

City of Sedona's Current Risk

of

TECHNICAL DEFAULT of its SERIES 2007 BOND ISSUE

Comments and Observations of J. Rick Normand on March 25, 2009

The City's Bond Counsel, Mr. Michael Cafiso of Greenberg Taurig LLP, has issued his public opinion, for the record, defining the term "other funds" as used in the Series 2007 Official Statement of the City's 2007 \$18,000,000 bond offering. It appears that Mr. Goimarac told Mr. Cafiso that his official opinion defining the term "other funds" in the Series 2007 Official Statement would serve as a rebuttal to what he perceived my argument to be...namely that the term "other funds" does not include reserves. Unfortunately for Mr. Goimarac, he was confused. The counterargument to Mr. Cafiso's point of view is postulated by none other than the City of Sedona's Independent Auditor, Cronstrom, Osuch & Company, not me. It's prominently posted on this City's own website within the Comprehensive Annual Financial Report-Notes to the Basic Financial Statements For the Fiscal Year Ended June 30, 2008, Sec. C entitled Long-Term Obligations (Pg 56), wherein it is stated categorically "The City has pledged future excise taxes to repay \$9.1 million in business-type excise tax revenue obligations issued in 2007. Proceeds of the bonds provided financing of drainage and sewer improvements within the City. **The bonds are payable solely from excise taxes and are payable through 2027.**" This is what most of the Series 2007 bond investors believed to be true!

Yet, Mr. Cafiso, Sedona's current Bond Counsel, has publicly argued that the term "**other funds**," as used casually and infrequently in the Series 2007 Bond Official Statement, means that the City of Sedona may use any funds, including those of any City precious reserves, to partially fund its scheduled Series 2007 debt service. As I understand it from Mr. Goimarac, he adopted Mr. Cafiso's argument long ago. What that argument has done however, rather than assuage this City, its bondholders, and the municipal bond trading market, of their concerns as to problematic bond performance issues, is identify three technical default prospects that likely have already occurred, as follows:

In the first place, as a result of Mr. Cafiso's public argument, we now know that the City's bond counsel and the City's auditor have 180 degree diametrically opposed interpretations of the meaning of the words "other funds" when used in conjunction with one another. This dichotomy results in a "material event" since it has created monumental confusion relative to promised security to bondholders. This is a **major financial issue** to bondholders which necessitates the need for issuance by the City, to the proper repository, of a "Notice of Material Event," especially since this conundrum must be considered in light of the following SEC Ruling:

SECURITIES AND EXCHANGE COMMISSION, 17 CFR Part 240, Release No. 34-34961; File No. S7-5-94, RIN 3235-AG13; Municipal Securities Disclosure; §[4] **The 1989 Release also stated that issuers are primarily responsible for the content of their disclosure**

documents, and may be held primarily liable under the federal securities laws for misleading disclosure. See 1989 Release at n. 84.

Thus, the confusion over the meaning of the term "other funds" likely will result in the need for a Court imposed interpretation. The City Attorney has had knowledge of this fact since June 30, 2008 but elected to avoid dealing with this critical legal issue. Since no "Material Event Notice" was issued concerning this matter, the City likely has caused its own (*existing*) technical default of the Continuing Disclosure Undertaking.

Secondly, Sedona's Series 2007 Bond Issue is subject to Securities and Exchange Commission Rule 15c2-12, which requires the bond issuer to enter into a "continuing disclosure undertaking" or agreement at the time the bonds were issued. In this undertaking or agreement, the City (*issuer*) agreed, and continues to agree, to provide regularly updated financial information to the marketplace, as well as to file a "Material Event Notice" if certain listed events occur. One of these events is a change in the bond rating **or the bond insurer's rating**, as documented below:

The Municipal Securities Rulemaking Board recites the following SEC reporting rule;

S.E.C. Rule 15c2-12, §b, §5, §c, §11;

RATINGS – Evaluations of the credit quality of notes and bonds made by rating agencies...The ratings may derive from the credit worthiness of the issuer itself or from a credit enhancement feature of the security (e.g. guarantor, letter of credit provider, [or] *bond insurer, etc.*).

The City's Series 2007 bond insurer is MBIA. MBIA's credit rating by the big three rating agencies, prior to our current economic debacle, was AAA. As of December 2007, just a few days after the closing of the subject Series 2007 bond obligation, MBIA was downgraded by all three of the big three rating agencies, as follows:

MBIA's (12) former rating; S&P AAA, Moody's Aaa, and Fitch AAA, while today the current ratings are; S&P AA-(7), Moody's Baa1 (7), and Fitch (*is in the process of determining the lower grade*) n/a (7)

This extraordinary downgrading of the City's Series 2007 bond insurer rating, subject to Rule 15c2-12, required that Sedona issue a "Material Event Notice," right then, as set out in Section 3 of the Series 2007 Continuing Disclosure Undertaking. This is notwithstanding the fact that the City knew of this requirement but thought the public media coverage of the downgrading of the Series 2007 insurer, MBIA, somehow constituted notice to the repository (*iteration of that belief was sent to me in an e-mail by Mr. Ramsey*). It did not!

