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PRESENTED TO THE PENNSYLVANIA SENATE LOCAL GOVERNMENT COMMITTEE

IN CONNECTION WITH ITS HEARING ON THE HARRISBURG INCINERATOR DEBT

ON NOVEMBER 13, 2012

Thank you for the opportunity to testify on this important issue. I salute Senators Eichelberger and Blake and the other members of the committee and Senator Folmer for holding these hearings.

Based on my experience as the first receiver for the City of Harrisburg and as a bond lawyer for over thirty years in Pennsylvania, I would like to make the following recommendations for consideration by your committee:

1. **Amend the Local Government Unit Debt Act to improve the DCED debt approval process including the review of proposed self-liquidating debt.**

In a typical issuance of debt by a local government in Pennsylvania, there is a basically a two step process. First, the debt is priced in the market and the local government signs a bond purchase agreement with the underwriter locking in the terms of the debt – this is called "the bond sale". Second, about 30 days later the bond issue closes and the debt is issued. This is similar to entering into an agreement of sale when you buy or sell a house and then you close on the sale about 30 days later. During this 30 day window in a debt issuance, the local government files certain documents with the Department of Community and Economic Development (DCED), and DCED has 20 days to approve or disapprove the debt. The review at DCED is done by one lawyer in DCED's Office of Chief Counsel. The lawyer reviews the filing to see if the debt structure complies with the requirements of the Local Government Unit Debt Act (the Debt Act) and to see if the amount of debt outstanding is within the local government's debt limit. If these requirements are satisfied, DCED approves the debt and then the local government can proceed to closing on the debt.

As part of this DCED approval process, the local government may request that the debt be treated as self-liquidating and not counted against its normal debt limit on the basis that the project being financed, such as a water system, will generate sufficient revenues to pay for its ongoing operating costs and the payments on its debt. The local government files an expert's report with DCED which is reviewed by the same DCED lawyer. If the report meets the requirements of the Debt Act, then DCED approves the treatment of the debt as self-liquidating and it is not counted against the local government's debt limit.

Each time the local government files with DCED for approval of new debt, the local government, if it has self-liquidating debt outstanding, must also certify "that no decrease in the amounts [of debt] to be excluded [as self-liquidating] is required by any change in circumstances or, if there has been a change …. that less debt is to be excluded." This requirement is in Section 8110(b) of the Debt Act, and the

certification is commonly referred to as an "8110(b) certificate". In other words, the local government must certify that its existing self-liquidating debt continues to in fact be self-liquidating, or if it is not, how much of that debt, if any, should be considered to still be self-liquidating. This is simply a certificate filed with DCED; it is not required to be accompanied by a new expert's report. The DCED lawyer reviews this certificate in connection with the debt approval process for the new debt.

As representatives from DCED testified to you on October 4, this is essentially a "check the box" approval process to make sure the technical requirements of the Debt Act are being met, but it is not a substantive financial review of whether the debt makes sense for the local government. Other states, such as North Carolina and New Jersey, do undertake a substantive financial review at the state level of proposed debt issuances by local governments.

I would suggest the following changes to the Debt Act with respect to the DCED approval process:

There should be a two step review and approval process by DCED. Under the current approval process, in a typical situation, DCED does not even know that the local government is intending to issue debt until the "bond sale" has already occurred. Buyers of the debt are already lined up by the time the filing is made with DCED. This puts tremendous pressure on DCED to approve the debt, because if the debt is disapproved by DCED, the local government will not be able to meet its commitment under the bond sale. The buyers who expected to buy the debt are angry, and this could likely negatively affect the terms the local government will get when it goes into the market again.

The Debt Act should be amended to require a new, first filing with DCED before any bond sale takes place. The local government should have to notify DCED that it intends to issue debt and should have to present evidence to DCED of the following items:

(1) Proof that the local government is up to date on its audited financial statements. The lack of financial statements is a very large red flag that there may be serious financial problems. If the local government does not have up-to-date audited financial statements, DCED should be empowered to prevent the local government from issuing debt until it does have such statements.
(2) Proof that the local government is up to date on its secondary market disclosures for its existing debt. Under Securities and Exchange Commission (SEC) Rule 15c2-12, if a local government issues debt that is publicly sold, the local government must make filings with the Municipal Securities Rulemaking Board's electronic EMMA System (http://emma.msrb.org), including annual updates of basic financial information and notice of any extraordinary events such as payment defaults. This enables owners of existing debt in the market to understand the current financial condition of the local government. The failure of a local government to meet its disclosure obligations under Rule 15c2-12 is another very large red flag that there may be serious financial problems. If the local government is not up to date in its disclosure obligations under Rule 15c2-12, DCED should be empowered to prevent the local government from issuing debt until it is in compliance.

