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MEMORANDUM FOR CITY COUNCIL MEMBERS

A Framework For Evaluating Alternatives For Harrisburg

February 24, 2011

Introduction

The City Council has asked for consideration of alternatives for addressing its financial situation, including proceedings under Act 47 and the filing of a case under chapter 9 of the Bankruptcy Code. This short note is intended to provide a framework for initial privileged, attorney-client discussions with Council Members about solutions and alternatives and about the Members' views. It is also intended to provide enough of an overview to enable Members to develop any particular questions that they may have about Act 47 and chapter 9 so that they can be addressed in our final report. It does not suggest, evaluate or provide advice on any alternatives that may be available to address the City's financial situation. We intend to cover such alternatives in our final report.

Background

Harrisburg's principal financial problems can be grouped roughly into two categories: on-going budget strains resulting principally from weakening tax and fee receipts and mounting expenditures and obligations arising from the City's guarantee of the Resource Recovery Facility ("Facility") obligations issued by The Harrisburg Authority ("THA") in the total amount of approximately \$288 million. The Facility obligations are a combination of bonds that THA issued to the public, a swap agreement and a note that it issued to Covanta Harrisburg, Inc. The Facility bonds are revenue bonds, which are secured by and paid from the stream of income from the Facility.

The City has guaranteed all of THA's Facility obligations. Assured Guaranty Municipal, Inc. has insured all of the THA Facility bonds, and Dauphin County has guaranteed some of the bonds. If THA does not make a bond payment when due, the City, the County or Assured is required to make the payment. As between the City, the County and Assured, the City is primarily liable, and the County is secondarily liable, so that City is liable under its guarantee to reimburse any payments that the County or Assured makes. The County and Assured have already made payments on some of the bonds. Thus, although there may be numerous holders of Facility bonds, the City effectively has only three major Facility creditors: Assured, the County and Covanta. The City's guaranty obligations are general obligations, that is, backed only by a city's full faith, credit and taxing power, not by any particular assets.

As a result of these two principal financial problems, among others, the Commonwealth's Department of Community and Economic Development declared Harrisburg a distressed city under the Pennsylvania Municipalities Financial Recovery Act of 1987 ("Act 47") on December 15, 2010. Initial observations suggest that no foreseeable amount of tax and fee enhancements or expenditure reductions alone would be adequate to enable Harrisburg to meet the Facility obligation guaranties. In addition, the City is a defendant in several lawsuits, which seeks to require the City to pay the amounts it owes under its guaranties of the Facility obligations. The lawsuits seek writs of mandamus, that is, an order requiring the City and its Treasurer to apply all tax proceeds first to the repayment of debt, before paying the City's operating expenses.

Act 47 and Chapter 9 Procedures

Neither Act 47 nor chapter 9 is a solution to Harrisburg's financial distress nor an alternative to addressing its underlying problems. Each is only a process by which a solution may be reached. Moreover, they are not mutually exclusive processes. Rather, they are integrated processes that may work together when necessary.

A solution to Harrisburg's financial distress will be embodied in a plan, whether adopted under Act 47 alone or also under chapter 9, that provides in detail how the City will address its financial obligations. Act 47 and chapter 9 both contemplate a consensual plan, that is, one on which each of the major stakeholder groups agree. Achieving a consensual plan should be a paramount goal of either process, because of the savings in time, expense, uncertainty and good will that will result. However, an Act 47 plan can be implemented only if the plan is fully consensual, that is, if all stakeholders agree. By contrast, a chapter 9 plan can be approved by the court and made binding on dissenting creditors under limited circumstances, as described in more detail below.

Act 47 and chapter 9 each provide tools that a city may use to create a plan. Act 47's tools include the services of management and economic consultants, at the Commonwealth's expense. The consultants are to advise on operational improvements and on the economic and financial effect of changes that the plan may propose and are to centralize negotiations with all stakeholders. Act 47 status also grants a city higher priority access to certain Commonwealth funds, limited access to a Commonwealth loan

fund to meet operating expenses on a temporary basis and the ability to raise taxes, with a court's approval, above ordinarily applicable statutory limits. The Act 47 Plan Coordinator must propose a plan within 90 days after formal appointment. If, after hearing and possible revisions, the plan is not accepted by all stakeholders and by Council, then the Mayor must propose an alternative plan that must be accepted by all stakeholders, including Council and the Act 47 Plan Coordinator.

Chapter 9's tools include an automatic stay that prohibits all creditor collection actions against the city and the ability to suspend payments on current obligations, including general obligation bonds. A city may also reject any of its executory contracts, that is, it may breach the contract with court approval and convert the on-going contractual obligation into a general claim that would be addressed under the plan. Under chapter 9, the city must propose a plan, not its creditors and not the court. However, Act 47 requires that even in chapter 9, the Act 47 Plan Coordinator has a central role in formulating the plan, and a specific provision in chapter 9 appears to provide that chapter 9 does not supersede that procedure.

