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Broadening the Use of Municipal Mortgages

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Comment

Broadening the Use of Municipal Mortgages

Peter Molk†

This Comment considers whether states and municipalities might benefit from altering prevailing practices regarding security interests and bond issues. After reviewing the primary methods of municipal bond financing and their current treatment by courts, the Comment argues for a broader use of municipal property as collateral for bonds, suggesting the typical connection between revenue stream and revenue source with revenue bonds be broken, and that property be attached to general obligation bonds. The Comment proceeds by exploring some policy implications related to its proposal and concludes that expanded power may be in municipalities' best interests.

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Introduction

Recent difficult economic conditions have affected the entire economy. Property values have plummeted, unemployment has increased,

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and consumer spending has declined. Although the recession’s impact on the federal budget has been well publicized, the effects spill over into state and local budgets as well. Most states and municipalities require balanced budgets. Unlike the federal government, decreases in revenue at the state and local level must be accompanied by corresponding decreases in spending or by new taxes or other offsetting revenue increases.

These pro-cyclical spending cuts and tax increases act to slow economic recovery by decreasing government and consumer spending. Unfortunately, municipalities are relatively limited in creative solutions to this problem. Traditional bond issues, a non-cyclical source of revenue, may not be a viable option. Although municipalities can generally issue bonds as an alternative to tax hikes or spending cuts, the issues may require relatively high interest rates at a time when the recession-saddled public lacks money to invest in bonds or anything else. These high interest rates come at a price, as they tie up a greater proportion of future budgets needed to service the debt.

Allowing municipalities to attach property as security on bonds—thereby reducing bond rates—could serve as a needed creative alternative. This practice would make it easier for municipalities to issue bonds during recessions, as well as lower their debt service in and out of recessions. Some limited mortgaging of public property already occurs today. This Comment proposes a broadening of municipal mortgaging, while still allowing sufficient safeguards to minimize the risk of losing essential properties to foreclosure. This broadening would increase the attractiveness of bond issues, reduce interest rates, and give municipalities more flexibility to refrain from pro-cyclical behavior during recessions.

The Comment proceeds by discussing general obligation and revenue bonds, the primary ways by which municipalities achieve financing. The

5 When incomes decrease during a recession, consumers have less money for all purposes, including investing in bonds. Therefore, municipalities must offer higher interest rates to entice enough buyers to purchase municipal bonds. This effect may be partially offset if consumers react to recessions by increasing their propensity to save, which would mitigate how much municipalities must increase rates.
Comment then surveys how these bonds currently interact with municipalities’ power to mortgage property, and proposes a broader use of the mortgage power that would provide better rates on bonds without sacrificing much flexibility. The Comment finally turns to the policy justifications both for and against giving municipalities this broader power. It concludes with a recommendation for granting the power to mortgage public property in limited circumstances, which will increase municipalities’ fiscal flexibility.

I. Types of Municipal Bond Issues

Municipalities typically issue bonds as either “general obligation” bonds or “revenue” bonds.6 General obligation bonds are secured by the municipality’s full faith and credit, meaning the municipality is required to draw from all available revenue services to meet these obligations.7 Thus, general obligation bonds are well secured and usually carry low interest rates. On the other hand, revenue bonds are secured only by the revenue stream generated from a distinct source, usually the underlying project the bonds are used to finance.8 With traditional revenue bonds, if the borrower defaults, the lender has no claim to any other assets,9 unlike general obligation bonds where the lender can force repayment from any revenue available to the municipality. Because revenue bonds have less underlying security, they tend to carry higher interest rates than general obligation bonds.10

Many municipalities have ceilings on the amount of debt they can incur.11 Typically, general obligation bonds count toward this ceiling, but revenue bonds do not.12 Revenue bonds thus offer an important form of financing if municipalities approach or break through their debt ceiling. Because pure revenue bonds are self-funded by an identified revenue stream, they do not count as debt since citizens of the municipality are not


7 GELFAND, supra note 6, § 10.20.

8 Id. § 10.21.

9 Id.

10 See, e.g., M. David Gelfand, Seeking Local Government Financial Integrity Through Debt Ceilings, Tax Limitations, and Expenditure Limits: The New York City Fiscal Crisis, the Taxpayers’ Revolt, and Beyond, 63 MINN. L. REV. 545, 560-61 (1979) (noting that revenue bond interest rates typically exceed interest rates of comparable general obligation bonds by 0.25% to 1.25% because of this difference in security).