(3) If the local government intends the proposed debt to be self-liquidating, proof that the debt will be self-liquidating. DCED should have an employee with a financial background review the self-liquidating analysis and also review the general financial condition of the local government as reflected in its audited financial statements. If DCED does not accept the self-liquidating analysis of the local government, DCED should be empowered to deny the treatment of the debt as self-liquidating. The local government could then only issue the debt if it fits within its normal debt limit under the Debt Act.
(4) If the local government has existing debt which was previously approved by DCED as self-liquidating, proof that the debt continues to be in fact self-liquidating. The DCED employee with a financial background would also review this self-liquidating analysis. If DCED does not accept the analysis of continued self-liquidating status, DCED should be empowered to withdraw the self-liquidating treatment of that debt.
(5) If the local government wishes to issue refunding debt which does not have net present value savings, proof that the refunding is a sound financial transaction and is in the best long term financial interest of the local government. The DCED employee with a financial background should review the refunding proposal. If DCED does not agree that the refunding is a sound financial transaction or is not in the best long term financial interest of the local government, DCED should be empowered to prevent the local government from issuing the debt.
(6) If the local government wishes to issue debt over 10% of the proceeds of which will be used for working capital, proof that the financing is a sound financial transaction and is in the best long term financial interest of the local government. If DCED does not agree that the proposed debt is a sound financial transaction or is not in the best long term financial interest of the local government, DCED should be empowered to prevent the local government from issuing the debt.

Once DCED is satisfied on these six points, it could issue a “preliminary approval” of the debt and allow the local government to proceed with the bond sale process. Once the debt is priced, the local government would then come back to DCED for the regular approval of the debt as contemplated under current law.

I believe this two step process, which includes a substantive review by DCED of some basic financial requirements, would flush out any serious problem situations and avoid the sort of irrational piling on of inappropriate debt of the type which took place in Harrisburg.

The Debt Act should also be amended to require DCED to retain its approval records for a bond issue until five years after the bond issue has been paid off.

The Debt Act should additionally be amended to prohibit any local government from collecting a “guaranty fee”. If a local government chooses to guaranty the debt of an authority, it should do so solely to help the marketing of the authority’s debt, not to make money for the local government’s own purposes.

2. **Amend the Debt Act and the Municipality Authorities Act to prohibit local governments and authorities from entering into any new interest rate swap agreements.**

Pages 80 to 98 of "The Harrisburg Authority Resource Recovery Facility Forensic Investigation Report" dated January 12, 2012 (the Forensic Report) contain a very disturbing description of the swaps entered into in connection with the Harrisburg incinerator debt: http://www.hbgauthority.com/news/Forensic%20Investigation/Harrisburg%20Report.pdf

Auditor General Jack Wagner issued a report in 2009 on swaps entitled "A Special Investigation of the Bethlehem Area School District, Lehigh/Northampton Counties: A Case Study of the Use of Qualified Interest Rate Management Agreements ("Swaps") By Local Government Units in Pennsylvania, With Recommendations" (http://www.auditorgen.state.pa.us/Reports/Investigations/invBASD111809.pdf). This report contains a fairly detailed description of the swaps which have been entered into by local governments, including school districts, in Pennsylvania. The Auditor General recommended eliminating swaps for local governments in Pennsylvania.

The Pennsylvania Budget and Policy Center published a report in January 2012 analyzing the swaps entered into by the City of Philadelphia and the Philadelphia School District: http://pennbpc.org/too-big-to-trust. The Center estimated that the combined losses of the City and School District through last year on their swap transactions were $331 million, and they have the potential of $240 million more of losses in the future. Philadelphia City Council held a hearing on October 23, 2012 to look into the City's swaps.

The Debt Act was amended by Act 23 of 2003 to permit local governments to enter into interest rate swaps and similar derivative instruments (I refer to them here simply as "swaps"). The broad contractual powers of authorities under the Municipality Authorities Act have been interpreted by bond lawyers to allow authorities to enter into swaps.

In simple terms, a swap is an agreement between two parties to trade payment obligations. For example, a local government agrees to pay a financial institution payments based on a fixed interest rate of 4% and the financial institution agrees to pay the local government payments based on a variable rate formula such as 67% of One Month LIBOR. The parties basically graft the swap onto a bond issue. The local government might issue bonds with a variable rate. When you add the swap on top, the financial institution pays the local government a variable rate which is "expected" to equal the variable rate due on the bonds, and the local government pays the financial institution the fixed rate of 4%. The net effect, when it works properly, is that the local government ends up with a 4% fixed rate obligation even though the local government originally issued variable rate bonds. If a party to a swap wants to get out of it early, the party may have to pay a "termination payment" or "termination fee" which could be in the many millions of dollars.

