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Mr. Chairman, Members of the Committee:

We deeply appreciate your invitation to testify here today.

At the outset, Mr. Chairman, we would like to comment directly on a matter that Members of this Committee undoubtedly already have very much in mind -- namely, that the institutions we represent have a clear self-interest in seeing that the financial affairs of New York City and New York State are stabilized. By the simple fact of location and our financial responsibility to the community we are deeply involved in the life of City and State. It is common knowledge, of course, that we and other major New York City banks own substantial totals of New York City, New York State, and New York State agency securities -- totals that have been enlarged in the course of efforts over many months to contribute to a solution of difficulties. Because of that, we appreciate that almost anything we say about the New York situation may be deemed to be self-serving. We also appreciate that, as a practical matter, there is little we can say to dispel such a view on the part of any who may hold it.

Nevertheless, Mr. Chairman, we would like to state formally and for the record that narrow self-interest related to our portfolio holdings is not the reason we are here today. The banks we represent are healthy institutions whose soundness has not been jeopardized by the acquisitions that have been made of City and State securities.

Our preoccupying concern -- the one that brings us here today -- is the likely trauma for New York, both the City and the State, if default is not avoided. We believe that the disruptive effects of default in terms of individual human lives are potentially large -- how large is a matter of judgment. We do not want to see New York go through the unnecessary turmoil and distress that could follow a default. Nor, as we shall discuss, do we want to see reverberations throughout the nation and its economy.

You have already heard a great deal of testimony relating to the current financial problems of New York City and New York State. Consequently, we do not devote any significant portion of this statement to additional elaboration. Our review of budgetary trends is limited to key points.

Prior to the current phase of budget strain, and going back well over a decade, New York City expenditures rose at an exceedingly rapid rate. During the 1960s, the expenditure increase was, to a large extent, sustainable because assistance from New York State and from the Federal government grew very rapidly in line with the urban-oriented philosophy of that decade. With the benefit of hindsight, it is now clear to everyone that New York City expenditures should prudently have been more closely related to own-source revenues. Even with outside assistance the City tended to run in deficit, and the deficit position was greatly aggravated in the 1970s when growth in intergovernmental aid payments started slowing down. The sheer momentum of expenditure rise was such that quick reattainment of a condition of budgetary balance would have

been exceedingly difficult even if efforts in that direction had been made with real determination. As we now know only too well, efforts to achieve a matching of income and outgo were anything but determined. Poor management of finances by the City itself inescapably bears heavy responsibility for present problems.

That fact of poor fiscal management is generally well known. What is less adequately appreciated is that national factors also have contributed materially to the budget problems of State and local governments -- with New York City simply the extreme case. The recent national recession -- by far the most severe of the postwar period -- squeezed State and local budgets in two ways. It added to costs by enlarging the total of people needing income supplements of one kind or another, and it adversely affected the flow of receipts from income taxes and sales taxes.

At the same time, our extraordinary inflation problem -- national and indeed international in origin -- greatly intensified difficulties by raising virtually all State and local costs substantially without having a commensurate expansive effect on revenues. Unlike the Federal government, whose revenues tend to be highly responsive to inflation -- in part because of the progressive rate structure for personal income taxation -- municipal governments in particular tend to rely heavily on taxes based on property holdings and sales transactions that do not benefit as automatically from rising price levels. The administrative adjustment upward of such things as real-estate levies almost inevitably tends to lag behind the pace of inflation. When the pace becomes a gallop, the lag becomes enormously significant. In New York City, the practical limits to achieving greater revenues by imposing higher real-estate levies are very close at hand for many types of property. Many States, to be sure -- including New York State -- do derive significant portions of total

revenues from income taxes. That has made inflation's budget squeeze less severe at the State level.

The impact on New York City and other local communities of national and international events -- and of national policy -- certainly provides some justification for Federal involvement with what is happening. We do not mean to suggest by that observation that New York can reasonably expect to look to other parts of the nation to solve its problems. New York City does bear prime responsibility for its situation, and, in the long run, it properly should bear essentially the entire burden of correcting its troubles. But the fact that the City's problems have been accentuated by national events deserves to be considered in weighing the question of whether some form of special, temporary stabilizing role for the Federal government is appropriate in order to bridge the time gap until the effects of meaningful fiscal reform can materialize.

In stressing that national problems have played a role in accentuating New York City's difficulties, we are not unmindful of the adverse impact of national recession and national inflation on other municipalities. The question of why New York City has been relatively more vulnerable to certain national problems -- especially to the problem of recession -- than other cities is extremely complicated. Part of the answer, though, clearly lies in the unique character of the huge migrations, both in and out of the City, that have occurred in the postwar period -- migrations that, in themselves, are exceedingly complex phenomena whose causes are not entirely of New York's making.

As you are well aware, the present problem of financial stress in New York -- tracing back to the default of New York State's Urban Development Corporation last February -- is no longer, unfortunately,

confined to the City. Despite a comparatively favorable budget record -- and a good prospect for decided budget improvement if general economic recovery continues -- New York State has seen its own credit-worthiness questioned in the markets. The rescue efforts of New York State on behalf of the City have impaired its standing in investors' eyes. The State's problems, moreover, have been greatly complicated by the fact that most of its agencies are not able to market debt at this time. We have now come to a point, in fact, where the securities of the entire State of New York, all its agencies, and many of its political sub-divisions -- not just New York City -- are for all practical purposes being boycotted by the national investment community. As indicated in an exhibit we are appending, the prospective borrowing needs between now and next June 30 of all the entities involved (the City, the State, and all State agencies and sub-divisions) appear to be upward of \$12 billion. There is simply no way that anything like that total of money can be raised without some degree of restoration of investor confidence.

It is important to realize that if default occurred -- followed by a suspension of all debt service payments -- it would be highly improbable that the ordinary business of the City could proceed at all normally. Indeed, both the City and the State need to have access to debt markets not just to cope with debt maturities and debt servicing, but to be able to avoid sudden and fundamental disruption in the provision of basic services. According to data compiled by the office of the New York City Comptroller, in New York City alone, the cash flow situation in the next three and a half months is so acute (as indicated in data appended to this statement), that even if the City could suspend all debt service payments -- both principal and interest -- it would still have a cash flow

short-fall in excess of \$1 billion. In other words, the City would be a full billion dollars short of being able to meet payments to its employees, its welfare recipients, and its suppliers. The consequences of an inability by the City to meet expenses of such magnitude (equivalent to one fourth of anticipated expenses excluding debt service during this period) could obviously be very severe.

The situation in the rest of the State -- posed by the fact that debt markets are basically closed down -- is also exceedingly worrisome in terms of potential disruption of services. If New York State cannot borrow the \$2½ billion in tax-anticipation funds that it would normally borrow next spring, that might well necessitate deferral of some considerable part of the aid flow to cities, towns, and school districts. In that event, serious adjustment problems would be inevitable widely throughout New York State -- in all its communities, including New York City.

