues.*

* This latter point was to become a significant issue years later, but is not relevant for the purpose of this case presentation.

Due to the fact that a state conduit financing agency—WDA—issued the original bonds, the city could not directly or legally defease another issuer's bonds. In addition, the city could not borrow funds to provide the required stock of funds to defease the state agency debt.

A plan to acquire federal, state, and city resources to implement defeasance took shape. It required an interwoven set of contingency commitments to make sure that all come to fruition and that no single source would be viewed as causing the plan to fail. The city considered the state government a prime source of funds. In fact, WDA possessed excess funds from interest earnings on several bond issues, but the gubernatorially appointed board was unwilling to apply the funds to help out only one city in the state. Despite meetings between city and gubernatorial representatives, as well as a strong political relationship between the mayor and governor, the importance of the issue was most forcefully made by market experts. The governor went to New York to brief "Wall Street" analysts on the state's fiscal health. Although the state's general credit quality was not directly tied to its conduit financing agency's default, the governor was bluntly reminded that the WDA default—although "technical"—was a point of concern to those interested in the state's credit standing, and would become even more so if the principal and interest payments on the RES bonds were abrogated. The governor's position on using the WDA to help the city became more accommodating thereafter, leading to a called meeting with the mayor. As a result, the WDA voted to make funds available for the RES financial reorganization.

In October of 1984, the city council approved the mayor's financial reorganization plan. This plan provided funding for the defeasance with \$13 million from a (new) congressionally enacted special EPA allocation, \$15 million from the state's WDA (backed by an implicit state agreement to replenish WDA's coffers) and \$6 million from the city. The city also contributed an additional \$2 million to cover transition costs. The city's total contribution of \$8 million was taken from the city's pay-as-you-go capital budget with the bumped capital projects financed instead by borrowing—merely a matter of fungibility of funds to meet legal requirements. Furthermore, defeasance would release \$850,000 held in special RES debt accounts that could be used, if needed.

Actions to secure a special grant of funds from Congress was seeded over several months. In October 1984, grounded in a long-standing trust between key members of Congress, an amendment to the continuing appropriations law specified that the city would receive a special "EPA grant." As a perfunctory condition for the dollars and to avoid having the grant viewed strictly as a porkbarrel project, the city had to allow the RES to serve as a "laboratory facility for municipal waste-to-energy research." The special law also restricted the city's use of the funds to only "refinance the bond debt" of the RES. Furthermore, the congressionally mandated grant specified that no more than 60% of the refinancing could be made up of the federal dollars. Due to the specified percentage requirement, the federal funds had to be the last dollars into the account. To create the proper paper trail concerning the appropriate percentage of funds derived from federal funds, the federal dollars had to be the first ones out of the defeasance account. Defeasance was thus delayed partially in response to the need to ensure that the federal dollars were the last in but the first out.

Defeasing the RES bonds depended upon an adequate stock of funds to buy a sufficient amount of U.S. Treasury securities. Once the funds were acquired, the next step was to use investment bankers for advice on market timing. This talent was needed because defeasance rested on an open market purchase of Treasury securities. Traditionally, defeas-

ance is accomplished by issuing debt, the proceeds of which are invested in a structured portfolio of U.S. government securities specially issued by the U.S. Treasury. The purpose of this arrangement is to achieve an optimum fit between the U.S. Treasury securities and the debt service schedule of the outstanding (defeased) bonds and to avoid making more interest on the investment than is due on the bonds—an illegal arbitrage gain. In the RES defeasance, however, no tax-exempt bonds were issued. An open market purchase was thus required to purchase a set of outstanding securities to make the best possible fit. The constraints involved matching a fixed stock of funds and a fixed debt schedule with an open market purchase of a portfolio of high-yield government securities.

