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COVID-19: Impact on State and Local Government Finance – Key Risks for Government Vendors, Lenders and Bondholders

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On June 16, 2020, Mayer Brown hosted a special edition COVID-19 update call as part of our Global Financial Market Teleconference Series, titled: "COVID-19: Impact on State and Local Government Finance – Key Risks for Government Vendors, Lenders and Bondholders." Joseph Seliga, co-leader of Mayer Brown's Government Practice and Projects & Infrastructure team, moderated the discussion, joined by partners John Schmidt, David Narefsky, Mitch Holzrichter, and Stephanie Wagner, who are fellow members of our Government practice and Projects & Infrastructure Team, and Sean Scott, a partner in our Restructuring practice. On the following pages we have summarized the presentation. This audio presentation is also available at any time on our podcast page.

Seliga: The financial impacts of COVID-19 are broad and many of them have the potential to be long lasting. State and local governments across the country have been impacted significantly—with a combination of reduced revenues and increased costs related to the pandemic response. Today we will be discussing these impacts, steps that have been taken and may be taken to address these impacts, and what vendors, lenders, and bondholders need to know as state and local governments face these challenges. First, I'll turn to John Schmidt. John, could you tell us about some of the impacts state and local governments are facing as a result of COVID-19?

Schmidt: Well, there's surely an impact in increasing costs for many public entities because of the pandemic. That's particularly true in the public health care area. But the really big impact is on the revenues side. I don't think there is a public entity at the state or any local level that has not experienced a drastic decline in revenues, and that really comes about for a couple of reasons. First of all, the general decline in economic activity—we're now into what is officially a recession—and when economic activity goes down, taxes go down, sales taxes go down, income taxes go down.

But where we see the particular impact of the pandemic is on taxes and other revenues that are directly dependent on the area of the economy where the pandemic is most having an impact—and that's transportation and travel. Unfortunately, that's an area where a lot of local entities, in particular, have turned for revenues. You know, it is always tempting—we're going to tax the tourists. So we have hotel taxes—hotel taxes at the moment are down to close to 0% with hotels virtually empty; rental car taxes, nobody's renting cars; amusement taxes on tickets sold to concerts and events—but,

there are no concerts and events. And it's not only taxes. There are other revenues. Transit systems get fare revenues, but when there are two or three people on the bus or a small number of people on the transit line, those revenues go way down. Airports depend almost entirely on revenues from activity at the airport, landing fees, rentals to airlines, passengers buying a lot of stuff in shops, and food and drinks, and restaurants and bars—anybody's seen a picture of an airport knows the airports are empty. So all those revenues are gone and the overall impact, particularly, in localities that have depended heavily on those transit, travel, and tourists' revenues is really very drastic. I think, unquestionably, the most drastic, immediate fall off in public entity revenues we've ever see in this country.

Seliga: Thank you, John, for that background about the wide-ranging impacts of COVID-19 on state and local governments. Now are there certain types of governmental entities that are experiencing more significant impacts or impacts that could have longer lasting effects as a result of COVID-19?

Schmidt: Yes, where you really have the problem…the biggest problem is if you're a public entity, what we call a special-purpose public entity, which operates a facility in one of those transportation areas I'm talking about and you're dependent entirely, or primarily, on revenues from that activity—and, again, unfortunately, we have a lot of those in this country. A very common way, for example, if the city wanted to build a convention center, has been to set up a new authority, have it issue bonds to build and operate the center. Bonds will be paid entirely by hotel taxes, auto-rental taxes. Airports, in this country depend almost entirely on revenues from the airport itself. So an airport authority is completely dependent on revenues, which are dramatically affected by the pandemic. Transit lines may be a little different, they sometimes have other revenues as well; because, public transit is not self-supporting, but they still depend on a big chunk of their revenues coming from fares at the transportation facilities.

I think what probably makes it hardest of all to deal with is, in those areas where nobody knows when any of that is coming back. We will come out of the recession, you can debate when. But if you Google "projections of when will aviation activity return to its 2019 level," the earliest projection I've seen is 2023. If you talk to someone in the convention business and say, "when are we going to get back to the kind of large-scale international gatherings we had, up until the pandemic," I have never heard anyone give a specific answer; and, unfortunately, some of them say, "we're not sure if we'll ever get back to it." So you combine that dependence on revenues in a particular area—if that's your sole source, and the extreme uncertainty about when any of those revenues are coming back, you've got a real problem.