Thirdly and worse yet, the City Administration must now consider this:

The City, as confirmed by Mr. Cafiso, Mr. Goimarac, Eric Levitt and Alison Zelms, has interpreted "other funds" to mean "**any funds**" under the City's control, and consequently, has

been partially paying bond debt service from reserves on a consistent basis...and the City has been doing this since the subject Series 2007 bond issue was taken down. If Mr. Cafiso's definition of "other funds" is correct, then those words, as used in the Official Statement in the context identified by him, have created yet another likely Technical Event of Default subject to Section 3. Reporting of Significant Events, sub§ (a) This Section shall govern the giving of notices of the occurrence of any of the following events (the "Listed Events") with respect to the Obligations:

(i) Principal and interest payment delinquencies.

(ii) Nonpayment related defaults.

> **(iii) Unscheduled draws on debt service reserves reflecting financial difficulties.** <

Whether you want to call it so, or not, Sedona is using its Wastewater Enterprise Fund as a debt service reserve. Parsing words is not going to change that fact!

Furthermore, consider this:

A commonly used guide relied upon by several major cities in the state of Arizona, but not our City, addresses time-proven indicators of impending credit rating risk. That guide is known as;

[Evaluating Financial Condition: A Handbook for Local Government](#) published by the International City Management Association (ICMA)

And, I quote below from the Handbook regarding the municipal credit rating risk I have just identified;

"Financial Management Practices

...The dangers of such practices are summarized below:

The use of reserves may allow government officials to meet current cash flow needs, temporary revenue shortfalls, or unexpected expenditure demands without adjusting tax rates or cutting expenditures. A consistent decline in fund balance over several years is one indication that the local government may be sustaining an operating deficit. Relying on reserves to fund the deficit can be damaging in that the local government is left with fewer resources to utilize in the event of a financial emergency. Additionally, reliance on the reserves may affect the government's credit rating, as credit rating firms examine the history of fund balances."

In light of the notorious credit rating risk factor just identified, we have to consider that municipal bond investors rely on credit ratings, which indicate the probability of default. The probability of default increases as the City's solvency is diminished to whatever degree, which is what happens as cash reserve funds are depleted coincidentally with the tailing off of revenues, such that the City has no excess excise tax collections in its Excise Tax Revenue Fund. The City of Sedona needs to understand what the definition of "insolvency" is in relation to its depletion of Wastewater Enterprise Fund reserves, as opposed to the current status of debt service payments. The definition of MUNICIPAL INSOLVENCY is:

From the publication: MUNICIPAL INSOLVENCIES: A PRIMER ON THE TREATMENT OF MUNICIPALITIES UNDER CHAPTER 9 OF THE U.S. BANKRUPTCY CODE by Wiley, Rein & Fielding LLP of Washington, D.C.;

"The second definition [used by the U.S. Bankruptcy Court] is an equitable, prospective test; even though the municipality may not yet have missed any payments, the court will look at its future inability to pay (Hamilton Creek, 143 F.3d at 1384)."

And furthermore,

From Black's Law Dictionary: Insolvency

"...lack of means to pay one's debts." As applied to municipal corporations, "Independent of statute, when applied to a person, firm or corporation engaged in trade (*the City does engage in trade since it charges fees for its services*), means inability to pay debts as they become due in the usual course of business."

So, if the City's risk of insolvency is increasing, if only in a momentary trend, due to consistent diminution of its cash reserves (of which the City was warned by Eric Levitt during discussion of Agenda Item No. 7 at the City Council meeting of July 24, 2007, and which was confirmed by Eric Levitt on Jan 16, 2008 in his email to Terry Nash, and which was again confirmed by Alison Zelms in her email of March 11, 2009 to J. Rick Normand), then shouldn't the rating agency lower the Series 2007 bond issue's rating, which should trigger a rate increase which would further increase the risk of insolvency? Doesn't Bond Counsel Cafiso's "City can use 'other funds' rather than earned revenues argument" auger in favor of an increase in risk of insolvency?

When a municipality begins to appear to face a perceived risk of becoming insolvent, which could result in an action by the bond trustee, then, their borrowing costs will increase at least 50 basis points. A basis point is 0.01 percentage point. If the interest rate on 10-year bonds worth \$1 million increases to 5.5 percent from 5 percent, borrowers pay an additional \$50,000 over the bonds' life. In Sedona's case, that's another catastrophic risk of \$3,550,000 added to our debt load just half-way through the subject debt service payment schedule! **Just the existence of such a risk is, in fact, a Material Event since it affects the City's credit rating.** That being the case, **once a trend towards not being able to pay all debt service solely from revenues has been clearly identified**, then the City of Sedona was required to issue, yet another, Notice of Material Event subject to the covenants of the Series 2007 Official Statement Continuing Disclosure Statement, Section 3. Reporting of Significant Events, Subsections (a) thereof, to (vi) thereof, to (B) thereof, to (II) thereof, to (xi) Rating Changes (*downgrading of the Sedona Series 2007 bond issue, itself, and its bond insurer per Rule 15c2-12*).

Finally, a 1999 Fitch Rating Agency study of municipal debt defaults was followed by a recent revision of its rating criteria for many sectors of public finance. The study concluded that municipal management practices were more important for predicting credit performance than

had been thought in the past. The three most important management practices identified that led to stronger credit and lower defaults were:

- Superior disclosure
- Maintaining rainy day funds or operating reserves
- Implementing debt affordability reviews and policies

The City of Sedona didn't do any of these, before the fact, or after the fact, which exacerbates credit risk disclosure requirements.

These three Notices of Material Notice were required to be filed with one of four “nationally recognized municipal securities information repositories”, or NRMSIRs, whether or not there then existed an actual Technical Default by the City relative to its Series 2007 bond obligation. However, failing to file those Notices may be Technical Defaults in and of themselves, which will have created additional technical defaults!