What the consequences will be elsewhere in the country -- and indeed elsewhere in the world -- if the New York situation cannot be stabilized or quarantined is something we believe no one can be certain of. The fact that voices from abroad are beginning to express serious worry testifies to the potential reach of default.

We are mindful, of course, that this Committee has heard a range of judgments about the effects that might ensue from default. Our own conviction is that the potential consequences of any default are essentially unknowable before the event. This is particularly so because there are no meaningful precedents to guide an assessment, and also because psychological considerations could be of such dominant importance.

What is particularly disturbing in a quantitative sense is the possibility of a markedly adverse psychological reaction in the consumer and

business sectors of the economy. Were that to happen, an enormous downpull on general economic activity would be exerted. In the realm of State and local government matters, there clearly would be a distinct possibility of an intensification of the adversity that already has been experienced for a wide range of borrowers as a result of unease over the New York situation -- with the extreme danger being that some governmental units in addition to New York City, New York State, and New York State agencies would be unable to borrow on any terms at all. Incidentally, we would note that it is not precisely clear how much of the recent upward rate movement that has so far occurred in the tax-exempt securities market can be attributed to worry about New York. For the sake of balance, it is also worth mentioning in passing that by no means all State and local borrowers have suffered market adversity as a consequence of fall-out from the New York situation. Indeed, States and municipalities with exemplary financial records -- in areas particularly of the South, Southwest, and the West-- may even have gained relative benefit in the special quest investors are now making for high quality securities.

Making an unconditional judgment about the full scope and severity of the repercussions that might flow from default is simply impossible, Mr. Chairman, as you yourself noted in your opening statement on October 8. Repercussions might be seriously troublesome to the national economy. Or, they might be much more muted than the grimmer possibilities suggest. However, the fact that neither we nor anyone else can know with certainty what the outcome of default would be seems critically relevant to the matter of whether this Congress should take some action. No one of the three of us joining in this statement is disposed in principle to urge Federal government involvement in the affairs of a State or municipality. But, in

this instance, we find ourselves obliged to acknowledge that a Federal role is inescapable if default is to be avoided. If one must think in terms of rescue funds running to many billions of dollars to help restore investor confidence, there clearly are not many avenues open.

Should this Committee come to the judgment that Federal assistance is appropriate, we would urge a very careful structuring of any aid package. We are firmly convinced that any kind of loan program, loan-guaranty program, or insurance program that did nothing more than simply relieve the immediate cash-flow problems of a troubled local or State government could be highly counterproductive over the longer term -- counterproductive in the sense of pushing today's problem into the future, only on a larger scale.

Experience demonstrates very emphatically that we need to tighten, not loosen, safeguards against undisciplined use of public funds. Simply making funds more readily available to a troubled governmental body would be a pointless step. In this regard, we are encouraged that the various proposals that have come before this Committee for creating a Federal mechanism for aiding troubled governmental units generally recognize in an explicit way the dangers that would be inherent in simply making it easier for funds to be secured.

The basic purpose of Federal assistance would be to afford time for a troubled governmental unit to restore its credibility in the marketplace. The specific form of such assistance -- whether direct loan, loan guarantee, or insurance -- seems less important to us than the criteria that ought to guide any assistance effort. These basically are:

- (1) that stringent budgetary and repayment conditions be attached to the assistance;

- (2) that assistance be for the shortest time span feasible;
- (3) that effective procedures be devised for continuous monitoring of the actual performance of recipient governmental bodies to make sure no slippage, intentional or otherwise, occurs in adherence to specified budgetary and repayment conditions;
- (4) That assistance be made available only after certification at the State level that all normal avenues of financing are closed both to the State and to a necessitous local governmental unit and that default is threatened;
- (5) that applicable interest rates on any Federal loan or service charges on any guaranteed or insured loan be sufficiently unattractive to the borrower to discourage recourse to such assistance except under conditions of extremity;
- (6) that Federal assistance be extended only at the State level and only after a State has effective machinery in place for controlling the use of funds by a local governmental unit;
- (7) that no new Federal bureaucracy be created to oversee or administer an aid program; and
- (8) that any State or State agency obligation guaranteed or insured under an assistance program be fully taxable.

Such terms are not meant to be punitive. They are essential, rather, to minimizing the risk that the Federal government could experience a loss as a result of extending temporary, emergency credit. They also are essential to maximizing the chance that assistance would really facilitate early reopening of normal debt-marketing channels. We would especially emphasize that some substantial portion of any sum lent, guaranteed, or insured be made available only for a limited term, say, up to one year, with renewal dependent on responsible self-discipline by

the user of the funds. For both safeguard and leverage purposes, specific provision should be made for tapping the stream of revenue-sharing funds flowing to a borrowing State in the event that a loan (whether made directly, guaranteed, or insured) was not repaid at maturity. The basic enabling legislation presumably would have to provide for use of the assistance by any one of the fifty States. As a practical matter, however, with strict criteria of the kind we contemplate, New York should be the only applicant.

Mr. Chairman, that essentially completes our prepared statement. In closing, we would make just one further point -- namely, that there would clearly seem to be a number of important legislative issues pertaining to State and local government affairs beyond those that can now be dealt with in the present emergency situation. Previous witnesses in these hearings have offered widely differing interpretations as to why New York City has had difficulties much more severe than other municipalities. At issue are allegations of unfairness relating to the Federal formulas for both revenue sharing and welfare support. Also involved is the key matter of whether the Federal government ought not to assume a greater share -- and perhaps all -- of the nation's welfare-cost burden. These are things that would seem to deserve very high priority by this and other Committees of Congress.

Mr. Chairman, Members of the Committee, may we again express our appreciation for this opportunity to testify today.

NEW YORK CITY CASH SHORTFALL: OCTOBER 18, 1975 - January 30, 1976
(In Millions of Dollars)

<u>PERIOD</u>	<u>10/18-10/31</u>	<u>11/1-11/28</u>	<u>11/29-12/26</u>	<u>12/27-1/30</u>
Cash out (including debt service)	433	1,134	1,441	2,151
Cash in	278	669	348	991
Net cash out	155	465	1,093	1,160
Debt service	0	289	472	1,039
Net cash out (excluding debt service)	155	176	621	121
Cumulative cash out	155	331	952	1,073

ESTIMATED CASH NEEDS OF NEW YORK STATE, STATE AGENCIES AND NEW YORK CITY
THROUGH JUNE 30, 1976
(millions)