Seliga: Thank you, John. I think that really sets the stage for an understanding, not only of the current impacts, but what could be some long-lasting challenges for various governmental entities. I'm now joined by David Narefsky. David, the federal government thus far has taken certain steps to address these needs of state and local governments and the revenue impacts they're facing. But many federal, state, and local leaders are saying "this is not enough." Can you talk through some of the steps that have already been taken at the federal level and that have been proposed?

Narefsky: Thank you, Joe, and good morning. So I would say that the response from the federal government, so far, can be broken up into two categories—direct financial assistance and borrowing assistance. Both of these being the result of most recent stimulus CARES Act legislation that was passed at the end of March of this year. On the direct grants side, there's approximately $200 billion of funding made available directly to states and general purpose units of governance—cities and counties. $150 billion of that is directly to cities, and counties, and states. $150 billion dollars sounds like a lot, but when you think about it's being allocated across the nation—it isn't quite so large. Of the $150 billion, $11 billion is set aside for tribal governance and territories for District of Columbia, Guam, etc. So you have $139 billion going to states, and large cities and counties—those who have populations of over 500,000. There is a minimum for each state—no matter what its population is, gets $1.25 billion. So when you allocate this across the country, the individual allocations really aren't so large. For just an example, we are in Chicago. The State of Illinois qualifies under the population allocation formula for approximately $3.5 billion; the City of Chicago $470 million. If you take another state like California which is entitled to $9.5 billion; the City of Los Angeles gets about $1 billion. These are not small numbers, but they're really small in comparison to the needs of the relevant governments. The numbers are meaningful but they're not nearly enough to cover the revenue losses of the kind John was alluding to.

So in addition, there's a $25 billion allocation for transit agencies, suffering from the problem that John was describing, and there's a $10 billion allocation for airports, for the same reasons—again, dramatic loss of revenues. But again, as you allocate those dollars across the counties—in accordance with the formula in the CARES Act, none of these special-purpose entities for airports and transit is getting the amount of funding that would be enough to address the revenue losses that they're currently experiencing. I would also note that the last of the relevant direct funding is to airlines—who, as John was noting, are critically important partners for US airport authorities. Commercial airports are entitled to get an aggregate of approximately $25 billion, cargo airports about $4 billion. Now, all that is not going directly or indirectly back to the airports, but some of it is certainly available. And I think it's helping the airlines to make some of their scheduled rates and charges payments to the relevant airports.

The second form of assistance is borrowing authority under a federal reserve municipal liquidity program, or MLF. And this is really designed to be short-term financial assistance that would allow state and local governments to deal with cash flow issues—from delayed income tax payments and particularly, revenue reductions or expense increases resulting to or related to COVID-19. The program has a number of limitations and restriction requirements that may make it challenging for governments to take advantage of. There's a maximum maturity limit—no more than three years. There's an interest rate formula, which is tied to the credit rating of the relevant borrower. And so, if you are a strong credit borrower your spread is 155 basis points to a comparable US treasury swap index; if you're a barely investment grade borrower it goes up to 365 basis points over this index. There are disclosure requirements and requirements regarding proof of inability to borrow at market standard rates. All in all, the state and

local governments are still trying to get their arms around how useful this program will be.

I should note that the State of Illinois has been the most notable borrower under this federal liquidity program—undertaken very recently for short-term borrowing purposes, and that the State used the federal program as an alternative to their otherwise required competitive sale borrowing. The State has barely investment grade credit and they concluded that the federal program was a positive way to go. There has to date been a limited amount of activity in the MLF program. We're really going to have to see how successful it is.

In terms of what state and local governments would want, I would sum it up, Joe, as more, faster, and easier. They clearly feel the need for more direct assistance and we're going to have to see how that plays out in the next stimulus legislation—which is, going to be the subject of negotiation everyone thinks between now and until perhaps the end of July or thereabouts. They would like fewer restrictions on MLF borrowing. As an example, the House bill that passed a couple of weeks ago would reduce the interest rate for all borrowing to the federal fund rates and would extend the maximum maturity to ten years. Those would be significant improvements for state and local government borrowers. And I think they would also like to have various of the current restrictions removed and have expansion of the purposes for which funds could be borrowed. There obviously is going to be a lot of attention over the next six to eight weeks or so about what will be in the next stimulus legislation and there certainly will be attention to whether additional funding or additional borrowing authorizations are going to be provided to local governments.

