

# No Standing News

Since we have no standing, we stand with those left standing

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## “A Litany of Lawsuits” – True Stories of the Free Lunch

Rolla's TIF project is like a council fairy tale, a treasure map based upon “best case” assumptions with a fictional pot of gold buried at the end of the can't-fail TIF rainbow. The biggest TIF fairy tale of all is the one **Mark Graham** of **Gilmore and Bell**, the city's own bond lawyer told the city on January 3<sup>rd</sup>. Some council members, **Sibley**, **Hicks** and **Matt Williams**, to their credit are suspicious of the TIF fairy tale. They worry about the \$10,000,000 in TIF bonds the city will owe. Graham told them that “A developer like Sansone wouldn't proceed if they didn't have a high degree of confidence in the project.” Graham's answer may have been a commercial for Sansone, but it wasn't an honest answer to their questions nor was it a guarantee that a lot of things can't go wrong. When they tried to pin Graham down about bond default he again dodged a straight answer and said the TIF “Notes” the council will give the developer will be repaid by the project “revenue stream” but if the revenue stream couldn't cover the city's \$10,000,000 IOU to the developer the city would have to sell TIF revenue bonds to pay off their IOU to Sansone – then they would owe the bondholders instead of Sansone. The obvious point he sidestepped was that if the revenue stream isn't sufficient to pay off the \$10,000,000 IOU to Sansone it's also not going to be sufficient to pay off the \$10 million revenue bond debt to the bondholders. The bond attorney, you see, doesn't make any money if he frightens clients away from the deal by telling them the truth about the real consequences of revenue bond default. If they're happy with the fairy tale, why should he tell them the bad news? That's the trouble with the council, they get all their TIF “facts” from experts each of whom have a personal financial stake in seeing this project goes forward. None of these hired guns will be around to share the pain if it turns out it was a bad idea to gamble \$10,000,000 on the future of retail sales – the riskiest commodity in the world of commerce. Pork bellies are a safer investment.

At the March 13 council meeting a few council members still had an uneasy feeling that some important clues had been left out of their copy of the TIF treasure map so they asked about the TIF bond debt again. This time it was Butz who told them the TIF revenue bonds are “not a debt of the city, county or state” issuing them. In other words it's a “no-debt, debt.” Comforted, several flip-flopped from their previous flip-flop and they approved the TIF Plan by an 8-3

vote. Several members of the council really believe that if this retail gamble collapses for any one of several reasons, such as the predicted downturn in the national economy, failure to pay off the TIF bonds is a “no default, default” on the “no debt, debt.” They believe Guido won't come after them with a baseball bat to collect on the \$10,000,000. Faith is for religion, not for financing land development deals.

**Take the NSN Challenge.** I issue this challenge to anyone in City Hall. If they can prove that the information contained below is wrong, if they can *prove* that the TIF revenue bonds and the Brewer Science revenue bonds are *not a city liability*, if they can prove that Rolla's overstrained taxpayers won't suffer any negative consequences in the event of a default, i.e. a shortfall in the sales tax revenue to pay back the \$10 million to either Sansone or the bondholders, then let's see their proof. If they can prove it, *NSN will get off their backs and publicly endorse the TIF project.* However, if they *can't* prove it they will admit that it is a city liability and start publicly discussing how they will deal with it (default insurance for instance) instead of pretending this is such a sure-fire real estate investment that it can't possibly turn brown and run downhill. Now what could be fairer than that?

The following article on municipal bond default is from “*Public Bonds*,” a research paper by the **Corporate Research Project of Good Jobs First**. Good Jobs First promotes openness and accountability in economic development practices – something all the amateur economic developers in Rolla should learn to do. It explains what really happened to the elected officials of three of the many cities who bought the fiction that revenue bonds were “not a debt of the city” and then watched in horror as their “no-fault” default turned into “a litany of lawsuits.” Notice that in two of the three examples, non-profit corporations exactly like **RCDC**, **RREC** and the **Chamber**, were involved in the project - for “progress” and the “betterment” of the town, of course.

The entire paper can be found at: [http://www.publicbonds.org/public\\_fin/default.htm](http://www.publicbonds.org/public_fin/default.htm). In the interests of space we have selected the most pertinent passages. All underlining and “Ed.” notations are ours but the text was not altered.