	<u>ROLLOVER</u>	<u>NEW MONEY</u>	<u>TOTAL CASH NEEDS</u>
New York State	\$ 648.5 (a)	\$3,448.0	\$ 4,096.5
New York City	3,253.2	1,000.0 (b)	4,253.2
New York State Housing Finance Agency	910.0	200.0	1,110.0
New York State Medical Care Facilities Finance Agency	52.0	41.5	93.5
New York State Dormitory Authority	211.0	206.0	417.0
New York State Environmental Facilities Corporation	21.0	-	21.0
New York State Job Development Authority	-	20.0	20.0
New York State Atomic & Space Development Authority	-	25.0	25.0
Battery Park	-	76.0	76.0
Project Finance Agency	230.0	-	230.0
Albany County South Mall	-	70.0	70.0
New York City Educational Construction Fund	-	8.0	8.0
Port Authority of New York and New Jersey	-	100.0	100.0
Power Authority	125.0	350.0	475.0
Regional Transportation Authorities	2.0	-	2.0
	<hr/>	<hr/>	<hr/>
	\$5,452.7	\$5,544.5 (c)	\$10,997.2 (d)

- (a) Includes \$611 million estimated deficit, for which an equal amount of outstanding TAN's will be rolled over.
- (b) Represents pro rata share of deficit and capital expenditures.
- (c) Estimates received from the New York State Budget Office and the New York City Comptroller's Office. It is possible that the new money requirements could shrink by as much as \$750 million by delaying or stopping currently programmed efforts.
- (d) The borrowing needs of other State municipalities are believed to be at least an additional \$2.0 billion making the total approximately \$13 billion.

October 16, 1975

Insert for Speech on New York City

All questions dealing with the financial integrity of New York City rests with the elected officials of New York City and to some extent with the elected officials of New York State. They are the ones who are responsible for determining the level of expenditures in the City.

They are the ones who have the authority to raise and lower taxes for New York City and the State.

The Federal Government under the Constitution is not, indeed cannot, be responsible for managing the financial affairs or maintaining the fiscal integrity of state and local governments. Only the elected officials of those jurisdictions have that authority and that responsibility.

Thus, the question of what can be done to avoid a default by the City of New York has to be addressed to the appropriate officials at that level. It cannot be addressed by the Federal Government without undermining fundamental constitutional principles this Nation has adhered to for nearly 200 years.

If the political leaders of the City and the State of New York wish to avoid default, they will have to find a way to do it themselves.

If they are unable to restore the financial integrity of the City's government, default will naturally follow.

At that point, the Federal Government does have an obligation to the rest of the country to take steps to minimize the impact on the economy of the inability of the elected leaders of New York to manage their own financial affairs. Then, and only then, will I be willing to have the Federal Government intervene.

THOUGHTS ON NEW YORK CITY SITUATION

Recent reports indicate that attitudes about whether or not the federal government should provide some form of assistance to New York City are fluid--in the Congress, in the media, and with some of the public interest groups.

The scare tactics being used by New York City and state officials, as well as some of the New York banks holding substantial amounts of the New York City paper, are largely responsible for this. Principal arguments revolve around the consequences the New York City situation could have on the economy of other state and local governments and, in fact, on the strength of the U.S. dollar abroad.

This climate has been developing over the last 10 days during a period when some of the backers and supporters of the President's position against aid to New York City are becoming fearful that they may be out on a limb if they continue to firmly oppose any sort of federal aid. The primary cause of this probably is related to certain statements reported and attributed to high-level administration officials who are saying that the President is reviewing his position and keeping all of his options open, and that he would approve legislation if enacted by the Congress.

To keep current supporters of the President's position locked and to do an adequate job of explaining the President's position, the following steps should be considered:

1. Media: A quick wrap-up should be done to identify which columnists have written pro or con pieces on aid to New York City. Those who haven't written to date should be contacted to explain the President's position and indicate that he remains firmly opposed to any aid.

Similar activities should be conducted with editorial boards of papers across the country. A press plan should be laid out for Ron Nessen, Bill Simon, Bill Seidman, and others to get the story moving around town that the President is still dead set against any aid.

2. The Congress: Hard-rock supporters of the President's position, as well as probable supporters, should be contacted and told that the President is dead set against aid. This is critical, as the probables, as well as some of the fence-sitters, may start moving over to the other side if our position is not clear to them, as they continue to be lobbied heavily by unions and other groups. Treasury and others should prepare floor speeches for use by members of the House and Senate on why we oppose aid and the fact that the only people who will benefit from it are the New York City politicians and speculators who have been buying New York City bonds. One or two effective members in each House should be identified who can be worked with in the weeks and months ahead to carry the President's position.
3. Public Interest Groups: Public interest groups are increasingly restless as they see continued speculation that the President's position may be changing. Most have taken public positions which essentially say that the federal government should assist with needed credit during a financial emergency only if it is apparent that the municipality and the state government have exhausted all constitutional, legal, and fiscal remedies available under their respective authorities.

Privately these groups have big problems with any aid to New York City. They fear that if some form of federal guarantee is given to New York bonds, this would increase their attractiveness to investors and thereby further dry up investor interest in the bonds of other municipalities and states.

4. Presidential Activity: The key element to each of the above suggestions is the President's announcing again publicly in the next 10 days his firm opposition to financial aid to New York City and the rationale for his action. This is the only way in which we can get people to seriously focus on the President's opposition in view of the high administration officials' statements of recent days.

ADMINISTRATIVELY CONFIDENTIAL-EYES ONLYMUNICIPAL FINANCIAL ADJUSTMENT PROCEEDINGS AND
SUGGESTED REVISIONS

I. Type and Scope of the Proceeding

- A. The present provisions of the Bankruptcy Act dealing with municipal debt adjustment are found at 11 U.S.C. §§ 401-403, Bankruptcy Act Sections 81-83 (Chapter IX).
 - 1. Chapter IX allows the voluntary filing of a petition by a city, town, county, water district, school district, port authority, or similar municipal bodies.
 - 2. Chapter IX has been found to be constitutional in that it permits only voluntary filings where not prohibited by the State. See United States v. Bekins, 304 U.S. 27 (1938).
- B. Chapter IX should be left intact in order to minimize the effect of a new chapter on the finances of small municipalities or their sub-entities; a new chapter modeled on Chapter IX should be proposed.
 - 1. The new chapter should be made applicable only to cities with a population of over 1,000,000 residents. (This figure could be adjusted upward to minimize the effect of the proposed legislation on certain cities.)
 - 2. There is no constitutional impediment to so streamlining the class of debtors affected by the proposed legislation so as to affect only a very small percentage of large cities. Hanover National Bank v. Moyes, 186 U.S. 181 at 188 (1902).

3. Subentities of a municipality that qualifies as one of the class of debtors benefited by the statute should be permitted to file a petition in order to maximize the effectiveness of a plan of composition; however, such a filing should not be mandatory so as to avoid the complication of including independently solvent districts, authorities, etc.