Chapter 9 permits the court to bind a dissenting creditor to a plan that discharges a portion or all of its claim. The mechanism to do so has two branches. The plan must "classify" claims based generally on the legal rights against the city arising from the claims. For example, general obligation bonds provide different rights than revenue bonds and would therefore be classified separately. Different classes receive different treatment under the plan. Creditors vote by class on a plan before the court considers whether to confirm it. The court may bind all creditors within a class, including the dissenters, if the class accepts the plan by the requisite vote—a majority in number of creditors in the class who hold at least 2/3 in dollar amount of the claims in the class. If a class does not accept the plan (referred to as a "nonconsensual plan"), the court may still approve the plan and bind not only the dissenting creditors in an accepting class but also all holders of claims in a non-accepting class (referred to as "cram down"). The court may confirm a nonconsensual plan and exercise the cram down power only if at least one other class has accepted the plan and if the plan requires the city to provide for the non-accepting class all that can reasonably be expected under the circumstances. A plan may not "gerrymander" the classification scheme to get a favorable vote.

Each process also has its limitations, costs and risks. Act 47 operates effectively only where all stakeholders can agree on a plan. The only sanction resulting from a failure to agree falls on the city, not on any of the other stakeholders. If the city does not agree to a plan that is also acceptable the Act 47 Plan Coordinator within the statutory time limits contained in Act 47, the DCED Secretary may cause the Commonwealth to suspend funding of all Commonwealth grants, loans and payments to the City (except for certain "pass-through" payments from the federal government). Act 47 does nothing to stop litigation or debt collection activities against the city nor to bind stakeholders to a solution that affects them, such as a partial discharge of a claim or the resetting of a contract, to which they do not agree.

Chapter 9 permits a city to gain court approval of a nonconsensual plan and cram down the plan on a dissenting class of creditors, but only if certain statutory

conditions are met: the city must do all that can reasonably be expected under the circumstances, whether that involves raising taxes and fees, cutting expenditures or selling property. Attempting to confirm a nonconsensual plan under this condition is likely to involve heavy litigation. Thus, chapter 9 does not operate simply to cleanse a city of its debt, and any discharge of debts comes only at an uncertain but likely large cost.

A city may file a chapter 9 case only if it is insolvent, is authorized by state law to file and meets one of four preconditions: it has reached general agreement with its creditors on a plan, it has engaged in good faith negotiations with its creditors on a plan and failed to reach general agreement, negotiations with creditors are impracticable or a creditor is about to take enforcement action against the city. A chapter 9 filing under the second or third precondition is likely to meet vigorous litigation from one or more creditor groups. Litigation in a chapter 9 case creates not only delay and expense but also uncertainty. Outcomes can never be assured, as the guiding precedents are limited and speak only in general terms, and the outcomes rely heavily on the court's judgment and discretion.

Chapter 9 also imposes indirect costs on a city. The city's access to credit markets is likely to be impaired for an indefinite period. Its access to new business and development may be impaired as well, at least until the business community gets comfortable that the uncertainty and distress surrounding the initial filing and the outcome of the case has been dissipated. The time and attention the city must devote to its debt restructuring and the chapter 9 case can detract attention from the rebuilding and growth needed to restore the city's health.

Chapter 9 imposes costs on creditors as well. The automatic stay permits the city to suspend payment of claims. Although a creditor may insist on full payment, if its demands cannot reasonably be met, it risks the city's attempt to file and obtain court approval of a cram down plan. That process may cost the creditor in both time and costs, including legal fees, and ultimately in recovery. For even if the creditor is successful in defeating such a plan, the path to recovery may be difficult.

If the city proposes and the creditor defeats a plan, both sides may suffer. The court may dismiss the case, leaving the city unprotected and without any mechanism to implement a payment plan, other than through negotiation with the creditor, which already failed. Dismissal also leaves the creditor with no clear means of recovery, because a city that has not restructured its debts will not be in a position to satisfy the creditor's claims. In addition, a failed chapter 9 case does not protect the city from the funds cutoff embodied in Act 47.

Neither Act 47 nor chapter 9 can affect a third party's obligations, such as THA's obligations on its Facility bonds or notes nor the County's obligations on its guarantee of some of THA's bonds, without the consent of the third party's creditors. Thus, a nonconsensual adjustment of a creditor's claim against the City on its Facility guarantees, for example, would not affect THA's liability on its Facility obligations or the County's obligations on its guarantees.

