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BILL ANALYSIS

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Senate Bill 160 (Substitute S-2 as passed by the Senate) *(enrolled version)*
Sponsor: Senator Darwin L. Booher
Committee: Banking and Financial Institutions

Date Completed: 3-31-15

RATIONALE

The Home Rule City Act allows a city to issue financial recovery bonds in the event of a financial emergency, and to issue additional bonds to the Michigan Finance Authority to pay for city obligations, to refund other bonds, or for other purposes. On December 10, 2014, the City of Detroit issued $275.0 million in financial recovery bonds in order to retire debt incurred in the course of its recent Chapter 9 bankruptcy and to begin making improvements within the city.[1] On the same date, the Michigan Finance Authority sold the bonds to Barclays Capital, Inc. To secure its obligations related to the bond issue, Detroit entered into a trust agreement and pledged its city income tax revenue, as authorized by the Act.[2] According to the Bond Purchase Agreement between Barclays and the Michigan Finance Authority, Barclays will make a public offering of the bonds within 150 days of the December purchase, and the Authority will obtain credit ratings on the bonds from at least two rating agencies before the offering.

As the public offering approaches, concerns have been raised about the security interest in the pledged city income tax revenue. Although the trust agreement gives the trustee a first priority lien in the revenue, and the Act creates a statutory lien applicable to the revenue received or to be received by the trustee, rating agencies apparently believe that additional statutory language is needed to protect the trustee's interest in the city income tax revenue. Evidently, without this language, it is likely that the bonds will be sold below investment-grade, which will translate into a lower credit rating for Detroit and a higher interest rate on the bonds. To address these concerns, it has been suggested that amendments to the Home Rule City Act should establish the trustee's right to the pledged revenue.

CONTENT

The bill would amend the Home Rule City Act to do the following:

- **Specify that if a city with a population of more than 600,000 in a charter county issued financial recovery bonds to the Michigan Finance Authority, and met other conditions, the city revenue to be deposited into a trust account would be held in trust for the benefit of the trustee after the bonds were issued and before the revenue was deposited.**
- **Provide that the revenue would be held in trust for the benefit of the trustee and the bonds regardless of who collected it, and would remain subject to the trust regardless of subsequent transfers until the trustee received the revenue.**
- **Specify that other interests in the revenue would be subordinate to a lien in favor of the trustee that would arise by operation of law and be superior to all other liens and interests of any kind.**

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[1] The sale involved the issuance of two series of bonds: one with a principal amount of $134,725,000 and a maturity date of 10-1-2029, and another with a principal amount of $140,275,000 and a maturity date of 10-1-2022.

[2] The pledged income tax revenue excludes a portion that must be transferred to the city's police department, and used to retain and hire police officers, pursuant to Public Act 370 of 2012.

Under the Act, if a financial emergency exists under the Local Financial Stability and Choice Act, a city may issue financial recovery bonds in amounts greater than the limits established by the city charter or the Home Rule City Act. A city that issues financial recovery bonds may refund all or a portion of those bonds at a later time, subject to the terms and conditions approved by the Local Emergency Financial Assistance Board. If financial recovery bonds are or have been issued by a city, the city may provide additional security for the prior bonds and may issue additional financial recovery bonds to be sold to the Michigan Finance Authority for the purpose of refunding all or a portion of the prior bonds, or other city obligations, and for other purposes approved by the Board.

Under the bill, if a city with a population of more than 600,000 located in a charter county were to issue or had issued financial recovery bonds and, as a specified condition of the issuance, entered into an agreement with a trustee for the deposit of city revenue pledged by the city into a trust account established for the sole purpose of paying principal of and interest on those bonds and related administrative expenses, and the city received the approval of the State Treasurer, then, at all times after the issuance of the bonds and before the deposit of city revenue into the trust account, the revenue to be deposited would be held in trust for the benefit of the trustee and the bonds by any party coming into possession of the revenue.

The revenue would be held in trust for the benefit of the trustee and the bonds regardless of whether the city directly collected the revenue, a third party collected the revenue on the city's behalf, or any other person came into possession of the revenue. The revenue would remain subject to the trust regardless of subsequent transfer or transfers of the revenue until it was deposited into the trust account.

To the extent that the city or any other person held a residual or other interest in the revenue held in trust and to be deposited with the trustee in the trust account, the interest would be subordinate to a lien in the revenue in favor of the trustee for the purpose of ensuring delivery of the revenue to the trust account. This lien would arise by operation of law and without further act or notice of any kind at the earliest time that the city had or acquired any rights in the revenue pledged pursuant to the agreement. The lien would be superior to all other liens and interests of any kind, and would be perfected without delivery, recording, or notice. The revenue held in trust and to be deposited into the trust account would be exempt from being levied upon, taken, sequestered, or applied toward paying the debts or liabilities of the city other than those expressly specified in the agreement.

MCL 117.36a

ARGUMENTS

(Please note: The arguments contained in this analysis originate from sources outside the Senate Fiscal Agency. The Senate Fiscal Agency neither supports nor opposes legislation.)

Supporting Argument

Despite the existing language in the Home Rule City Act, the provisions of the trust agreement that Detroit entered into, and various other documents, bond rating agencies have expressed concern about the security in the city income tax revenue pledged for the Detroit financial recovery bonds. Evidently, absent a more precise statutory lien, they have indicated that the bonds will not be rated investment-grade when Barclays re-offers the bonds to the public. Presently, Detroit is paying a variable rate of interest on the bond issue, but the interest rate will be fixed when the sale takes place. If the bonds are sold at investment-grade, the city will save several million dollars annually in lower interest payments over the 15-year period that the bonds are outstanding. Those funds could be used by the city to invest in public safety and municipal services.

To help ensure this outcome, the bill would establish a statutory lien tailored to the Detroit financial recovery bonds. Specifically, the pledged revenue would be subject to the statutory lien before it is deposited into the trust account, it would be held in trust by any person coming into possession of the revenue, and it would remain subject to the trust regardless of any transfer until it is deposited, and the lien would be superior to all other liens or interests of any kind. As a result, in the theoretical event of a subsequent bankruptcy or other unforeseeable circumstances, the same revenue could not be pledged for another purpose before the bonds are repaid.

The bill also would help ensure that the Grand Bargain[3] remains intact. In addition, by preventing a negative impact on Detroit's credit rating, the bill would protect the credit rating of the State, which can be influenced by the financial soundness of its largest city.

Legislative Analyst: Suzanne Lowe
Jeff Mann

FISCAL IMPACT

The bill would reduce the costs of the City of Detroit for debt service on financial recovery bonds by approximately $2.0 million to $3.0 million per year over the 15-year period when bonds are outstanding. A $275.0 million issue of financial recovery bonds initially was privately placed on December 10, 2014, with Barclays Capital, Inc. for up to 150 days. These bonds are to be reoffered in a public sale at which time the bonds will be converted from a variable interest rate to a fixed interest rate. Bond rating agencies have stated that a statutory lien on the income tax revenue pledged to repay the bonds would improve the bond rating and result in lower interest costs. The bill would have no fiscal impact on State government.

Fiscal Analyst: Elizabeth Pratt

[3] "Grand Bargain" refers to the complex series of agreements, arrangements, and legislation that enabled Detroit to emerge from bankruptcy.

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