II. Jurisdictional Aspects of the Proceeding

- A. The present Act allows no interference with the sovereignty of the States or their political subdivisions; a provision to this effect should be included in any proposed revision of municipal financial adjustment proceedings. See 11 U.S.C. § 403(c)(i).
 1. Constitutional considerations: Congressional authority to legislate under Article I, Section 8, cl. 4 is restricted by the provisions of the Tenth Amendment. A constitutional barrier is presented should any proposed statutory provision so interfere with State sovereignty as to deny the State's right preserved under the Tenth Amendment to control its own fiscal affairs.
 - a. See Ashton v. Cameron County Irrigation District, 298 U.S. 513 (1936) and United States v. Bekins, 304 U.S. 27 (1938).
 - b. Since involuntary proceedings against a municipal corporation without State consent are not contemplated, we foresee no impediment to the proposed statutory provision presented by the Tenth Amendment.
 2. State consent to proceedings undertaken pursuant to the proposed statutory provisions should be explicitly provided for in the statute.

- a. Although commentators in discussing the present provisions of Chapter IX have stated that where a State is silent regarding the availability of Chapter IX to its municipalities, such silence implies the State's consent to the availability of Chapter IX, any proposed legislation should state that if no State prohibition exists the municipal instrumentality may file a petition under its provisions.
 - b. It should be noted that proposed bills now under consideration by the Congress take this approach which dispenses with express State permission whenever a municipality desires to avail itself of the relevant bankruptcy remedies available to it. (House Document 93-137, Part II, Sept. 6, 1973 (containing the bill later proposed by the Commission on Bankruptcy Laws) and S. 235, 94th Cong., 1st Sess. 1974 (proposed by a committee of Bankruptcy Referees)).
 - c. Cf. Municipal Assistance Corporation Act, 5 McK. N.Y. Sess. Laws 237, Chapter 168, June 10, 1975, 198th Sess. This Act represents the State of New York's attempt to aid municipalities, who are unable to sell sufficient securities to permit them to refund their outstanding obligations or to meet their cash requirements, through a State corporation's issuance of bonds. We have found no provision therein nor in any other law of New York prohibiting the proceeding.
3. There is no trustee in a Chapter IX proceeding and the municipality remains in control of its property, revenues and expenditures. The new chapter should propose to continue this scheme as do the above mentioned proposed bills before Congress regarding Chapter IX.

B. A provision specifically stating that the chapter does not impair or limit laws governing the use of Federal funds should be added.

1. The present Chapter provides that the plan itself cannot require actions by the debtor which are unlawful. 11 U.S.C. § 403(e)(6).
2. The present Chapter does not specifically deal with the treatment of Federal funds during the proceedings and this silence should be clarified. (Note Art. 5 General Municipal Law § 99-h (McKinney 1974 supp.)).

C. There should be no provision for trustees' avoidance powers.

1. All other bankruptcy proceedings provide for the avoidance of: (1) preferential transfers within four months of bankruptcy, (2) fraudulent conveyances in certain circumstances, and (3) liens obtained within certain periods. See 11 U.S.C. §§ 96, 107 and 110 designed to enhance equitable distribution of the debtor's assets.
2. Bankruptcy authorities favor the exclusion of such remedies in municipal debt adjustment proceedings. See the proposed bills cited supra; 5 Collier on Bankruptcy ¶ 81.27
 - a. Such avoidance powers may constitute interference with the governmental and fiscal affairs of the debtor in contravention of the Tenth Amendment, discussed supra.
 - b. Such powers would complicate the proceedings.
 - c. Since there are usually provisions preventing a judgment creditor from obtaining a judgment lien against a municipality, some of the avoidance powers are unnecessary. Cf. 7B McKinney's Consolidated Laws of New York Ann. CPLR 5203(a)5.

D. The duration of the bankruptcy court's jurisdiction should be clarified.

1. The present Act contains no provision on this point.
2. Commentators have suggested retention of jurisdiction until the court is satisfied that the plan is successfully in operation. See e.g., George H. Hempel, "An Evaluation of Municipal Bankruptcy Laws and Procedures", Journal of Finance Vol. XXVIII No. 5 p. 1339, December 1973.

E. The binding effect of the proceedings on creditors should be clarified.

1. The present Act provides that all creditors, whether secured or unsecured, and whether or not their claims are filed or allowed, are bound by the provisions of the confirmed plan (11 U.S.C. 403(f)). Therefore, they cannot challenge the plan outside the proceedings.
2. As in present Chapter X proceedings, this provision should be clarified to apply to unscheduled creditors without notice of the proceedings. See 11 U.S.C. § 624(1).
3. Present Chapter IX provides for a discharge of all debts dealt with in the plan and there is no exception for unscheduled creditors without notice, as is the case in straight bankruptcy and Chapter XI proceedings.
4. Provision for the discharge of unscheduled debts, together with a provision providing for a totally binding plan, has proved constitutional in the Chapter X context. See 6A Collier, supra ¶ 11.18.

F. The new chapter should provide for an automatic stay upon the filing of all suits against the debtor and all proceedings to enforce liens.

1. The present Chapter allows the bankruptcy court discretion in granting such a stay. The Chapter also allows the filing of a petition seeking a stay by a municipality which is attempting to enter Chapter IX but which has not completed all requirements for filing a petition to enter Chapter IX. 11 U.S.C. 403(c).
2. The stay would be granted without hearing and those seeking relief from the stay must proceed affirmatively in the bankruptcy court.
 - a. Such a provision avoids delay and is necessary where the debtor has no power to avoid liens already obtained.
 - b. The New Bankruptcy Rules provide for such a stay, as do the above mentioned bills now before Congress.

III. Operation of the Proceeding

A. The requirements of a petition initiating the proceeding should be modified.

1. The present Chapter requires the debtor to file a petition alleging insolvency and the petition must be accompanied by a plan of composition that has been accepted by creditors owning 51 percent of the outstanding debt of the municipality. A list of all known creditors must also be attached.
2. The 51 percent requirement is not constitutionally mandated. See Hanover National Bank v. Moyses, supra; Cambell v. Alleghany Corp. 75 F.2d 947, 954-955 (4th Cir. 1935), cert. denied 296 U.S. 581.

3. Several commentators have suggested reducing the 51 percent requirement and both proposed bills eliminate it entirely. The total elimination of the prior acceptance requirement is desirable.

a. The petition would merely state that the city is unable to meet its debts as they matured. S. 235 § 9-202.

b. A list of creditors could be filed with the petition or at a time the court directs. See S. 235 § 9-301.

c. Rather than requiring creditors to answer the petition, as in 11 U.S.C. 403(b), creditors opposed should affirmatively challenge the petition. See S. 233 § 9-203.

B. The present provisions classifying creditors should be retained.

1. Chapter IX now provides for the modification or alteration of the rights of creditors generally; secured, unsecured, municipal bondholders, and holders of bonds to be paid out of special assessments, revenues, taxes, etc., 11 U.S.C. § 403.