Neither the Act 47 Plan Coordinator nor the chapter 9 court may impose solutions on the stakeholders, except in limited statutorily-prescribed circumstances. That is, neither becomes a "super-administrator" that has the power to develop and implement a solution. And in fact, each process requires City Council approval of a plan, even in the limited circumstances under which a plan may be imposed on creditors. In a chapter 9 case, the court may not interfere with any of the city's political or governmental powers, including its use of property or its payment of expenses. The court may not displace Commonwealth procedures, such as Act 47, for controlling the city, so the Act 47 process continues during a chapter 9 case, and the Plan Coordinator remains a central player in developing a plan in a chapter 9 case.

A solution to a city's financial distress may include some combination of operational improvements, budget adjustments, revenue enhancements, expenditure reductions (including from contract renegotiations), asset sales, debt refinancings and debt reductions or other adjustments. A solution serves a city best if it is fully consensual, so that it can be accomplished and implemented without the need for a chapter 9 filing and the attendant direct and indirect costs. That should be any distressed city's goal.

At the same time, the threat of a chapter 9 filing and the power the filing can bring to bear on a recalcitrant creditor provides useful negotiating leverage that would not be present where the possibility of a chapter 9 filing has been removed from the table. And, importantly, chapter 9's automatic stay can protect a city against disruptive or debilitating creditor collection action, such as a mandamus proceeding, that could starve a city of tax revenue. Thus, there are two principal reasons that a city would use chapter 9: to bind a group of dissenting creditors to a plan that some creditors have accepted (or would be willing to accept once the restructuring terms for the dissenting creditors have been set) or to obtain the automatic stay of the enforcement of a judgment or mandamus order against the city.

Evaluating Alternatives

With this Framework in mind, the following matters should be considered in developing and evaluating alternatives for addressing Harrisburg's financial situation.

- A chapter 9 case must be filed promptly if a writ of mandamus is issued and if its enforcement is not stayed in any of the pending litigation against Harrisburg. The chapter 9 filing would stay the enforcement and restore tax revenues to the payment of City operating expenses.
- Unless there is an imminent threat of enforcement of a judgment against the City, a chapter 9 case may not be filed unless the City has first engaged in negotiations with its creditors or such negotiations are impracticable. The limited number of principal creditors here would make it more difficult to show that negotiations are impracticable.
- The Facility obligations effectively are general obligations of the City, even though the underlying obligations are only revenue bond

obligations, not general obligations, of THA. Therefore, the claims of the three principal Facility creditors, the County, Assured and Covanta, are likely to be classified together in a chapter 9 plan for the City. If only two of them accept the plan and their claims constitute 2/3 in amount of the total claims of the three, then the Court could bind the dissenting third creditor. Otherwise, only a cram down would be available, and only if another class accepted the plan. A cram down proceeding would be hotly contested. There may be more complex classification schemes that could limit the ability of the County or Assured to control the vote on the plan, but any such schemes would also likely require lengthy, intense and risky litigation.

- As in most negotiations, the concessions that may be obtained from a negotiating counterparty will depend on the risk to the counterparty of not reaching an agreement and, more importantly, on the counterparty's perception of the risk. Chapter 9 provides a threat that there will be a substantial delay and that at the end of the case, the court may conclude that a city's proposal provides the creditor all that can reasonably be expected under the circumstances. Conversely, the city has a risk that the court will not so find.
- Creditors may be willing to adjust their claims under certain circumstances. The two principal motivators are a borrower's inability to pay and the risk of a defect or flaw in the creditor's claim. The risk of litigation in a chapter 9 case over plan confirmation may also provide some motivation, but that depends on the city's and the creditor's evaluation of the strength of their litigation positions. In some cases, however, a creditor will disregard litigation risk if it has an institutional reason that prevents it from compromising a particular position. In some cases, that is, a party is willing to accept a defeat handed out by a judge rather than agree to a compromise, to protect its position in future negotiations with other counterparties. Conversely, creditors sometimes compromise to preserve a future business relationship. Thus, a creditor's willingness to compromise depends heavily on the particular facts, and there are no general numerical guidelines, least of all in municipal distress situations, because of the infrequency of their occurrence. It is fair to say, however, that creditors do not typically compromise without a sound legal or financial reason to do so.
- A bankruptcy court is not likely to approve a cram down plan unless the City proposes to do all that can reasonably be expected under the circumstances. Those actions might include not only the operational improvements that the Plan Coordinator is planning to address but also maximum effort to enhance tax and other receipts and the sale of non-essential assets to reduce principal amounts outstanding.

- Bond refinancings, not only of the Facility bonds but also of other bonds, coupled with operational improvements at revenue producing projects, may provide additional sources of financial relief.
- Unless the City gets the consent of THA and its creditors (or perhaps acquires the Facility from THA), neither Act 47 nor chapter 9 will address the underlying Facility bonds and other obligations. Act 47 and chapter 9 can address only the City's guaranties and its obligations to reimburse the County and Assured to the extent that they meet their guarantee or insurance obligations directly to the bondholders.

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