Seliga: Thank you, David. In addition to the steps that have been taken and are being proposed at the federal level that you discussed, state and local governments are taking actions directly as well. Can you tell us about some of these actions, and what other steps we may see state and local governments take to address these issues?

Narefsky: Yes. So I think there are a couple of approaches and initiatives that are being taken, and let me just hit on a few of them. So I think first that I would mention, Joe, is government drawing on reserves—on rainy-day accounts. It's a commonplace financial management practice for state and local governments to build up reserves—sometimes, they're called "rainy-day funds" to make sure when there are emergencies, when there are challenges, they have funds available. Now it has to be said that the current history of having sufficient rainy-day fund is mixed, as a number of state and local governments over time have found it challenging to build up reserves to the level that would probably be appropriate. But all have some level of reserve accounts and I think the COVID situation really makes it front and center as to what to do when you have a challenge like this and you have a rainy-day fund. It's a bit of a doubled-edged sword, I'd say. These are the kind of situations to which the rainy-day fund is totally logical; this is why you have such a fund. On the other hand, I think a number of state and local governments are concerned, based on rating agencies discussions and otherwise, that if they draw down on these reserves, it may have an impact on their credit rating. Which in many cases it's already challenged. So we're going to have to

watch carefully, as to what level of drawdown of these kind of reserve funds is used on short-term basis.

I would say, second, I think you're hearing more and more talk about increased borrowing. Even if it's the sort of borrowing to deal with operating shortfall or expense increases; which, normally would either be the subject of just short-term borrowing or not borrowing at all. But I think you're seeing increasing attention, but not surprisingly, for state and local governments to look at ways that they might increase their borrowing—not for capital, but to deal with these short-term challenges and maybe pay that back over time. That isn't necessarily the best approach to municipal finance, but I think we're starting to see more and more attention to that.

A third approach is looking for new revenue sources where they can be found. That may be challenging, of course. Locally is here in Chicago, the City of Chicago has been very focused for some time on getting authority to develop a casino in the city—which it successfully accomplished in the recent state legislative session. The money is not going to come in immediately. There are a number of steps that have to take place before the casino opens and the revenue becomes available. And back to John's point, we'll have to see about level of patronage at casinos, and similarly at conventions and hotels as we go forward in a post-COVID world. I think governments are going to work hard for new revenue sources.

The last consideration that I want to raise here about what state and local governments are doing right now is not on the revenue side but on the infrastructure side. With COVID and "work from home," we're not out and about quite so much and this made it easier for state and local governments to complete certain important infrastructure projects that were in process, and a number of them are taking advantage of this opportunity to accelerate completion. On the other hand, certain projects that are not yet fully funded and need additional stakeholders' consent or buy-in are clearly challenged by COVID, and often, in a very significant way.

Just to highlight this contrast, I point to the airports at the Port Authority in New York and New Jersey. We saw last week that the Port Authority with some fanfare announced the opening of the new terminal at LaGuardia. This is the central terminal, terminal B, which has been under planning and now under construction for a number of years. And with COVID reducing passenger flow, the Port Authority was able to accelerate working with its private-sector partners to complete the terminal. And to open the terminal with all kinds of attention on the lovely artwork that is installed at the terminal. So they're getting some positive attention. You know, they need to get passengers back, of course. And by contrast, at JFK Airport where there's a separate initiative to redevelop several new terminals with private investments leading the way. Those projects are very much on hold because the airlines, who are the main users of those projects, are dealing with the kind of challenges that John mentioned, both domestic and international airlines. And so those projects are on a slower timeframe than they previously were. But I think you're going to see state and local governments working hard to find ways to accelerate new infrastructure projects. The obvious reason is putting people back to work and will be an economic stimulus—in addition to the infrastructure itself.