2. There is no constitutional impediment to the alteration of the debts of bondholders. 5 Collier, supra, § 81.09, note 9. Furthermore, Chapter X has been consistently upheld even though vested rights are affected and even secured creditors may be subordinated. 6 Collier, supra, ¶ 0.01 and ¶ 3.26; Matter of Prima Co., 88 F.2d 785 (7th Cir. 1937).

C. The requirements for confirmation of the plan should be revised.

1. Presently, Chapter IX requires that creditors owning two-thirds of the claims in a class whose claims have been filed and allowed and affected by the plan must consent to the plan.

2. There is no constitutional reason for the two-thirds requirement. S. 235, § 9-307(c) suggests majority approval only.
3. A revision requiring only majority approval would contribute to the likelihood of acceptance and eliminate some delay.
4. Chapter IX provides for separate classes of creditors; those entitled to priority (for example, the United States Government), unsecured creditors generally, and secured creditors.
 - a. Secured creditors are not in one class but in separate classes, defined according to the property upon which they have liens. 5 Collier, supra, ¶ 81.15. For example, bondholders with liens on specific revenue would constitute separate classes, defined according to the particular bond issue involved. This coincides with general State law. See e.g., N.Y. General Municipal Law Art. 14-C § 407. (McKinneys 1974).
 - b. If any class of creditors affected by the plan in a material way did not accept the plan, Chapter IX requires that they be paid in full or that their liens be protected. 11 U.S.C. § 403(d).
 - c. In order to accelerate confirmation of the plan, a time limit for acceptance should be established. Hempel, supra, suggests 90 days.
- D. Presently, Chapter IX proceedings are handled by the District Court Judge rather than by the bankruptcy judge, as in Chapter X. There appears to be reason to revise this.

IV. Miscellaneous

Any disruptive effects of the proposed chapter might be reduced by the inclusion therein of a specific provision for the limited duration of such proceedings.

DRAFT

DECISION MEMORANDUM

Subject: Submission of Amendment to Bankruptcy Act to
Facilitate Filing by New York City

This Memorandum discusses the question whether the Administration should support new legislation providing for the orderly restructuring of municipal debt in the event of a default. Rod Hills and Nino Scalia have drafted such legislation. OMB is circulating it to interested agencies for comment.

Financial Status

On September 29, the New York Court of Appeals held unconstitutional the provisions of the new state legislation which mandated purchases of MAC bonds by certain state employee pension plans. If, on the basis of this decision, the remaining pension plans covered by the legislation refuse to purchase MAC securities, there is a strong possibility that the financial package designed to get New York City through December 1 may collapse. In that event, New York City may run out of cash as early as October 7 and would default on \$453 million of notes on October 17.

Over the longer term, New York City faces a large cash shortage during the December - March period. This is not a problem of overspending, but rather one of the timing of receipts. While waiting for April tax payments, the City must borrow to pay its expenses for December - March.

Mayor Beame has estimated the shortage at \$1 billion. Treasury is trying to obtain data to confirm this estimate but, since only city officials have the figures, Treasury has been experiencing delay. They do expect to receive it shortly.

Background

When any large entity is perceived to be in financial difficulties, all creditors -- security holders, other lenders, vendors, employees -- strive to maximize their opportunities for payment. When the difficulties reach the point of giving rise to legal causes of action -- i.e. default -- creditors pursue their claims in court. In addition to demanding payment in cash, such lawsuits would also seek an injunction pending the outcome of the litigation against the payment by the debtor of other claims. Since more than one court will normally have jurisdiction to hear such claims, the debtor is likely to be faced with conflicting injunctions and in effect be prohibited from paying anyone. This quandary is particularly serious in the case of a municipal default, where such an injunction could well prohibit payments for essential services: police, fire protection, and the like.

Under our legal system, protection for the debtor is provided by the bankruptcy laws. The Constitution gives the Federal government the sole power to provide for bankruptcy and Congress has exercised that power by enacting a comprehensive set of laws, each of which, in the final analysis, confer upon a single Federal judge the authority to determine how the debtor's resources will be apportioned among creditors. Through this mechanism, all creditors can be treated fairly and the essential needs of the debtor preserved.

Existing Municipal Bankruptcy Law

Existing law governing municipal bankruptcies is, as a practical matter, of no value to any but the smallest municipal governments. The fundamental flaw in the law is that it in effect requires that the debtor -- the city--- and its creditors -- the security holders -- resolve the ultimate issue before coming to court. It does so by requiring as a condition to the filing of a petition in bankruptcy (the event which establishes Federal court jurisdiction), the concurrent filing of a plan of debt reorganization and assents to such a plan by a majority in interest of the creditors. In short, existing law fails to provide a mechanism for re-ordering the relationships between the city and its creditors.

These infirmities have been widely recognized. The Commission on the Reform of the Bankruptcy Laws of the United States, created in 1970, recommended elimination of the prior assent requirement and other improvements. These recommendations are embodied in S. 235 and H.R. 32, now pending in Congress.

The Hills/Scalia Proposal

The Hills/Scalia proposal is substantively the same as this pending legislation. It was prepared as a separate bill because the pending bills effect a comprehensive reform of all bankruptcy laws and will undoubtedly be the subject of extended consideration. Further to minimize interference with Congress' comprehensive review, the proposal leaves the existing municipal bankruptcy provisions intact, instead taking the form of a separate chapter of the laws, applicable only to cities with population in excess of 1,000,000.

Functionally, the proposal has three operative provisions:

1. A municipal government (of the appropriate size) could enter bankruptcy by filing a petition alleging that it was unable to meet its obligations as they mature;
2. The filing of such a petition would confer plenary jurisdiction on the court in which it was filed and effect an automatic stay of all lawsuits brought by creditors against the city;

3. During the proceeding, with the approval of the court for good cause, the city would be authorized to borrow additional funds and assign a first priority of payment to the notes issues in consideration. (This provision is important with respect to the New York City cash shortage problem discussed above.)

Pros and Cons

Pros

- Would provide Federal assistance in dealing with New York City's problems with no current or future financial commitment.
- Would avoid conflicting litigation, thus assuring the flow of revenues for essential services.
- Would allow for an orderly restructuring of the City's short term debt.
- Would provide a vehicle for temporary borrowing to smooth out cash flow imbalances.
- Would reflect Administration concern with the problem and a willingness to take action in appropriate areas.

Cons

- Could be interpreted as favoring default.
- Could be interpreted as callous in that it reinforces USG unwillingness to provide financial assistance.

Questions Presented

Two questions are presented:

1. Whether the Administration should support such legislation, and
2. If so, whether the Administration should take the lead in introducing the legislation and seeking its immediate enactment.

The Yeo/Dunham/Hills/Scalia/Collier group believes that such legislation is necessary and recommends Administration support. They have no recommendation on the degree of Administration leadership.

