

How Cities Can Tackle Post-Pandemic Budgeting Dilemmas

By **Lary Stromfeld, Ingrid Bagby and Thomas Curtin** (May 16, 2023, 4:51 PM EDT)

Cities across the country are facing a real estate crisis following the pandemic.

With the rise of remote work and increased layoffs, cities are facing growing office vacancy rates and large budget deficits. While cities will need to reduce their spending and revise budgets, they also may attempt to access the capital markets to achieve savings.

This article discusses the options that cities may have to access the capital markets, the potential impediments to pursuing certain alternatives in the wake of recent court decisions, and the risks for creditors and debtors with any Chapter 9 filing.

The Emptying of America's Downtowns

The COVID-19 pandemic upended the nation's economy in 2020, prompting lockdowns and forcing many Americans to work from home. Three years later, remote work has become a fixture in society.[1]

And, as the economy is potentially heading into a recession, certain companies are also downsizing their workforce. As a result, many companies have started to reduce the size of their office footprint, including Yelp, Meta and Salesforce.[2]

Office vacancies have therefore been on the rise, with the national vacancy rate reaching 16.7%.[3] Some cities have reported higher vacancy rates than others, including Houston (23%), Denver (19%) and Seattle (18.6%).[4]

This trend of office vacancies is perhaps most pronounced in San Francisco, where the city's office vacancy rate climbed from 5% to 29.4% in four years.[5] That number is expected to grow as more leases expire, with the city projecting that rates will reach 33% in fiscal years 2025 and 2026.[6]

Cities are now facing large budget deficits. With rising office vacancies, some cities have witnessed a decline in business, sales and property tax revenue collections.[7] For example, San Francisco announced a \$780 million budget deficit for the next two years and has projected a \$1.2 billion deficit in five years.[8]



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Mayor London Breed recently ordered San Francisco departments and agencies to cut their budgets by 5%.^[9] But San Francisco is not the only city facing a large budget deficit. For example, Oakland has a projected \$350 million budget deficit.

Lower tax collections and reduced federal relief funding also may constrain municipalities' continued ability to fund their pensions. Over the past decade, 10 of the nation's largest cities increased their pension benefits, sometimes doubling their expenditures.^[10]

Following the pandemic, cities have not been able to fund these increased expenditures, including Phoenix, which has \$5 billion in unfunded liability,^[11] and San Jose, which has \$3.6 billion in unfunded liability.^[12]

San Jose's unfunded liability represents 132% of its annual revenue.^[13] Without sufficient resources to pay their pensions, those cities' unfunded liabilities may continue to grow.

Nonbankruptcy Alternatives

Confronted with rising deficits, cities have already started to cut their budgets,^[14] but increased demand for social programs and other benefits could stymie those efforts.

Cities also have the option to raise taxes, but that is not a politically popular action. Absent prompt action to balance their budgets, cities' credit profiles could be pressured.^[15]

Municipalities also have the option to turn to the capital markets to help balance their budgets. Similar to Chicago Public Schools, some cities may attempt to reduce any risks associated with fluctuations in interest rates by converting certain of their debt from floating to fixed-rate debt.^[16] Taking such measures could help insulate some cities from future volatility in the market.

However, some court decisions in Puerto Rico's Title III case may ultimately complicate those efforts because they call into question the treatment of traditional forms of municipal securities, such as revenue bonds.^[17]

One way to alleviate those concerns is for cities to utilize securitization vehicles to finance their expenditures or to otherwise help balance their budgets.

Because securitization issuers are often established as bankruptcy remote entities and the revenue streams are separated from the city, the bonds issued by those issuers may be more attractive to investors.

Chicago and the U.S. Virgin Islands pursued this strategy.^[18] After Chicago's credit ratings were downgraded, the city established a securitization issuer, which issued bonds backed by certain sales taxes.^[19]

The securitization bonds received higher credit ratings because the bonds were issued by a bankruptcy remote issuer and the bond structure involved a true sale of the sales tax revenues.^[20] Those measures proved successful, as the city was able to close its budget deficit and has thus far avoided bankruptcy.

Chapter 9 Bankruptcy

If these measures do not prove fruitful, however, cities may consider Chapter 9 bankruptcy as an option.

Based on our experience in Detroit and Puerto Rico's restructuring proceedings, Chapter 9 filings generally are used as a last resort.

Many of the larger cases were filed after downgrades to the issuers' credit ratings and where those issuers subsequently lost access to the capital markets.[21] Thus far, the cities that have witnessed the highest office vacancies have not received any credit rating downgrades.

Not every municipal issuer will be eligible for Chapter 9 relief. To be eligible for Chapter 9, a city must, among other things — (1) be specifically authorized under state law to file for Chapter 9, (2) be insolvent, (3) have a desire to effect a plan of adjustment, and (4) negotiate in good faith with its creditors.