11 See, e.g., id. at 546-51 (discussing the history and theory of debt ceilings); see also, e.g., ARIZ. CONST. art. IX, § 8 (requiring a debt ceiling of six percent of taxable property unless otherwise approved by voters); OKLA. CONST. art. X, § 26 (requiring a debt ceiling of five percent of taxable property).

12 See, e.g., City of Joliet v. Alexander, 62 N.E. 861, 861-62 (Ill. 1902); State ex rel. Hammermill v. La Plante, 205 N.W.2d 784 (Wis. 1973); GELFAND, supra note 6, §§ 10.20, 10.21.
adversely affected by the indenture; if the project succeeds, then the project pays for the bonds, and if the project fails, then residents do not have to pay for the default.\textsuperscript{13} The municipality can be conceived as merely managing the revenue for the lenders, while assuming no financial liability of its own.\textsuperscript{14} As noted previously,\textsuperscript{15} this decreased payout to lenders in case of default (relative to general obligation bonds) translates into higher interest rates, encouraging some municipalities to attach property as additional security to these revenue bonds. Attaching security increases the expected payoff that lenders have under a default, which in turn reduces the interest rate that the municipality must offer on these secured bonds. Some examples of the current use of mortgage-secured bonds and their ramifications are considered in the next Part.

II. The Legal Landscape

To help bridge the gap between general obligation and revenue bonds, some municipalities have given lenders mortgage interests as additional security for the revenue bonds. The pledged property usually consists of the underlying property bought or built with the bonds, or already-owned property that the bonds are used to improve or modify. For example, bonds to finance waterworks construction could be secured by the newly purchased land and eventual waterworks\textsuperscript{16} or, if the bonds are used to improve existing waterworks, they could be secured by the waterworks and land.\textsuperscript{17}

Some states explicitly authorize the issuance of mortgage-secured bonds by municipalities.\textsuperscript{18} Others provide ambiguous power grants that do not clearly address the power to mortgage property,\textsuperscript{19} while still others grant this authority but limit how it can be wielded.\textsuperscript{20} The ability of a

\textsuperscript{13} See State ex rel. Morgan v. City of Portage, 184 N.W. 376, 377 (Wis. 1921).
\textsuperscript{14} See id.
\textsuperscript{15} See supra note 10 and accompanying text.
\textsuperscript{16} State ex rel. Morgan, 184 N.W. at 376.
\textsuperscript{17} Alexander, 62 N.E. at 861.
\textsuperscript{18} See, e.g., ALA. CODE § 11-81-141 (1975).
\textsuperscript{19} See, e.g., CONN. GEN. STAT. ANN. § 7-148 (West 2008 & Supp. 2009) (giving the ability to "hold, condemn, lease, sell, manage, transfer, release and convey such real and personal property or interest therein absolutely or in trust as the purposes of the municipality or any public use or purpose ... require"). This type of broad power grant has been held both to allow and not allow municipalities to mortgage property. Compare Adams v. City of Rome, 59 Ga. 765 (1877) (determining that similar language gives the power to mortgage property), with Vaughan v. Comm’rs of Forsyth County, 118 N.C. 636 (1896) (ruling that similar language did not include the power to mortgage property). Connecticut municipalities can mortgage property if the property is held by a municipally-created authority, but the municipality’s power to mortgage property directly is ambiguous. CONN. GEN. STAT. ANN. §§ 7-130(b), -130(d) (West 2008).
\textsuperscript{20} See, e.g., TEX. CONST. art. XI, § 9 (requiring that "[t]he property of counties, cities and towns, owned and held only for public purposes, such as public buildings and the sites therefor, fire engines and the furniture thereof, and all property used, or intended for extinguishing fires, public grounds and all other property devoted exclusively to the use and benefit of the public shall
municipality to mortgage property in some form is not in serious doubt then, as long as the power has been explicitly granted.