Decision

1. Whether to support legislation.

Support _____

Do Not Support _____

Other _____

2. Whether to take lead on pressing legislation.

Take Lead _____

Do Not Take Lead _____

Other _____

*Class action suit
already filed*

OUTLINE OF HOW A PROCEEDING FOR THE ADJUSTMENT
OF DEBTS OF A MAJOR MUNICIPALITY
WOULD PROGRESS

The city would file a petition under a proposed new Chapter XVI of the Bankruptcy Act. The petition would state that the petitioner is insolvent or unable to pay its debts as they mature and that the city desires to work out an adjustment of its debts with its creditors.

With the filing of the petition, the statute would provide for an automatic stay of suits by creditors so that the essential functions of the city would not be disrupted. This stay, essentially an injunction, would continue until the proceeding is terminated unless the United States district court for good cause altered or amended the stay as to certain creditors.

All creditors identified by the petitioner would be given notice of the initiation of the proceeding. The petitioner would file lists of its debts and the creditors. Unless a particular creditor's claim is disputed, the listing would serve to establish the claim so the court would not be burdened with the filing by creditors of countless proofs of claim. The creditor whose claim is disputed would file a proof of claim and would have to establish it to the court's satisfaction.

The petitioning city would endeavor to work out a compromise with creditors. This might take the form of payment in full but over a longer

*and a plan of
operation (?)*

period of time, or it might involve compromise for less than the full amount due the creditors, or a combination.

How central budget?
While the city is negotiating with its creditors and trying to work out a compromise with them essential governmental functions would continue. The statute would provide authority for the city to borrow money. Because the city might have trouble borrowing, the legislation would authorize the court to provide that such loans to the city would be paid ahead of other creditors. While the court could not, under the Constitution as interpreted by the Supreme Court, interfere with essential Governmental or political functions of the city, it could withhold approval of borrowings which are for nonessentials.

As soon as the city comes up with a plan of compromise the terms of the compromise proposal would be sent to all creditors and they could vote to approve or disapprove the compromise. Votes would be counted by classes of creditors and any class of creditors disapproving the plan could be dealt with by the court by providing for payment of the value of their claims in another way. Thus the court would provide for some method of payment which would give these particular creditors the true value of their claims and this would not necessarily be the face value of the claims.

? There would be opportunity for contest before the court as to whether a particular plan of compromise should be finally approved by the court. However, the plan, if approved, would be binding on all persons and creditors and all debts of the city dealt with by the plan would be wiped

out except to the extent saved by the plan. The city would be obligated to abide by the plan and deposit new bonds, cash or property in accordance with the court-approved proposal and see that its terms are carried out. The court would retain jurisdiction until it was satisfied that the terms of the plan were being met satisfactorily by the city and that further court supervision was not required.

THE WHITE HOUSE
WASHINGTON

From: Robert T. Hartmann

To: _____

Date: _____

Ch 11

Time: _____

a.m.

p.m.

default
orderly composition
with creditors

The Way I See It

If the New York Domino Falls...

By Edward W. Duffy

"No man is an island
intire of inselke . . ."

This wisdom, penned nearly four centuries ago, takes new relevance and immediacy in the plight of New York City. As this country's business center and largest city, as the world's major financial mar-

The puzzling indifference exhibited thus far in Washington and other quarters toward the crisis is not shared by thinking citizens throughout New York State. Those people understand that what happens to New York inexorably affects their own communities; they feel the big city's agonies with a genuine sense of involvement.

out regard to precedent or political beneficiaries. To preclude needed measures on grounds that they set an "intolerable precedent of federal intrusion in local affairs" ignores the dimension of today's crisis.

The governor of New York, the State Legislature and other groups are zealously working to save

Editorials

New York City's Money Ills Can't Be Quarantined

President Ford remains convinced that New York City "has the ability to solve its own fiscal problems," and that in any case the city's default wouldn't affect other communities or the national economy. But his top aides are not so sure anymore. In recent days there has been a wholesale reassessment by top administration officials:

- Treasury Secretary William Simon, who earned both fame and fortune as a New York City bond dealer, now concedes that the city's financial collapse could have

Echoes in Ford's Tax Plan

"It is time to get big government off your back and out of your pocket."

—Richard Nixon, January, 1973

"... Only by getting the government off your back and out of your pocket will we achieve our goals of stable prices and more jobs."

—Gerald Ford, Monday night

President Ford's audacious tax-cut plan, in which he offers to sponsor what he calls a "dollar-for-dollar" reduction in both fed-

workers, tables issued by the White House indicate that a family of four earning \$5,000 would get no additional tax relief at all

W S J. 10/20/75

REVIEW & OUTLOOK

New York Myths

After New York City's close call with default Friday, Mayor LaGuardia headed straight to Washington to plead with Congress for federal help. Since he continues his campaign in testimony today, there are a few points that listeners might keep in mind.

It's important to remember, for example, that the pain to the city comes from balancing its budget, whether it is forced to do this by default or by a federal law. Temporary federal help pending a balanced budget would be help not to the city but to the bondholders, and Saturday's testimony by New York bankers should be seen in that light. Of course, what the city really wants is not temporary emergency help, but a permanent subsidy from the rest of the nation so that it can avoid

den for its budget. But New York is far from unique. According to the National Center for Social Statistics, 10.9% of New York's population receives Aid to Families with Dependent Children. This compares to 12.6% in Newark, 13.9% in Philadelphia, 14% in Washington, D.C., 14.5% in Baltimore and 15.8% in St. Louis.

In New York welfare payments pass through the city, where in most locations they are handled by counties or special welfare districts. More significantly, New York pays a share of the benefits out of its own tax funds while some other cities have been relieved of this responsibility by their states. But in 13 states a local jurisdiction still puts up its own tax money toward wel-

THE WHITE HOUSE

WASHINGTON

October 23, 1975

TO: DONALD RUMSFELD

FROM: JERRY JONES

SUBJECT: Forums for Presidential Message on New York City

Dick asked for a layout of the possible forums on Monday, Tuesday and Wednesday of next week for the President to deliver a message as to his position on New York City's financial crisis. Unfortunately, the options are rather limited; the following is the entire range that Bill, Red, Terry and I have been able to develop:

1. A forum in New York City on Wednesday morning on the way to Los Angeles. The standing forums are as follows: the Investment Association of New York -- 650 members under the age of 41; the National Alliance of Businessmen in New York City; Columbia Business School Club; New York Society of Security Analysts which the President appeared before in February of this year.

The benefits of a New York forum are that the President takes on the problem in the lion's den; the down side is a travel issue, a potential demonstrator problem and the lack of a truly appropriate forum to address the humanitarian side of this problem. In addition, Mayor Beame would probably want to greet the President and this could not help but be an embarrassing situation.