State laws vary across the country.[22] Some states authorize cities to file for Chapter 9 if they satisfy certain criteria,[23] while other states prohibit municipalities from filing for Chapter 9.[24] Careful consideration of state law is therefore necessary to assess the bankruptcy risk of a municipality.

A city must also be insolvent to file for Chapter 9, which generally means that the city is not paying its debts as they come due.[25] A recent decision by the U.S. Bankruptcy Court for the Eastern District of Pennsylvania in the City of Chester's Chapter 9 case has suggested that a city's failure to fund its pension systems, coupled with budget deficits, may serve as evidence of a municipality's insolvency.[26]

Thus, the large unfunded liabilities reported by cities after the pandemic could potentially serve as evidence of their insolvency.

Finally, a city must first engage in good faith negotiations with its creditors prior to filing for bankruptcy, unless negotiations are "impracticable" under the circumstances of the case.[27]

Creditors should be mindful that the good faith negotiation requirement is reciprocal. If a creditor refuses to meaningfully negotiate with a municipality, a court may find that negotiations with the creditor are impracticable.[28]

However, markets have not been forgiving of cities that sought bankruptcy protection. Notably, 10 years after filing for bankruptcy, Detroit still does not have investment grade ratings.[29]

Without investment grade ratings, cities may be forced to incur debt that bears higher interest rates, thereby eliminating any savings that the city may have achieved through its Chapter 9 filing.

Conclusion

While the duration of the current real estate crisis remains unclear, cities may encounter financial hardship due to the rise of remote work.

Office vacancies are increasing across the country, resulting in lower tax collections and large budget deficits. Cities may now be placed in a difficult position, requiring politically unpopular actions to balance their budgets.

Cities may also look to the capital markets to ride out the current real estate crisis. By tapping the capital markets, cities may achieve debt service savings, which could help balance their budgets.

However, cities' ability to issue traditional debt — such as revenue bonds — could be complicated by decisions from the Puerto Rico Title III case. Cities also may securitize certain of their assets to attract investors. Pursuing these measures may ultimately help cities to avoid bankruptcy.

If all other options fail, a municipality could seek Chapter 9 bankruptcy protection. However, not every city will be eligible for Chapter 9 relief, and the bankruptcy risk for each city will vary depending on its circumstances.

And any Chapter 9 filing would come at a significant cost for cities, potentially resulting in significantly higher costs of borrowing.

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[1] See Madison Hoff, How 3 Years of Work From Home Have Changed the US Economy Forever, Business Insider, (Apr. 2, 2023), <https://www.businessinsider.com/work-from-home-remote-work-changed-economy-pandemic-2023-4>.

[2] Yelp to Close Three of its Offices, Saying the "Future of Work" is Remote, CBS News (June 23, 2022), <https://www.cbsnews.com/news/yelp-closes-3-offices-future-of-work-is-remote/>; J.D Morris, Why Bad News for Downtown is Also Bad News for the Rest of San Francisco, San Francisco Chronicle, May 1, 2023, available at <https://www.sfchronicle.com/projects/2023/downtown-sf-map-recovery/>; See Salesforce is Leaving a San Francisco Office Tower Bearing its Name, The San Francisco Standard (Apr. 1, 2023), <https://sfstandard.com/business/salesforce-looks-to-dump-its-remaining-office-space-at-salesforce-east/>.

[3] See National Office Support, CommercialEdge (Apr. 2023), <https://www.commercialedge.com/blog/national-office-report/>.

[4] See id.

[5] See What Comes Next for the Most Empty Downtown in America, N.Y. Times, (Dec. 17, 2022) <https://www.nytimes.com/2022/12/17/business/economy/california-san-francisco-empty-downtown.html>; see also J.D Morris, Why Bad News for Downtown is Also Bad News for the Rest of San Francisco, San Francisco Chronicle, May 1, 2023, available at <https://www.sfchronicle.com/projects/2023/downtown-sf-map-recovery/>.

[6] See Annie Glaus, San Francisco's Budget Deficit Swells to \$780M in Latest Sign of Budget Distress, The San Francisco Standard (Mar. 31, 2023), <https://sfstandard.com/politics/city-hall/san-franciscos-deficit-swells-to-780m-in-latest-sign-of-budget-distress/>.

[7] See *id.*; Anna Tong, As Downtown San Francisco's Recovery Lags, A Tangle of Business Taxes Encourages Work From Home, The San Francisco Standard, <https://sfstandard.com/business/san-francisco-tax-code-encourages-work-from-home/>; Madison Hoff, How 3 Years of Work From Home Have Changed the US Economy Forever, Business Insider (Apr. 2, 2023), <https://www.businessinsider.com/work-from-home-remote-work-changed-economy-pandemic-2023-4>.