Spreading alarm that the RES might be unmanageable (but not affecting the defeasance per se), the RES was not operational during much of the time of the financial reorganization. An explosion in December 1984 fatally injured three workers and injured seven. A quick investigation confirmed that a New Jersey firm mixed into a regular shipment, by "error," three highly flammable chemical solvents that should have been transported instead to a federally approved hazardous-waste landfill. As these products were being processed in the shredder, they exploded, killing three workers from an independent maintenance contractor working above the pit. In terms of the facility itself, insurance covered its physical damage.

Although negotiations had been ongoing for months, this event galvanized opinion that the operator's role had to come to an end, and the contract, specified in the operating service agreement, had to be bought out. The city recognized that the contract might be upheld in a court of law, but convinced the contractor that it might end up as a Pyrrhic victory. After reflection, the contractor settled the contract on terms favorable to the city.

Implementing the defeasance solution had to await receipt of the federal dollars. On January 17, 1985, the city picked up the \$13 million check from the EPA regional office in Chicago. Market drifts made the optimizing decision difficult to achieve for awhile, causing some apprehension by all parties. Finally, in late January, an investment banking firm made a bid to sell the required portfolio of Treasury securities at a slightly higher than anticipated, but still acceptable, price of \$34.85 million. The bid was accepted pending verification as to accuracy and accomplishment of the defeasance requirements by an independent accounting firm. The delivery of the purchased securities to WDA occurred about two weeks later. On March 20, 1985, the portfolio of structured securities was transferred to the trustee to defease approximately \$42 million of RES revenue bonds, only two months shy of the next debt service due date! The trustee then released the RES back to the city. This allowed the trustee, and soon thereafter the private management firm, to end their involvement with the RES facility.

SUMMARY AND CONCLUSION

As a profit-making enterprise, the RES was a loser. As an integral part of a local solid waste collection and disposal system, however, the RES faced a brighter future. The state of affairs facing a newly elected mayor was bleak, however, with the parties to the bonds in technical default quickly adopting intractable positions, and legal warfare the likely result. The trustee focused on short-term operational concerns, thinking the RES could operate itself out of the financial quagmire. In contrast, the mayor viewed a long-term solution as the only way to proceed, keeping his options open until settling on a path out of the legal and financial conundrum. A workout requiring a steady-hand unraveling of

the Gordian knot of interlocking contracts seemed impossible, but a financial reorganization that peeled away the most imposing binds, aided by bold strokes (such as turning bondholders into allies and securing the congressional grant of funds), achieved debt reduction and a return of the RES to local control and management.*

REVIEW QUESTIONS

1. How is a “technical” default different from a “monetary” default? Does it make a difference to government officials, taxpayers, or bondholders?
2. To what degree is a city’s general obligation credit rating at risk if taxpayers end up paying more in fees or taxes to bail out a project revenue bond-financed enterprise operation?
3. Outline the legal and economic linkages among and between the various parties involved in the RES. How did the new mayor use this tension to structure a solution to the technical default?
4. A bond trustee’s normal ministerial duty is to process bondholders’ interest and principal payments. As the threat of default looms, the trustee’s duties increase according to the terms of the bond indenture agreement. Prior to an event of default, a trustee only has a good faith responsibility to monitor compliance with the indenture and other factors important to the bondholders’ interests. After default, however, a trustee generally must meet a prudent person rule, taking care to act as if the assets are personal ones. The indenture specifies the remedies a trustee can take on behalf of the bondholders. Fundamentally, the trustee’s role is to protect the bondholders’ repayment mechanism—the ability of the system to continue operation so it can generate funds for bond repayment. Assess the trustee’s role in the RES case.
5. What lessons should this city’s officials, and public officials generally, gain from this episode in the life of a community?
6. If you were the state auditor, would you have instituted proceedings to issue a determination of a financial emergency? What would have been the likely implications of such actions?
7. What could the city do to avoid default if the special congressional appropriation had been voted down and not enacted? Why should local projects such as this even be able to receive U.S. taxpayer funding given that every community has garbage disposal problems?

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* Not covered in this default case study is the story of the continuing operation of the RES, but that story is not as interesting!

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