2. Reschedule the luncheon speech in Albuquerque in front of the Western Governors. There will be ten Democratic governors at this conference, the subject of which is energy. The governors would probably support the President's position on New York. However, the down side problems are: (a) Rescheduling a canceled event adds to the disorganization charge; (b) addressing the New York City problem in front of Western governors may not be appropriate; (c) the conference topic is energy.

3. Deliver the message in a speech at the Los Angeles fund raising dinner. While this gets the President's position in front of the public it is bad form because it is a partisan function, it is in Los Angeles, it is in front of fat cats, we lose the news cycle because of the late hour on the East coast.

4. Deliver the message at the San Francisco fund raising function. Same as above except you do make the East coast news cycle on Thursday.

5. A function in Washington, D.C. This would be the best except there are no appropriate forums the first three days of next week. The following groups are in town: (a) the beauticians (b) American Institute of Aeronautics (c) National Council of Jewish Women (d) Girl Scouts of America (e) Air Traffic Control Association (f) Railway Progress Institute and several others of like quality. In addition, Baroody currently does not have a large group coming in next week. If we create an event by inviting mayors or governors or some other appropriate group the down side is the charge of media manipulation and at this late date it would be difficult to avoid that problem.

6. Ask for network television time to deliver a speech to the nation. While this would be the best possible option in terms of getting the President's position well stated to the country, we believe that the networks would not grant the time request and that the topic in reality is not of sufficient importance to risk the second consecutive turndown on a time request.

7. Address a joint session of Congress on Wednesday morning. We believe that such an address should be limited to major national issues of over-riding importance. This is not one and we feel such a request would be an over-reaction to the problem and thus be a political minus.

8. Send a written statement to the Congress and make a brief statement for film on the New York City problem on Tuesday morning or Wednesday morning. Because of the lack of an appropriate forum in Washington this is our recommended option. The brief four or five minute statement can be made either from the Oval Office or in the press room and if it is properly worded it will generate the same television exposure of any of the above options with the exception of the nationwide television address. We also feel that this type of response is the most "Presidential." It does not involve travel, it does not involve theatrics, it is not an over-reaction to what is not actually a national problem and it gets maximum exposure with minimum inconvenience.

Therefore, we recommend Option 8.

_____ Approve _____ Disapprove

Statement of
Robert D. Reischauer
Special Assistant to the Director
Congressional Budget Office

before the
Subcommittee on Economic Stabilization
of the
House Committee on Banking, Currency and Housing

October 23, 1975



Mr. Chairman, I appreciate the opportunity to appear before this subcommittee. The Congressional Budget Office prepared at your request a background paper entitled New York City's Fiscal Problem which was released on October 10, 1975. My remarks today will center on a few of the issues raised in that paper but, in keeping with the CBO's mandate to provide the Congress with nonpartisan analysis of policy options and budget matters, I will not make any recommendations concerning whether or not some form of federal assistance should be provided to New York.

The first thing that strikes one about the drama that is being played out is that there is no single villain. Rather, responsibility for New York's dilemma must be shared, to a varying degree, by the whole cast of characters. Clearly New York City officials are guilty of irresponsible budget behavior, of spending more than they were receiving, and of hiding these practices with budget gimmickry that would relegate the most ingenious of OMB directors to the minor leagues. The citizens of New York are also to blame for allowing themselves to be deluded into believing that they could forever consume more public services than they paid for and for providing little support to those officials who warned that the city was heading down the road towards fiscal disaster.



New York State, for its part, did not exercise its legal responsibility to ensure that the city was behaving in a fiscally sound manner. In a less direct sense, the state contributed to the city's woes by requiring that local governments in New York bear an unusually high fraction of the costs of the state's welfare programs, programs whose payment levels and eligibility requirements are specified by state law. The financial institutions also are not without blame, for as Felix Rohatyn has testified, "Money was made available to the city in ridiculous amounts and on ridiculously easy terms." And some responsibility must rest with the bond rating agencies who chose to upgrade the ratings on city securities while the city was running a large current account deficit and accumulating a huge amount of short-term debt.

To the extent that the federal government is responsible for the state of the economy, its part can not be ignored either. The immediate crisis was precipitated now rather than at some later date largely because of the recession and the inflationary pressures of the past few years. Finally, like any good tragedy, the fates -- or the forces over which men seem to have little control -- have played their role. Through the accidents of history



and geography, New York has been the nation's port of entry, its mecca for drug addicts and the home of the United Nations. Therefore the city has had to bear costs that are imposed on no other local government in the nation. Furthermore, the suburban and regional shifts in economic activity that are affecting the tax base and service requirements of many of the older large cities in the northeast and northcentral regions have also hurt New York's fiscal position.

Without some form of federal assistance, or at least a good prospect for such assistance, New York City will probably default on its obligations in December. Unfortunately, no one can provide you with a definitive judgment concerning the repercussions of such a default since the nation has not experienced a comparable event. Honest men will disagree over the likely impacts -- some believing that they will be small and manageable, others convinced that they will be of catastrophic proportions. Much will depend upon the nature of the default, the speed with which the city is able to put a reorganization and repayment plan into effect and the responses of investors and persons doing business with the city.

The impact of a default would be felt most heavily by city residents, since a default would involve a sharp and



immediate reduction in service levels. For, even without payments for debt service, city receipts will fall some \$600 million below expenditure requirements during the December through June period. Cuts beyond the \$600 million level might even be necessary, since cash flow during this period is uneven, and funds therefore would not be available to meet payrolls on the designated days. City services would likely be further disrupted if vendors and employees withheld the goods and services normally provided because of the uncertainty over whether or when they would be reimbursed.

The announced policies of the Fed and the FDIC should considerably lessen the impact of a default on the nation's financial institutions, but how the stock market, international money markets and other markets might respond to a default is by no means clear. If a default by the city results in a closing of the municipal bond market to all but the highest rated jurisdictions, other state and local governments that depend upon rolling over short-term notes could be forced into temporary default -- even those that are in a basically sound financial position. Unfortunately, no one knows how many governments must have continuous access to the bond market, and cannot avoid borrowing while



the after-shocks of a city default die down. It is possible that, even if the bond market does not shut down, governments will be forced to pay higher interest rates -- or a risk premium. While the evidence to date does not suggest that this has been as significant a factor as has been alleged by some, it would be foolish to dismiss the possibility that escalating interest rates will result from a default.

Just as the focus of responsibility for New York's current problems is diffuse, so too are the possible sources of actions that could help stave off a default. At this late stage, the city acting on its own can do little to avoid defaulting on its obligations. From December 1 until the end of the fiscal year, the city's cash requirements for services and debt service exceed its receipts by some \$3.5 billion. It is unrealistic to think that the city could either raise taxes or cut services to the extent needed to avoid borrowing to make up much of this shortfall. The state's ability to provide the resources required by the city may also be inadequate, especially if, as seems to be the case, the state cannot borrow in the city's behalf without being itself forced out of the bond



market. A surcharge on state revenues of roughly one-half, a complete cessation of direct state services, or some combination of these approaches would be required to generate \$3.5 billion over a seven-month period.