While securing revenue bonds with previously owned property and securing revenue bonds with newly acquired property appear to be similar financing methods, courts treat them quite differently. Debt limits are a way to prevent municipal bankruptcies, and mortgages of previously owned property increase this default risk by putting municipalities in a worse position than before the loan if they default. Alternatively, securing bonds with the newly acquired property leaves the municipality in the same position as before the issue if it defaults, so these forms of revenue bonds do not count towards debt limits.

Revenue bonds secured by newly acquired property are not particularly uncommon. The following Part considers advantages of expanding this process in two ways: by augmenting revenue bond security with previously owned property unrelated to the revenue bond stream, and by using mortgages as additional security for general obligation bonds. Neither of these topics has been the focus of legal literature, yet both offer potential advantages that make them worthy of consideration.

III. Advantages of Broadening the Use of Mortgage Power

Expanding the scope of securing bonds with property could provide numerous benefits to the municipality and its citizens. In particular, the municipality should achieve a reduction in interest rates on both its revenue and general obligation bonds.

A. Reduction in Revenue Bond Rates

Although some jurisdictions have secured revenue bonds by mortgages, the mortgaged property tends to be the property that produces the revenue stream pledged to pay the bond. Even though the mortgage

be exempt from forced sale and from taxation, provided, nothing herein shall prevent the enforcement of the vendors lien, the mechanics or builders lien, or other liens now existing*).

21 See Gelfand, supra note 10.

22 State ex rel. Hammermill v. La Plante, 205 N.W.2d 784, 804 (Wis. 1973). However, if previously owned property of equal or lesser value than the newly acquired property were mortgaged instead of the newly acquired property, then the municipality may be in a relatively better position when it defaults. It would maintain control over the more valuable, newly acquired property, although revenue from the newly acquired property would still belong to the lender. Perhaps in some cases, contrary to the accepted view, revenue bonds secured by previously owned property should be treated the same as revenue bonds secured by newly acquired property.

23 Id.

24 For example, two prominent treatises on municipalities and municipal financing consider at most the situation where revenue bonds are secured by newly acquired property. See GELFAND, supra note 6, §§ 1.4, 2.25; 10 EUGENE MCQUILLIN, MUNICIPAL CORPORATIONS § 28.43 (3d ed. 2009).

25 See, e.g., supra notes 16-17 and accompanying text.
provides some security, the security is of only limited value because of the high positive correlation between the value of the security and the revenue stream. When the security produces the revenue stream, and the revenue stream dries up sufficiently so it cannot cover scheduled payments, the value of the security as encapsulated by its ability to produce future revenue has also diminished. Thus, the value of the security decreases in circumstances where it is most likely the security will be called upon to serve its loss-limiting purpose.

A broader use of the mortgaging power could break this positive correlation between property and revenue stream. Pledging property with value less strongly correlated with the revenue stream results in a less volatile overall security package and decreases lenders' expected losses, thereby increasing their expected return under default and reducing the bonds' interest rates.\textsuperscript{26}

One might wonder why a municipality would bother with a revenue bond secured by an outside property source instead of simply issuing general obligation bonds with their low interest rates, since both types of financing are treated as debt and would count towards applicable debt ceilings. Revenue bonds, whether or not secured by property, offer flexibility that general obligation bonds cannot.\textsuperscript{27} A municipality would have a difficult time abandoning a general obligation bond, because general obligation bonds require the municipality to increase taxes on its citizens to meet the obligation. However, a municipality can abandon a mortgage-backed revenue bond, in which case it could lose the property and the revenue stream, but the taxpayers would not be ultimately required to meet the obligation. Although both the revenue bond backed by outside property and the general obligation bond count towards debt ceilings, the revenue bond could be better received by property owners who need not worry about tax hikes to service bonds on underperforming projects.\textsuperscript{28} A municipality could also always increase taxes to ensure holders of revenue bonds are paid, essentially giving it the option, but not the requirement, to treat the revenue bond as a general obligation bond.