As confusing as the last paragraph is, that is about as simple a description of a swap as one can give. Swap transactions can have an unlimited number of complexities that can make them extremely difficult to understand.

Add to this the reports that LIBOR, the variable rate commonly used in swaps, may have been manipulated by large financial institutions (http://www.economist.com/node/21558281).

There no doubt have been "good" and "fair" swap transactions entered into by local governments and authorities since 2003, and swaps are not inherently "evil". However, there have also without doubt been some very bad swap transactions entered into by local governments and authorities.

The bottom line for me is, if you view the nine years of swaps under the Debt Act as an experiment, it has been a failed experiment, and it should be discontinued. Swaps are simply too volatile for local governments. All the risks in swaps that seemed so theoretical up to 2007 became real and active once the Great Recession hit. The plunging interest rates put local government officials in the difficult position of trying to decide when to get out of swaps which had gone bad.

One financially strong county in Pennsylvania agonized for years over when to get out of a swaption (which is a particular type of swap). Five years ago they could have gotten out by paying a termination fee of $4 million. It is extremely difficult politically for public officials to vote to send $4 million to a financial institution to get out of a swap. So those county officials waited and waited. Meanwhile interest rates kept going down and the termination fee kept going up. Finally, under the terms of the swaption, the officials needed to terminate the swaption this year. They paid over $24 million to terminate the swaption. I do not relate this to criticize those officials, but to point out that the types of decisions required when an entity enters into or gets out of a swap are simply incompatible with the environment in which public officials have to operate. That means that local governments and authorities should be prohibited from entering into swaps. The county council in the situation I described above adopted a resolution in July of this year setting a policy to never enter into a swap transaction again; they described swaps as a "financial nightmare and predatory gimmick".

The Debt Act and the Municipality Authorities Act should be amended to prohibit local governments and authorities from entering into new swaps. There are also other statutes governing other types of authorities (for example, parking, housing and redevelopment) which could also be amended to prohibit the future use of swaps.

Let me just say one more thing about swaps. If a bill is introduced to eliminate swaps, the financial industry will no doubt heavily lobby the General Assembly not to eliminate swaps but to add additional "protections" for the local governments. You should not accept these arguments. If you continue to allow the use of swaps, even with additional protections, I believe it is inevitable that there will be more multi-million dollar fiascos that result for local governments and authorities. This is one of those situations in which you really do need to protect Main Street (your local communities) from Wall Street.

3. **Amend the Debt Act to include criminal penalties for knowingly participating in an ultra vires act of a local government or for filing a materially false certification with DCED or for aiding and abetting any such act or filing.**

One thing that came out of the Great Depression of the 1930's was the realization that the securities markets cannot operate under the principle of *caveat emptor* (buyer beware). The securities industry needs to be regulated, and those professionals and financial institutions which are part of the securities industry need to deal honestly and in good faith with the issuers and the investors. The approval process under the Debt Act, with its minimal review by DCED, has also relied on the honesty and good

faith of the professionals and financial institutions who are involved in the issuance of debt by Pennsylvania's local governments.

It seems to be an inescapable conclusion from reading the Harrisburg Forensic Report that the debt issuance process went horribly wrong on the many incinerator financings. The number one policy goal of the Debt Act is to prevent a local government from issuing more debt than can be supported by its taxpayers. All the detailed provisions of the Debt Act are geared to fulfilling that policy goal. The parties involved in the incinerator financings should have known very well that preventing the over issuance of debt is the main goal of the Debt Act – certainly for the bond lawyers there can be no question that they understood that policy. And yet, as described in the Forensic Report, the self-liquidating provisions were stretched or twisted or distorted or ignored or violated, and the City incurred over $300 million of debt in incinerator financings that its taxpayers simply are incapable of paying.

Although the overwhelming majority of Debt Act financings are undertaken in compliance with the letter and spirit of the law, I believe it is necessary to have specific criminal penalties in the Debt Act to put the fear of the law into participants in financings that are highly questionable or illegal. It is particularly important that public officials who are filing certifications with DCED, and professionals and others who assist those public officials, are not knowingly filing materially false or misleading certifications. There is a statute in Pennsylvania which makes it a second degree misdemeanor to make "a false statement under oath or equivalent affirmation …. intended to mislead a public servant in performing his official function." (18 Pa.S.A. 4209.) A violation of this statute is punishable by up to two years in prison and a fine of $5,000. This statute could be the basis for an investigation over what happened on the Harrisburg incinerator debt. But it will be even more effective in future situations if there is a specific criminal provision included in the Debt Act itself.