Seliga: Great. Thanks very much, David, for those insights. I now would like to turn to my partner Sean Scott of our Restructuring practice. Sean, one of the steps that we have already seen at least one small municipality take since the onset of COVID and we may see more of is a municipal bankruptcy filing under Chapter 9 of the United States Bankruptcy Code. Sean, you have extensive experience advising on municipal and infrastructure restructuring matters and experiences advising clients related to Chapter 9. Can you provide some background on Chapter 9 and its use by municipalities prior to COVID-19?

Scott: Sure, Joe, I'd be happy to do so. As you mentioned Chapter 9 is the chapter of the US bankruptcy code that is available to municipalities to allow them to adjust or to restructure their debts in federal bankruptcy court. And I note that, municipality in the context that I am talking about, is the term of art in the bankruptcy code and it generally includes political sub-divisions, public agencies, or instrumentalities of states, but not states themselves. States themselves cannot file Chapter 9. Pre- COVID, Chapter 9 was used sparingly, certainly in contrast to its cousin, Chapter 11, which governs corporate bankruptcies. I think for most people, Detroit, Michigan is the most recent example that comes to mind when thinking about Chapter 9 bankruptcy when it became the largest city to file Chapter 9 in 2013. Prior to that, Orange County, California's filing in 1994 is another major filing that may come to mind.

But since the first municipal bankruptcy legislation was passed in 1934 by Congress during the Great Depression, there've been less than 1,000 total Chapter 9 filings. And that stands in pretty sharp contrast to the number of filings under Chapter 11 by corporations or certainly by individuals under Chapter 7 or Chapter 13 of the bankruptcy code, which governs individual filings. Now why is that, as we will talk about in a bit, Joe, and as you know there are some greater hurdles for a municipality to file Chapter 9 than there are for corporations to file for bankruptcy, but I don't think that alone explains, or even primarily explains, why Chapter 9's have been so uncommon. Instead as John Schmidt and I wrote about just recently, in a piece for *Bloomberg Law*, I think there is a stigma around being an elected official, whether it's a mayor, city council member, or board member, for causing a municipality to seek bankruptcy protection. That bankruptcy word is a bad word and in particular for a municipality, it has been viewed as the absolute last resort. I think we've seen pre-COVID the few local government entities that took that step and actually filed for Chapter 9 have really been at the end of their rope and unable to provide even the basic services that they are required to do so. So that, I think, Joe, has been, at least until the pandemic, the view of Chapter 9.

Seliga: Great, thanks Sean. So, Sean, you referred to corporate filings under Chapter 11 of the bankruptcy code, and there are some important differences between municipal filings under Chapter 9 and corporate filings under Chapter 11. Can you provide an overview of those differences?

Scott: Sure. I think there's three major differences that I highlight for today's purposes. First, any filing under the bankruptcy code under Chapter 9 is entirely up to the municipality. It's up to the entity that qualifies as a municipality under the bankruptcy code. No one, no creditor, can force a municipality into bankruptcy. That is unlike the situation for

private corporations which can voluntarily file for bankruptcy but also can be subject to involuntary bankruptcy petition. No municipality can be the subject of an involuntary bankruptcy filing.

Second, the hurdle for a municipality to enter bankruptcy is higher than for a corporation to file for bankruptcy. For a corporation to file Chapter 11, the threshold is fairly low. The entity does not need to be insolvent; it just needs to have desire to reorganize its capital structure or its assets or liabilities under the US Bankruptcy code. The goal of Chapter 11 is to allow overburdened corporations to propose a plan of reorganization and get a fresh start. In contrast, Chapter 9 proposes some additional requirements, even if it qualifies as a municipality, as I talked about earlier, an entity also must be specifically authorized by state law to file under Chapter 9. So there must be enabling legislation. The entity must be insolvent, which I'll talk about in a bit, the municipality also must desire to effect a plan to adjust its debts and there are some requirements around negotiations and potential agreement with impaired creditors. So just to highlight a couple of those, enabling legislation is a key hurdle. We know that states themselves are not eligible to file for bankruptcy as mentioned, but even for local entities a number of states have not authorized them to file for Chapter 9 or have provided very limited authorization.