\textbf{B. Reduction in General Obligation Bond Rates}

Securing general obligation bonds with property should also reduce the rates that municipalities must offer on their general obligation bonds.

\textsuperscript{26} The potential gains are also tempered, but because lenders are not equityholders, they only care that the downside risk is reduced so that the revenue stream combined with the property value will cover the loan.

\textsuperscript{27} Revenue bonds may be less flexible than general obligation bonds in municipal bankruptcy, however. \textit{See infra} Section III.B.

\textsuperscript{28} Of course, even with property-secured revenue bonds, the municipality might feel pressure to ensure the property is not lost, and might increase taxes to do so. But even in situations where this is the case, the municipality would have the option, but not the requirement, to treat the revenue bond as a general obligation bond.
General obligation bonds are well-secured by the "full faith and credit" of the municipality, which works well when the municipality is solvent. However, if the municipality declares bankruptcy, holders of general obligation bonds become general creditors and thus receive only the same pro rata share as other general creditors in bankruptcy.29 Further, unlike bankruptcy under Chapter 11, a municipal bankruptcy has no requirement that unsecured claims receive the liquidation value of their claims for confirmation of a bankruptcy plan.30

A mortgage, on the other hand, is a security interest that survives in municipal bankruptcy.31 Thus, holders of general obligation bonds secured by additional property could expect a higher payoff in bankruptcy than holders of traditional general obligation bonds, who are treated as unsecured creditors. Even though municipal bankruptcies are relatively rare and usually involve smaller municipalities,32 several high-profile cases (including Bridgeport, Connecticut;33 Orange County, California;34 and Vallejo, California35), as well as looming bankruptcies including Harrisburg, Pennsylvania36 and the near bankruptcy of Jefferson County, Alabama,37 remind us that municipal bankruptcies can be a very real threat considered by lenders when determining interest rates. Secured general obligation bonds would come at the expense of increased costs for abandoning the obligation, but this cost emerges only in the case of a municipal bankruptcy.

C. Summary

Securing both revenue bonds and general obligation bonds with outside property could achieve reductions in interest rates that municipalities must offer on these bonds. A lower interest rate on bonds corresponds to lower expenditures on servicing the bonds, reducing the size of the required budget and allowing for tax decreases or for spending on other items. These benefits are particularly helpful for state and local authorities.

29 See, e.g., In re Sanitary & Improvement Dist., No. 7, 98 B.R. 970, 973-74 (Bankr. D. Neb. 1989); see also Kevin A. Kordana, Tax Increases in Municipal Bankruptcies, 83 Va. L. Rev. 1035, 1048 (1997) (noting that general obligation bonds "are not secured for bankruptcy purposes because they do not have a concrete interest in any of the municipality's property").
33 In re City of Bridgeport, 129 B.R. 332, 335 (Bankr. D. Conn. 1991).
34 In re County of Orange, 183 B.R. 594 (Bankr. C.D. Cal. 1995).
35 In re City of Vallejo, 408 B.R. 280 (B.A.P. 9th Cir. 2009).
36 Ianthe Jeanne Dugan & Kris Maher, Muni Threat: Cities Weigh Chapter 9, Wall St. J., Feb. 18, 2010, at C1. Harrisburg's controller was quoted as saying "[b]ankruptcy is inevitable." Id.
37 See, e.g., Leslie Wayne, Regulator Reviews Troubles in Municipal Bond Securities, N.Y. Times, July 1, 2009, at B3.
governments during economic downturns, because such governments generally require balanced budgets. Nevertheless, broadening the use of mortgages on municipal bonds has potential negatives, considered in the following Part.