## MUNICIPAL BONDS AND DEFAULTS

The frequency of defaults depends on the type of bonds. Municipal bonds are considered the second safest category following securities issued by the federal government.

Within municipal bonds, **general obligation bonds** are considered the safest, since they are backed by the full faith, credit and taxing powers of the government that issued the bonds. Some jurisdictions may be in better financial shape than others. There are also fewer risks during economic upswings when governments usually collect more revenues from taxes.

**Revenue bonds** are considered riskier than general obligation bonds because repayment is dependent on specific revenue streams, such as user fees or lease payments. Revenue bonds issued for private institutions such as hospitals are even more risky. If the institution goes bankrupt and is unable to meet its debt obligations, the government or agency issuing the bonds for the companies is not under any legal obligation to repay the debt. (Ed. This is the no-fault “free lunch” part but not the whole story.)

## TRENDS IN MUNICIPAL DEFAULTS

In 1988, a study by Enhance Reinsurance Co. looked at historical patterns of municipal defaults from the 1800s to the 1980s and concluded that municipal defaults usually follow downswings in business cycles and are also more likely to occur in high growth areas

that borrow heavily.<sup>1</sup> Following the 1873 Depression, when more than 24 percent of the outstanding municipal debt was in default, the greatest number of defaults occurred in the South, the fastest-growing region at the time. Factors that caused defaults included fluctuating

regional land values, commodity booms and busts, cost overruns and financial mismanagement, unrealistic projections of the future, and private-purpose borrowing. The report also said that since World War II, revenue bonds have been a new source of default, largely a result of revenue over-projections. (Ed. “Revenue over-projections” like doing the cash-flow cost/benefit analysis *before* you know who the Big Box is or before you find out that the Big Box is a Not-So-Big-Box?)

Another new finding was that defaulted municipal bonds have a fairly high recovery rate of 68.33 percent based on the number of defaults. Recovery can be made in a couple of ways. The borrower may get out of the default situation by making full debt service payments or

collateral securing the bonds may be liquidated. Most issuers, particularly providers of essential services such as water and sewer, resume paying debt service. These types of securities are backed by physical assets that are public property. Thus they are never pledged to bondholders. In such cases, bondholders maintain a lien on revenues, which often enables full recovery. Industrial development bonds and multifamily housing bonds, the two sectors with the highest default rates, are often backed by collateral leading to higher than average recovery rates. (Ed. “Recovery” through lawsuits is the flip side of the “not a debt” story. The bondholders can sue to get their money back and the long-term damage to the cities bond ratings is severe.)

## DEFAULT AND CREDIT RATINGS

The 1999 Fitch study of municipal debt defaults was followed by a revision of its rating criteria for many sectors of public finance. The study concluded that management practices were more important for predicting credit performance than had been thought in the past. The three most important management practices identified that led to stronger credit and *lower defaults* were:

- **Superior disclosure** (“Superior disclosure” from *this Administration?*)

- **Maintaining rainy day funds or operating reserves** (Rolla’s reserves are low and they don’t plan on having any rainy days.)
- **Implementing debt affordability reviews and policies** (The council has no debt policies and conducts no “debt affordability” reviews.)

## REVENUE BOND DEFAULTS AND THEIR IMPACT ON GOVERNMENTS

**Example #1 The River Square Parking Garage (Spokane, WA):** In 1998, the Spokane Downtown Foundation, a non-profit corporation, sold \$31.5 million in revenue bonds to finance a parking garage for the River Park Square Mall backed by the moral (i.e., non-binding) obligation of the City of Spokane. A lease between the Foundation and the Spokane Parking Public Development Authority backed payments for the bonds. The city also pledged to contribute parking meter revenues for the operation and maintenance of the garage. A contract between the developer of the mall and Nordstrom, the mall’s major tenant, allowed the retailer to choose the garage operator, set parking rates and approve any changes to the contract. (Ed. The Spokane Downtown Foundation is the equivalent of RCDC, both are non-profit private corporations that are for the “betterment” of the town as long as they risked the taxpayer’s money – not their own.)