And the solvency requirement also raises some issues. Under the bankruptcy code a municipality is insolvent if it is not generally paying its debts as they become due, or is unable to do so. A question this is raised in the context of municipalities is how close to the wall does a municipality have to be to qualify as being insolvent. In other words, is it running out of cash this year, next year, or does a projection of its cash flows show that, from a pure accounting measure, is it insolvent?

And a third point is that the bankruptcy court has a much lesser role in Chapter 9 than in Chapter 11. Municipalities still have the exclusive right to propose their plan of adjustment, and they also have broad power to operate as usual law functioning under Chapter 9 without the need for bankruptcy court approval. So, in practice, this means that municipalities have a lot more power to drive the actual plan of adjustment and the bankruptcy court itself has a much lesser oversight role.

Seliga: Thanks, Sean, for that overview. Now as an alternative to authorizing filings under Chapter 9, may we see other approaches at the state level to the restructuring municipal obligations?

Scott: Yes, there certainly will be discussions around monetizing key assets, as I think both David and John alluded to earlier, there's going to be consideration of ways to allow investors, particularly those that focused on infrastructure assets to be a source of additional funding for liquidity. There's going to be a lot of pressure on state legislatures to potentially make relief available or municipalities the direct funding in other programs, like David talked about, at the federal level may need to be bolstered at the state level to allow municipalities to provide the basic services that they offer to residents and the stakeholders. And then I think there will be a lot of negotiations and discussions around potential long-term obligations. Certainly in the context of pension obligations or other long-term agreements there will be an attempt, I believe, to negotiate restructuring of those agreements, without resort to Chapter 9.

One of the key issues in Detroit's bankruptcy filing itself was the ability of the city to alter those pension obligations under Chapter 9. It raises some constitutional issues between federal and state courts, particularly where, in that context, the obligations were protected by the Michigan state constitution. Judge Rhodes issued a ruling holding that Detroit was in fact permitted to alter those pension obligations in bankruptcy. I think other courts will have to address that issue in the context of Chapter 9, but certainly the precedence of Detroit will allow some state and local government to use the potential bankruptcy filing and the potential for non-consensual modifications in Chapter 9, but the threat of non-consensual modifications to pension plans and other long-term agreements is certainly a tool that state and local governments may use in the context of negotiations.

Seliga: Thanks very much, Sean. Now let us move on to the effects on government bondholders, vendors and lenders of the fiscal strain of COVID-19 that state and local governments are facing. Stephanie Wagner, who is a leader in our Municipal and Infrastructure Finance practice, is now with me.

Stephanie, what do bondholders need to know related to the impacts of COVID-19 on state and local governments?

Wagner: Thanks, Joe. As has been noted, COVID-19 has cut off critical revenue streams for municipalities and states around the country. Many of these revenues are pledged either directly or indirectly to pay bonds. So first and foremost, the degree of impact that COVID-19 might have on bondholders and the bonds they hold will depend on the specific security for the bond. The greatest impact likely is on bonds secured by the specific revenues that are experiencing significant reduction, such as fees and taxes related to entertainment, hotels, rental cars and air travel as well as the reduction in revenue for certain issuers like tolls for toll roads and others similarly impacted by the significant revenue reductions that John talked about earlier. Given these impacts, for bonds that are rated, rating agencies are reviewing credits and may issue changes to those ratings. This may have an impact on the ability to sell bonds in the secondary market by bondholders, the ability for issuers to come to the market for new issues to refinance existing bonds or to issue new bonds for new capital or operating cash flow needs. And, in certain cases could result in a covenant default under their bond documents.

Bondholders can get certain information about the impact of COVID-19 on existing bonds through what's known as the municipal securities rulemaking board EMMA website, where issuers are required to file certain annual financial and operating information. Issuers also must file certain event notices related to rating changes, bankruptcies, payment default and other non-payment material defaults among other events that may impact the credit and security for the bond. Various issuers have also chosen to make voluntary filings regarding the impact of COVID-19 on the issuer. A related impact is that issuers may be delayed in making their annual financial filings due to the impact of COVID-19, which might mean that bondholders have less timely information about the health of the issuer. Issuers have to file notices of such delay on the EMMA website as well. Additionally, for bonds that were issued after February 27, 2019, an issuer must file a notice when it incurs a new financial obligation, which may