IV. Concerns with Broader Mortgage Power

In addition to worries that may arise whenever power is delegated to government officials, there is a unique concern that essential public property could be lost in foreclosure. Restricting what and how property can be mortgaged mitigates this concern. Another concern is that overall bond interest rates may not decrease because the decrease in the rates of secured bonds might come at the expense of increased unsecured bond rates. Particular factors of the municipal bankruptcy process moderate this concern as well.

A. Public Property Could Be Foreclosed

A significant concern that could be levied against broader mortgaging of public property is that if the municipality defaulted on these loans, the collateral property could be seized by private interests and would no longer be publicly owned. For mortgages to have any effect on bond interest rates, foreclosure must be an enforceable option. While this concern may initially cause hesitation, further consideration reveals that mortgaging could still be expanded without the risk of losing essential municipal properties. Restraints could be put into place to ensure both that the chance of foreclosure is small, and that the properties subject to foreclosure are not essential for municipality operation.

Mortgaging public property could be accomplished in a conservative manner to minimize the chance of forfeiture while still deriving value from the previously unencumbered land. For example, municipalities may be given the power to use property as collateral for debt only if the property's value greatly exceeds the debt's amount, say by four hundred percent. Some reduction in bond interest rates for that debt should occur because the debt is secured, and because the reduction would be achieved with only a slight risk of property forfeiture by the municipality. Of course,

38 See supra note 3 and accompanying text.
39 These might include the risk of corruption or mismatched interests between government officials and their constituents. Because these concerns are not unique to the present topic, they are left to further development in other literature.
40 Outside of bankruptcy, property forfeiture would occur only on revenue bonds, and then only when the value of the property fell below the outstanding debt balance. If the collateral were initially required to exceed 400% of the debt, then property values would need to contract by three-quarters plus whatever principal had been paid for the rational municipality to consider forfeiting the property—an unlikely event even given the current deterioration in land values. If property values do not decrease to this point, then the municipality has an incentive to find revenue from other sources, perhaps increased taxes, to ensure it does not default on payments.
bondholders must be prohibited from foreclosing without a default, since their over-securitization ensures they would be paid in full in most cases upon foreclosure.\textsuperscript{41}

To mitigate public concerns about potential loss of essential public property, particular classes of real property might be prohibited from being offered as collateral. This prohibition, in addition to the requirement that the value of pledged property greatly exceed debt, could be codified and placed into states' statutes that define and limit municipal powers. Important structures held in the public trust\textsuperscript{42} such as streets or police stations might fall into this prohibited category, whereas nonessentials such as office space or vacant land might not; some property (like parks) might be ambiguous.\textsuperscript{43} Another perhaps more accurate way to envision the divide would be to allow municipalities to mortgage only those nonessential properties that are worth more in private hands than when owned by the municipality,\textsuperscript{44} so that no special value from public ownership would be destroyed if the property were transferred.\textsuperscript{45}

While it may seem difficult to determine how safe to make the mortgage or which properties should be allowed to be mortgaged, municipalities are already making these determinations with their current use of mortgages on revenue bonds. This Comment requires the same kind of analysis, but would alter which assets are attached to which revenue streams and, in the case of general obligation bonds, whether any assets are attached at all.

\begin{itemize}
\item[41] Municipalities would never default on a secured general obligation bond outside of insolvency because by definition they must meet the obligation as long as they remain solvent. They may default on the bond within bankruptcy because the bonds no longer must be met by the municipality's full faith and credit. However, as with revenue bonds outside of bankruptcy, the municipality still would not default if the property's value exceeded the remaining principal on the loan.
\item[42] Municipalities should also be given a period to cure a payment default. This period must be long enough for the government to obtain revenue from other sources, such as from other funds or from a special tax. Municipalities require this time to cure default so that any default would be only a strategic default, where the outstanding principal exceeds collateral value, and not a default stemming from short-term illiquidity with the value of collateral exceeding the debt balance.
\item[44] Prominent parks such as Central Park in New York City likely provide the public with significant value that might be lost if the park were held privately. Other parks may not give such unique value to the public as a public park, and so could be mortgaged. See Baker v. City of Lexington, 273 S.W.2d 34 (Ky. 1954) (allowing a municipality to mortgage a public park for construction of a swimming pool).
\item[45] A similar distinction is drawn in Michael W. McConnell & Randal C. Picker, \textit{When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy}, 60 U. CHI. L. REV. 425, 477 (1993). McConnell and Picker go on to conclude that bankruptcy courts should be given the power to sell off these assets. \textit{Id.}
\item[46] More accurately, this formulation would allow property transfer when the gain to private ownership exceeded any loss from public ownership. Although some public benefit might be lost, the overall societal benefit would increase.
\end{itemize}
B. Unsecured Bond Rates May Increase