The Foundation defaulted on its debt payment after revenues from the garage fell short of projections. Bondholders argued that the city had pledged to back the revenue bonds with parking meter revenues. But the city reasoned that it could not honor its pledge to loan money to the authority since it was improbable that it would be repaid and thus would be illegal under the city’s investment guidelines. The bonds went into technical default in 2001 and monetary default in 2003, resulting in a downgrade of the city’s bond rating. In 2001 Moody’s downgraded the city’s unlimited tax and general-obligation bonds from A1 to A2, the city’s limited tax general obligation bonds from A2 to A3, and the city’s water and sewer revenue bonds from A1 to A3. Standard & Poor’s downgraded the city to BBB and the parking garage bonds from BBB- to D (junk status) and switched to Not Rated in September 2003.<sup>3</sup>

Institutional and retail investors sued the city, the developer of the garage and the underwriting team. The city of Spokane sued its bond counsel Perkins Coie and its chairman and partner Roy J. Koegen, saying that that the law firm should become liable if the city became liable. Perkins Coie terminated its relationship with the city as outside bond counsel in 2001 and closed its Spokane office in 2002.

In mid-April 2004, Spokane’s chief financial officer announced that the city would arrange for interim financing to settle the lawsuit by selling six-month bond anticipation notes. The Spokane City Council approved selling up to \$39 million in long-term, limited tax general

obligation bonds to raise money for settling the lawsuit in early April. The city’s purchase of the garage from the Foundation was deemed taxable by the Internal Revenue Service in a preliminary ruling in 2001. That ruling is still being negotiated because the Foundation disputed the agency’s findings. A lawyer representing institutional investors said that the city would indemnify bondholders if the IRS ruling held. (The Project from Hell. It probably started with someone telling the council that “revenue bonds are not a debt of the municipality.”)

While the city was raising the money to settle the lawsuit, it also planned to get money from other defendants named in the lawsuit, which included underwriter Prudential Securities (now a part of Wachovia Securities) and the bond counsel Preston Gates & Ellis. Walker Parking Consultants, Inc., the firm that had provided the estimates for the garage was also a defendant in the lawsuit.<sup>4</sup> It agreed to pay the city \$1.5 million. Including expenses such as attorney fees and unpaid interest payments, the \$31.5 million bond issue was expected to cost the city \$34.0 million.<sup>5</sup>

In mid-April, the presiding judge postponed the scheduled trial in federal court after bondholders agreed to settle with the city, arguing that the case would possibly never go to trial if the city settled with all the parties involved. If the case does go to trial, the city would become the litigant against any remaining defendants.

**Example #2 The Cicero Commons Recreation Facilities (Cicero, NY):** In 2001, the Cicero Local Development Corp. (CLDC) sold \$15.25 million in revenue bonds to help finance the \$16.5 million Cicero Commons Recreation Facility that included two skating rinks and a YMCA on 140 acres of land. The town of Cicero signed a 41-year lease with the Corporation and also backed its general obligation debt and underlying mortgage. But the Facility failed to generate adequate revenues to cover debt service payments. Bank of New York, the trustee, made debt service payments by drawing on reserves, which led to a technical default by the Corporation in August 2003. Moody’s put the Corporation and Cicero’s credit rating under review following the technical default. (The CLDC is another RCDC/REEC-type non profit corporation with great ‘betterment’ ideas to risk public tax money on.)

In November 2003, Cicero defaulted on its monthly interest payment of \$513,000 and had only \$236,000 in reserves. The Cicero Town Council had a line item in its 2003 budget for the Facility but did not appropriate any money for the project until after the default.<sup>6</sup>

Between September and December, the Corporation's rating fell from investment grade to junk status (from Baa2 to Caa1) following three downgrades by the rating agency. The town was downgraded twice and fell to below investment grade rating (from A3 to Ba2).