The inappropriateness of false certifications is already contemplated by the Debt Act. Section 8209(b) provides as follows: "Liability for willful violations or fraud. – This section does not relieve any person participating in the proceedings from liability for knowingly participating in an ultra vires [*means - beyond the power*] act of a local government unit or from any civil or criminal liability for false statements in any certificates filed or delivered in the proceedings." The Debt Act should be amended to include specific criminal violations and penalties for knowingly participating in an ultra vires act of the local government or for the knowing filing of materially false or misleading certifications or for aiding and abetting any such act or filing.

4. The General Assembly should pass no further extensions of the bankruptcy prohibition.

As you know, the City of Harrisburg is a distressed municipality under the Municipalities Financial Recovery Act, known as Act 47. Because it is under Act 47, Harrisburg cannot file for federal bankruptcy without the consent of the Secretary of DCED. Because Harrisburg has a receiver under Chapter 7 of Act 47, only the receiver may file for federal bankruptcy on behalf of the City. Therefore, in order for Harrisburg to file for federal bankruptcy, the filing must be made by the receiver with the consent of the Secretary of DCED.

In addition, the General Assembly passed statutes in June 2011 and June 2012 which prohibited any third class city (including Harrisburg) from filing for federal bankruptcy first before June 30, 2012 and now before November 30, 2012. This total prohibition on filing for bankruptcy is not needed. The General Assembly should have complete confidence that no frivolous bankruptcy will be filed by Harrisburg, because under Act 47 that decision is within the total control of the receiver and the DCED Secretary.

I have no inside information on what is currently going on in the recovery plan negotiations, but based on the public information I have seen, I believe that the receiver, Major General William Lynch, is doing a very good job, and he needs to be supported in his efforts. As contemplated by the recovery plan approved in February 2012 by the Commonwealth Court, the receiver must conduct serious and difficult negotiations with the various creditors of the City. Some of these negotiations will be impossible to accomplish outside of bankruptcy unless there is the threat of bankruptcy if those parties do not agree to significant concessions. General Lynch asked that the bankruptcy prohibition not be extended in June 2012, but the General Assembly extended the prohibition to November 30, 2012. The General Assembly should not extend or reimpose the prohibition again.

5. **The General Assembly should ask the State Attorney General and United States Attorney to conduct a criminal investigation of the Harrisburg incinerator financings, or the General Assembly should pass an act for the creation of a special prosecutor to conduct such an investigation.**

When I served as receiver, I got to see first hand the financial devastation caused by the incinerator financings. Every aspect of daily life in Harrisburg – water service, sewer service, police protection, fire protection, trash collection, economic development, parks and recreation – has been negatively affected by the incinerator financings. The City's relationships with the County, the suburban residents, the state government, the federal government and the credit markets, and the City's reputation in the state, in the nation and internationally, have been poisoned by the incinerator financings. The reputation of the state has also been negatively affected by the problems of its capital city.

There is a small group of probably 25 to 50 people and institutions who collectively caused this devastation because of what was done in the incinerator financings. Their individual responsibilities probably vary widely, but as a group, they did this terrible thing. I believe that the incinerator debt was clearly not self-liquidating, and much of that debt should never have been able to be issued under the law as set forth in the Debt Act. I believe that certain parties within that group of 25 to 50 showed a fundamental disdain for the law.

The current members of the board of The Harrisburg Authority should be saluted for having the courage to commission and issue the Forensic Report. This Local Government Committee of the Senate should also be applauded for searching for the truth in these hearings. There are also many regular citizens and members of the media who have worked hard to bring to light what happened in the incinerator financings.

But in spite of all of these efforts, the only way to really find out, for the good of our democracy and our Commonwealth, whether there was criminal activity involved in these financings is to have an experienced prosecutor conduct a thorough investigation. I would recommend that the General Assembly encourage the State Attorney General and the United States Attorney to undertake such an investigation, or to continue the investigation if one has already been commenced. But if the State Attorney General and United States Attorney have not and will not conduct an investigation, I would recommend that the General Assembly enact a statute providing for the appointment of a special prosecutor.

Some parties who may be subject to such an investigation may argue that an investigation should not be commenced because the five year statute of limitations has run. But the law of statute of limitations is quite complex, and when the five years actually runs and when it is paused and does not run may depend on the exact facts uncovered by the prosecutor. In addition, other acts may have occurred since the financings closed which could have their own statutes of limitations. Statute of limitations arguments should not prevent the investigation from commencing.

Thank you very much for the opportunity to provide this testimony.