be occurring with greater frequency as issuers take out new debt for cash flow needs, including debt for some of the various federal programs that David described earlier. They must also file notices for any defaults, acceleration, termination or modification of terms or similar events under these financial obligations that reflect financial difficulties. These types of filings may give bondholders additional information about the health of the issuer based on its activities under other financial loan arrangements. Bondholders should also be aware that to the extent any of these impacts do result in a covenant default, other than a payment default and some bankruptcy-related defaults, likely the issuer will have a cure period. However, if cure is not possible, bondholders may need to work through the trustee or similar agent to determine a course of action, and most issuances require a majority or a super majority of bondholders to agree on remedies or relief in a default situation. However, for a direct purchase, or other similar bonds, the relationship with bondholders may be more direct and more flexible.

As a last note, I think it's important to remember that for tax-exempt debt, revisions to covenants, debt service payment requirements or interest rates or forbearance of remedies under a default situation, may also result in a reissuance under US Tax Code or have other tax consequences. And so, as reorganization may come to pass, tax counsel must be involved in any such restructuring as well. Those are just a few things bondholders should be thinking about in this time.

Seliga: Thanks very much, Stephanie. We often think municipal debt is being issued for the benefit of state and local governments. But it's also issued for the benefit of private entities, which are also being impacting by COVID-19. Can you discuss these types of issuances as well, and the potential risks related to the impact of COVID-19?

Wagner: Sure, Joe. Millions of dollars of municipal bonds are issued each year for what are called qualified private activity bonds, where a governmental entity issues the bonds, as a conduit issuer, but another non-governmental entity is then provided the proceeds of those bonds, usually through a loan agreement or a lease structure. This non-governmental entity is considered the obligated person on the bonds and the party looked to by bondholders for repayment of the debt. If certain requirements are met, these bonds are still given tax-exempt treatment under the US Tax Code. Qualified private activity bonds can be issued for various sectors, including 501(c)(3) not-for-profit corporations. Many of which are hospitals and universities or schools, for airports, where airlines are the obligated person, for certain types of port transactions and for other qualified private businesses, including developers of certain qualified transportation projects, many of which are toll roads, that have entered into long-term public-private partnership, or P3 agreements, with governmental owners. Each of these sectors has been hit by COVID-19 in some fashion, but the impacts differ. For example, a significant sector for conduit bonds are elderly care facilities, which have been hit quite hard by the impact of COVID-19. By contrast, we are not yet aware of significant impact on bonds secured by P3 revenues whether under a revenue risk or an availability payment structure.

Like states and municipalities, these types of borrowers may also consider restructuring their outstanding bonds for savings, or for cash flow or other operating needs to the extent possible. So they may be active in the market despite the economic downturn.

Different from states and municipalities, however, if these obligated persons experience bankruptcy or reorganization, it is not through Chapter 9, but would be a filing under Chapter 11 of the US Bankruptcy Code. Additionally, these types of issuances may be more likely to have financial covenants or other covenants that speak to the overall health of the company, and so in addition to considering restructurings directly related to payment requirements, efforts to address defaults may be necessary for companies even if still able to pay debt, but not able to meet these other covenants. These obligated persons are also required to make the same filings on the MSRB EMMA system that I described with respect to states and municipalities. Similar to governmental issuers some obligated persons are issuing voluntary event filings on the impact of COVID-19 or for public companies that are obligated persons, 8-Ks are being made through the SEC filing system.

As a final point, if a restructuring of debt is needed, similar considerations discussed previously also will need to be addressed for these conduit bonds, including the possibility of a reissuance and other tax consequences under the US Tax Code.

Seliga: Thanks, Stephanie, for that background. I now would like to conclude with my partner Mitch Holzrichter, who represents public and private clients on a variety of governmental regulatory and infrastructure matters and is a former Deputy Counsel and Deputy Chief of Staff to the Governor of Illinois. Mitch, bondholders are not the only parties with potential risks, stemming from the impact of COVID-19 on state and local governments. Can you tell us about some of the other parties that may be affected?