Moody's also said that, "Future rating action will reflect the town's ability and willingness to honor their obligations as per the lease agreement, thus ensuring bondholder security as well as the ability of the CLDC to provide for debt service, and the rebuilding of debt service reserve, from its own resources."<sup>7</sup>

**Example #3 Wilkes-Barre, PA:** When Wilkes-Barre, a small city of about 50,000 in eastern Pennsylvania defaulted on its debt service payment in 2002 on \$5.3 million of taxable guaranteed revenue bonds, the bond insurer, Ambac Assurance Corp., was obliged to cover the missed payment. In December 2002, after announcing that Ambac had paid the claim, the company's managing director of public finance surveillance commented that it was an extremely rare occurrence as

public finance was typically a safe bet and cities were typically a safe investment. Wilkes-Barre cured the default within four days after the bond payment was made by the insurer. (Ed. The only smart thing these people did was to get their revenue bonds insured. Did the Rolla City Council buy this insurance on the \$14.3 million in revenue bonds they issued for Brewer Science? Are they going to buy default insurance for the TIF project? If not, why not? )

The Wilkes-Barre Redevelopment Authority issued the bonds in 1998 to finance construction and related work of an 80,000 square foot office building and rehabilitation of a parking garage. Both Moody's and Standard & Poor's assigned the insured debt a triple-A rating. The city's chief of administration said that the city had failed to make its payment on time because *it had not received lease payments from its tenant*. The bonds were secured by the full faith, credit and taxing power of the city's general obligation. In addition to the projected lease revenues the city was also collecting revenues from a tax increment financing district. The redevelopment authority took legal action against the tenant.

In this case, the default occurred because of the bankruptcy of the intended payer (the tenant) and the inability of the City to honor its pledge in a timely manner.

## DEFAULT: WHO'S ACCOUNTABLE?

As the cases described in this section illustrate, there is no clean formula that determines who is accountable and who will bear the financial burden in case of a default. The outcome depends on circumstances and usually involves a litany of lawsuits. If payment is not resumed or covered by bond insurance, investors are, in some cases, able to recover their money through litigation, which can involve the entire range of actors, from the issuer to the bond counsel to the underwriters. What seems to be true is that, in most cases, none of the parties assume responsibility and are quick to blame someone else in the chain.

**How the "not a debt of..." fiction started.** "Not a debt of the city" is actually what it says in the Missouri Constitution and in state law: **Art. VI Sec. 27(c)** of the **Missouri Constitution** says, "*The term "Revenue bonds" means bonds neither the interest nor the principal of which is an indebtedness or obligation of the issuing county, city or incorporated town or village.*" The "not a debt of the city" is one of those lawyer brainteasers that does mean something but it doesn't mean what it clearly seems to mean. What it means isn't clear unless you know the back story. Revenue bonds are not a debt in the same way voter-approved General Obligation bonds are, *but they are still a public debt* and that's why the city officials who voted to issue the bonds are the ones whose names will be on the subpoenas when the unhappy revenue bondholders file civil suits to recover their money.

The "not a debt" disclaimer is merely a legal device to *distinguish Revenue Bonds from General Obligation Bonds*. General obligation (G.O.) bonds are debt of the municipality. They are backed by the "full faith and credit" of the municipality's taxpayers because taxpayers voted to repay the debt from a special tax assessment on their property - that's the "full faith and credit" part. Revenue bonds, however, can be issued with only a simple majority vote of the city council and can only be repaid from the revenues generated by the specific project they are issued to finance. They aren't backed by the "full faith and credit" of the city like G.O. bonds but they are *still a public debt* as the examples above clearly demonstrate. In addition to lawsuits to recover bondholder's money the long term damage of default is a *ruined municipal credit rating* which will cost taxpayers higher interest rates on all future borrowings.

The Missouri Constitution sets a G.O. bond debt ceiling for municipalities of 20% of total assessed valuation to impose fiscal prudence on those who otherwise might run their communities into bankruptcy. However, fiscal prudence has always had its detractors. In the booming industrial 70's, some kind of revenue generating device

was needed to put a handy "tool" in the municipal "toolbox" without the risk of asking fiscally conservative taxpayers to approve G.O. bonds for what are clearly dicey investments. The answer was revenue bonds. They had long been used in commerce so revenue bonds were retrofitted for government use. Clever lawyers came up with the "not a debt of the city, county..." gimmick to resolve the conflict between the G.O. bond and this new type of "not really a debt," debt. With a simple majority vote a city council could incur nearly unlimited debt to finance development even if they were already at or near their constitutional debt ceiling for voter-approved G.O. bonds. Revenue bonds were one of the shiny new credit cards the state gave to local government in the roaring industrial development 70's. During this era, the state encouraged every city to get into the industrial development business no matter how far out on a fiscal limb they went so state politicians, with very little effort, could claim credit for all this new job creation.