[8] See S.F.'s Budget Deficit is Even Worse Than Expected. Here's Why More Cuts Are on the Way, San Francisco Chronicle (Mar. 31, 2023), <https://www.sfchronicle.com/sf/article/s-f-faces-bigger-deficit-even-months-ago-17867788.php>.

[9] See Annie Glaus, San Francisco's Budget Deficit Swells to \$780M in Latest Sign of Budget Distress, The San Francisco Standard (Mar. 31, 2023), <https://sfstandard.com/politics/city-hall/san-franciscos-deficit-swells-to-780m-in-latest-sign-of-budget-distress/>.

[10] Daniel DiSalvo and Jordan McGillis, Big City Pensions and the Urban Doom Loop, Manhattan Institute Report, (Apr. 2023), at pp. 1-2, <https://media4.manhattan-institute.org/sites/default/files/big-city-pensions-and-the-urban-doom-loop.pdf>.

[11] *Id.* at p. 10.

[12] See Katie Lauer, These Bay Area Cities Are Facing the Greatest Financial Risk, State Auditor Says, East Bay Times (Oct. 23, 2022), <https://www.eastbaytimes.com/2022/10/23/these-bay-area-cities-are-facing-the-greatest-financial-risk-state-auditor-says/>.

[13] *Id.*

[14] See Annie Glaus, San Francisco's Budget Deficit Swells to \$780M in Latest Sign of Budget Distress, The San Francisco Standard (Mar. 31, 2023), <https://sfstandard.com/politics/city-hall/san-franciscos-deficit-swells-to-780m-in-latest-sign-of-budget-distress/>.

[15] See Standard & Poors Ratings Direct, San Francisco City and County, Mar. 17, 2023, at p. 5.

[16] See Illinois to Issue Bonds to Refund Variable Rate Debt, Terminate Swaps, The Institute for Illinois' Fiscal Sustainability (Aug. 17, 2018), <https://www.civicfed.org/iifs/blog/illinois-issue-bonds-refund-variable-rate-debt-terminate-swaps>.

[17] See, e.g., *In re Fin. Oversight & Mgmt. Bd. for P.R.*, 931 F.3d 111 (1st Cir. 2019) (holding that special revenue exception from stay merely permits, but does not compel a debtor to apply revenues pursuant to the flow of funds); *In re Fin. Oversight & Mgmt. Bd. for P.R.*, 618 B.R. 619, n. 19 (D.P.R. 2020) (finding that a pledge of revenues does not create a security interest on the revenue stream, and instead constitutes an unsecured promise to transfer revenues). Cadwalader represents a monoline insurer in Puerto Rico's Title III case.

[18] See, e.g., Robert Slavin, About \$918 Million in U.S. Virgin Islands Bonds Expected Wednesday, The

Bond Buyer, (Mar. 29, 2022).

[19] See Chicago Mayor's Fiscal 2018 Budget Wins City Council Approval, Reuters (Nov. 21, 2017), <https://www.reuters.com/article/us-chicago-budget/chicago-mayors-fiscal-2018-budget-wins-city-council-approval-idUSKBN1DL2SZ>.

[20] Fitch Rates Chicago Sales Tax Securitization Bonds, IL's First Lien Rev 'AA'; Second Lien Revs 'AA-', Fitch Ratings, (Dec. 6, 2022) <https://www.fitchratings.com/research/us-public-finance/fitch-rates-chicago-sales-tax-securitization-corp-il-first-lien-rev-aa-second-lien-revs-aa-06-12-2022>.

[21] See, e.g., S&P Cuts Detroit Rating to CCC-As City Strives to Avoid Bankruptcy, Reuters, June 12, 2013, available at <https://www.reuters.com/article/us-usa-detroit-sandp/sp-cuts-detroit-rating-to-ccc-as-city-strives-to-avoid-bankruptcy-idUSBRE95C01U20130613>.

[22] 11 U.S.C. §109.

[23] See Cal. Govt. Code § 53760.

[24] See Tom Hoffman, Municipal Bankruptcy Authorization Under Chapter 9: A Call for Uniformity Among the States, 34 St. Louis Univ. Pub. L. Rev. 215, 224 (2014).

[25] See 11 U.S.C. §109(c)(3); id. § 101(32)(C).

[26] In re City of Chester, No. 22-13032-AMC, 2023 WL 2504708 (Bankr. E.D. Pa. Mar. 14, 2023).

[27] 11 U.S.C. § 109(c)(5); In re City of Vallejo, 408 B.R. 280, 297-98 (9th Cir. B.A.P. 2009).

[28] In re City of Chester, No. 22-13032-AMC, 2023 WL 2504708 (Bankr. E.D. Pa. Mar. 14, 2023).

[29] See Hernz Laguerre, City of Detroit One Step Closer to Investment Grade Status After Moody's Rating Upgrade, WDET (Apr. 6, 2023), <https://wdet.org/2023/04/06/detroit-investment-grade-status/>.