Holzrichter: Thanks, Joe. Let's start with government contractors and vendors. According to the St. Louis Federal Reserve, state and local governments spend $3 trillion per year. But unlike the federal government, they're subject to stricter spending controls, whether through balanced budget requirements or limitations on their ability to issue debt. So when we think about what the revenue shortfall means, at least one recent think tank study put the aggregate budget shortfall at $765 billion over the next three years, based on current spending. So we expect that something has to give. Of course one option is to cut spending, and some governments have already instituted spending cuts or freezes. Government contractors and vendors may be among the first to feel the brunt in the months or years ahead as governments try to reduce spending and to rebalance their budgets.

In the meantime though, we are likely to see payment delays. If a government cannot issue new debt, it's likely to get behind in its bills. We've seen this story play out in a number of large states before, including California and Illinois. After the 2008-2009 financial crisis, California issued $2.6 billion in warrants, which were basically IOUs to provide short-term liquidity. Fortunately California largely brought its budget under control in the years since. But today, after COVID-19, it's now projecting a $54 billion budget deficit for next year to deal with the impacts of the revenue shortage. Illinois is another case, although unlike California, one that did not take the best advantage of the intervening economic growth years. Illinois's bill backlog grew to a record $16 billion, almost half of its annual revenue, before the state was able to issue general obligation bonds and pay it back down. And it fell to about $5 billion just before this

current crisis. At its peak though, vendors were waiting six months, a year, two years or even longer, for payment of their bills, depending on the source of funds.

So vendors may be looking to assignment programs to get paid when they can afford or don't want to wait for the state to pay them. Both California and Illinois have offered state administered programs and in many other cases we've helped vendors to assign or securitize the government receivables even without some sort of government program. The key though is navigating government restrictions on assignment.

So in sum, I do think we are going to see a lot of pressure on that $3 trillion in spending and think vendors are the ones who are going to be at the front line, in terms of feeling that pressure.

Narefsky: Mitch, I just wanted to note that you are framing the state and local government's relationship with vendors raises the point they all have to consider: What's the easiest and/or cheapest way to borrow? Borrow in the capital market, borrow from the Fed or in essence borrow from their vendor, depending upon what interest rates they need to pay?

Holzrichter: That's right, and the interest rate that they pay to vendors are often significantly higher, even under statute, than they would be paying to borrow in the capital markets.

Seliga: Mitch, we have already heard about state and local government pension systems and some of the impacts they may be facing from COVID-19. Those pension systems often are organized as independent entities from state and local governments, but are dependent on those governments to fund their obligations. What risk do you see for parties that interact with public pension systems?

Holzrichter: We often work with private investment funds, lenders as well as the pensions systems themselves, and many are nervous about the combined effect of investment returns declining or destabilizing and government employers coming under greater fiscal stress. A majority of benefit payments are funded on the current year employer contribution basis, which comes from state and local governments. If those contributions decline that would cause pension systems to draw down on their investments to fund the shortfall. Pension holidays, which is when an employer skips or reduces a contribution payment, were a common response to the last fiscal crisis in 2009. The long-term effects are still being felt today, amplified by the loss return on those missed payments and the 11-year bull market run that followed. And according to one study, the average funded ratio, in other words, how well funded our pension systems are relative to their future obligations, fell from 87% in 2008, right before the last crisis, to 71% in 2019, before the current one. Even though we had a significant investment return over that period. So you can appreciate the worry that a similar scenario will play out today in response to COVID. And our pension systems on average are in a weaker position than they were in 2009.

Still that doesn't mean that pension systems are likely to default on their current obligations, they generally have assets that cover the obligations for years, if not decades, ahead. For investment managers or subscription credit facility lenders, who are looking at short-term investment commitments by pension systems, the risk might not be materially different in the year or two ahead. But we have to expect that in many

cases, pensions systems will experience a deteriorating fund ratio. They will be less likely to invest their assets in longer term funds, including because in many cases, their state laws or investment policies require them to have sufficient amount liquidity on hand to fund benefit payments or cap the portion of their assets that can be invested in alternative or liquid assets. So there will be an impact just as there was in 2009, and I think the key question is, how well prepared are they to handle it and for what duration.

Seliga: Thanks, Mitch. I would like to thank all of my colleagues for their insights today. For more information on Mayer Brown's extensive resources in relation to COVID-19, please visit our website, https://covid19.mayerbrown.com/. If you have questions related to today's content, please contact any of our speakers below.

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