It was a great gimmick. Cities could now run up debt but avoid the voters and the new debt was exempted from their constitutional debt limit. Now they could double down their debts. With the new Revenue Bond 'Gold Card,' a city's revenue bond debt could exceed its constitutional debt limit but politicians could pretend it wasn't "real" debt. It was "off the books" so to speak because taxpayers wouldn't see it on their property tax bills. "Progress" could now be built upon a house of cards.

Now that we are again on the old TIF road and the road is mined with TDD and NID tax issues that also have not yet been explained or discussed, debate over this project will continue whether the "Progress at any Price" crowd likes it or not. It would be helpful if we could have these critically important civic discussions based upon financial reality instead of emotional accusations from the Chamber that anyone who dares to question public policy decisions is "*tearing Rolla down*" or Waterman's silly idea that we must go ahead with a flawed project because, "*The whole state is watching and we don't want to send the wrong message.*" Trust us, the whole state isn't watching. They got the message about Rolla and the RCDC decades ago. That's why we've always trailed the pack in the industrial development race - a race that NAFTA ended in the 90's.

It would be reassuring even to the skeptics if the council would face the truth about using high-risk 'tools' like revenue bonds and if they would discuss and weigh the risks honestly. When only twelve people get to vote on whether they will incur millions in public debt, the very least they owe the public is to face facts and not hide behind half-truths that revenue bonds are "not a debt of the city" or

that there is no risk because, "A developer like Sansone wouldn't proceed if they didn't have a high degree of confidence in the project." Barklage may adore Sansone, but we're positive his first loyalty isn't to Rolla. The council owes us an honest job of the "due diligence" necessary to ensure that the project will be able to support repayment of the debt so we won't find out too late we have to sacrifice public safety and other critical public services when the city's reserves and the general fund has to be stripped out to comply with a court order to repay a revenue bond default. So far, the city's 'due diligence' has consisted of, "We don't like Warren, his land is ugly, we adore the developer, so let's do it."

**Sansone doesn't pay his taxes!** One of the ways Sansone pitched his TIF project to the council was for the great property tax benefits - someday. Sansone, our civic benefactor, will develop the property so it will generate big property taxes in a few decades. That's why it's ironic to find that **Sansone owns a very expensive property in Rolla but he pays no property taxes!** Yes, Don's idol owns the *Rolla Apartments* at 1101 McCutchen and like the RCDC he claims his lucrative income-producing property is a "charity" so he can get out of paying property taxes to our schools, city, county and the handicapped. The Rolla City Council is in bed with a really generous civic-minded guy aren't they?

**The 'Buzzer' strikes...and misses.** Now let's see if we have **Buz Harvey's** RDN exposé letter straight. After wading through big steaming piles of "me and Col. Bill and the Army are gen-u-ine patriots working round the clock to restore order to a dangerous world" blah, blah, blah, Buz hurls the shocking accusation that in 2004, mayoral candidate **Tom Sager** testified that DNR should enforce state laws at Ft. Wood. The accusation is true. Sager did say, "I think the least DNR could do is enforce existing law." Sager doesn't think anyone is above the law - not even Ft. Wood. The Buz says however, that we must "treat Ft. Wood as a prized private employer" i.e. give them a pass on obeying laws they don't like.

Buz, who says he simply won't sit still and let Sager's flagrant respect for the law go unchallenged, goes on to say (he really should have said much less) that mayoral candidate **Bill Jenks** is *opposed* to whatever Sager is *for* which means Jenks *doesn't* think DNR should enforce the law at Ft. Wood. Buz says this proves Jenks would be a better mayor because he and Col. Jenks believe some important people are...ah-h-h, above the law?

The Buzzer also says that as mayor, Jenks will "lead from the front" (as opposed to what Buz, leading from the rear?) because "he (Jenks) understands all this"- that prized private employers are above the law - better even than he, the Buzzer, understands it.

That's what we're afraid of.

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