Typical unsecured creditors have no security attached to their bonds. In bankruptcy, these creditors are reimbursed by revenue that is earned or by unattached assets that can be sold. If unsecured creditors fear that revenue streams or assets could become attached as security to other bonds, they would demand a higher interest rate because their interests could become subordinated to secured creditors', decreasing their expected payout in bankruptcy. In theory, more expansive use of mortgaging municipal property could be met with offsetting higher interest rates or restrictive covenants on other bonds unsecured by mortgages.

However, unsecured creditors are not treated the same way in municipal bankruptcy as they are in private bankruptcy. Unlike unsecured lenders in private bankruptcies, unsecured lenders to a bankrupt municipality are largely unable to force sale of the municipality's unsecured property to recoup loans. General creditors of the municipality are therefore interested in the municipality's property only to the extent that it can produce a future revenue stream when held by the municipality. Unlike unsecured lenders to individuals or businesses, who would respond to this subordination by increasing interest rates, unsecured lenders to municipalities should react less intensely to subordination, if at all, and only to the extent that the secured property could have produced unattached revenue in bankruptcy.

Municipalities already subordinate unsecured creditors' interests in these revenue streams by issuing revenue bonds, thereby removing revenue streams from the pool of assets that unsecured creditors can access in bankruptcy. Furthermore, additional subordination already occurs when municipalities attach related previously owned property to revenue bonds, yet presumably, since both these subordination practices continue, they must result in net interest rate reductions. Therefore, it is likely that reductions in the bond rates from an increased use of property as security would not be offset completely by increases in the rates demanded by unsecured creditors.

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46 See, e.g., Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 118, 136 (1979). These problems have helped drive the use of bond covenants. Id. at 136.
48 See, e.g., McConnell & Picker, supra note 44, at 472, 476-77.
49 Income from revenue streams attached to revenue bonds is treated as a security interest in municipal bankruptcy. See 11 U.S.C. § 928 (2006).
50 See supra text accompanying notes 16-17.
C. Summary

Expanding municipal mortgage use raises two unique concerns: that public property could be lost through foreclosure, and that unsecured bond rates could rise to offset any reductions in secured bond rates. The first concern can be effectively managed through placing restrictions on how the municipal mortgage process is used. Ensuring mortgaged property values greatly exceed bond amounts and prohibiting some special property from being mortgaged reduces the chance that valuable property will be foreclosed. Regarding the second concern, unique features of the municipal bankruptcy process relative to private bankruptcies ensure that any rise in unsecured debt rates would not offset the decrease in secured debt from using municipal mortgages.

Conclusion

Although there are legitimate concerns about municipalities exercising an expanded practice of mortgaging public property, they can be minimized through a mixture of limitations and safeguards on the exercise of this power. The resulting decrease in bond rates would provide municipalities with the flexibility to either divert spending to other projects or to reduce taxes. While there is a negative climate surrounding mortgage securitization that stems from the current economic downturn, this proposal does not come close to assembling the same risk factors that led to the market collapse.\textsuperscript{51} Instead, a measured and carefully considered broadening of using municipal property as security for bonds could allow municipalities to unlock some of the value in publicly owned property.

\textsuperscript{51} For instance, municipalities would maintain significant ownership interests in their property, which reduces the likelihood of default, unlike residential owners who bought houses with little or no down payment. Municipalities, as enduring entities, may also have more reputational concerns than individuals, which may make them less likely to default and incur the resultant higher bond rates in the future.