As is evidenced by the financial plan approved by the Emergency Financial Control Board on October 20, the city and the state have already made great strides towards putting the city back on a sound financial footing. However, because much has been done already and because default probably cannot be avoided solely by city and state policies, it does not necessarily follow that the city and state have done all that is conceivable to help the situation. State and city officials have concluded, after weighing the pressures they are facing, that the city should move gradually over the next three years towards a truly balanced budget. A more rapid shift is possible but also would be likely to cause significant hardships for the residents of the city. City taxes could be increased or service cutbacks instituted more rapidly. More employees could be terminated.

While New York City has made significant personnel cuts already, these sacrifices should be placed in a national perspective. The Joint Economic Committee's survey of the effect of the recession on state and local governments indicated



that many large cities that are not faced with fiscal difficulties as severe as New York's are making significant cutbacks in personnel in order to balance their fiscal year 1976 budgets. Also it is worth pointing out that over the past five years, with much less fanfare, a number of other cities have made very dramatic reductions in personnel. For example, Pittsburg reduced its full-time equivalent employment by 24 percent between 1969 and 1974 and Cleveland cut its workforce by 38 percent over the 1971 to 1975 period. Further wage cuts offer an alternative to service reductions. While New York has instituted a three-year wage "freeze," this does not mean that workers are receiving the same pay check today as they received before the freeze was instituted. Rather the freeze for the first year allowed for longevity pay increases -- those similar to moving up the steps in the civil service pay scale, continuation of the limited cost of living increments city workers receive and, for the lower-paid workers, some increase in base pay scales.

At the state level, taxes could be raised or state services reduced to provide New York City with additional revenues if the state legislature could be convinced to approve such assistance. Alternatively the state could



begin to assume a larger fraction of the welfare costs now borne by its local governments, a course of action that would necessitate higher state taxes but could result in some local level tax relief. While it is true that New York's state and local government taxes and charges per \$1,000 of personal income are already nearly the highest in the nation, this does not necessarily mean that taxes can go no higher. Presumably those high taxes support superior levels of public services which the state's residents value highly and are justly proud of.

At the federal level, there are a number of possible approaches that could be used to provide assistance to the city either directly or indirectly through New York State and its agencies. I will confine my observations to programs currently under discussion -- that is, to direct federal loans or some form of federally guaranteed or insured taxable issue. While from a budget perspective these two alternatives may be treated very differently, their economic impact would be equivalent. In the first place substituting taxable federal or federally guaranteed issues for tax-exempt municipal notes would result in a gain to the Treasury in the form of increased tax receipts.



If, as was assumed by the Emergency Financial Control Board's plan of October 20, \$6 billion worth of taxable securities were issued at an interest rate of $8\frac{1}{2}$ percent, the tax gain would be in the neighborhood of \$150 to \$200 million dollars per year. If an insurance premium and service charge of 1 percent were imposed on these issues, the federal government would collect another \$60 million per year. Against these certain gains must be weighed the possible cost to the federal government if the city were to default on these issues and leave the federal government with the responsibility of paying the creditors.

Some analysts have been concerned that federal loans or federally backed loans will put added pressure on the capital markets. It is important to recognize that this is not correct; these loans do not represent borrowing that is above and beyond what the city of New York would have engaged in had the crisis of investor confidence not occurred. In fact, New York's borrowing requirements this year should be considerably below what was planned before the market closed last March.

It should be realized that any form of federal assistance is likely to result in substantial capital gains or reduced capital losses for those holding New York City paper.



This is because any "solution" to the current crisis should reduce the risk premium now associated with city securities. As the interest rates facing the city fall, the price of outstanding city bonds and notes should rise, since they are close substitutes for new issues. Some may consider that such gains are well deserved by those who were willing to risk their capital in a very uncertain situation. Others may feel that federal action should not lead to large gains by private investors. If the latter view prevails, it is difficult to suggest a policy that could avoid such gains. While it may be possible to renegotiate interest rates with large holders of these securities such as the pension funds, commercial banks and insurance companies, it would be an extremely complex, if not impossible undertaking, for the great number of other holders. Moreover, the gains would not be limited to those holding the high-interest securities issued by MAC over the past few months. Those who had purchased older city securities on the secondary market at significantly discounted prices could also reap large gains. So too would purchasers of New York State securities or the bond and notes of other jurisdictions if the yields of those securities had been affected by the New York City situation. For



example, it is probable that the risk premium charged Philadelphia or Detroit would be measurably reduced by any federal plan to assist New York if that plan was generally available to other cities. This is because investors would realize that there existed a "savior" of last resort to which a city could appeal to avoid default. While small capital gains could be fairly widespread, the benefits of reduced interest costs would be equally widespread. For example, the citizens of Philadelphia and Detroit would gain in reduced debt service if the interest cost to these communities declined.

It is possible to place too much emphasis on this issue. It should be noted that a great many federal actions result in substantial capital gains to the holders of certain assets. The federal assistance provided to Lockheed affected the price of that company's stock; new public facilities can vastly increase the value of the real estate located in the vicinity of the facility; and many other similar examples could be cited.

In conclusion, I would like to point out that the situation in New York is going to affect the federal budget whether or not the city defaults on its obligations and whether or not the federal government provides explicit



assistance. Over the next few years New York will be reducing the size of its operating deficit and begin cutting back on its outstanding short-term debt. This will mean that there will be a decline in the total fiscal stimulus provided by the public sector. The effect of New York's austerity will be not unlike what would occur if the federal deficit were reduced. City cutbacks will reduce federal tax receipts and increase expenditures for such programs as welfare, foodstamps, medicaid and unemployment insurance.

The first-round effects on the federal budget of eliminating New York's current deficit cannot be estimated with any great degree of precision for they depend upon such matters as whether the city cuts services by laying off workers or by reducing the wages of those working for the city. However, our crude calculations suggested that the elimination of the city's deficit could add as much as \$400 million to the federal deficit. This, it should be made clear, does not constitute a legitimate justification for permitting New York to continue running a deficit. Fiscal policy has been and should be the responsibility of the federal -- not the state or local -- government sector of the economy.



New York's immediate problem will be resolved one way or the other in the next few months. While many of the attributes of this crisis are unique to New York City, some more general issues have been raised by this crisis. These include the fiscal pressures facing our large older central cities, the division of responsibilities for providing services between the various levels of government, the adequacy of existing institutions for marketing and rating the securities of state and local governments and the treatment of these securities under our tax laws. I hope that the process of examining these issues will begin before they are forced upon us by new crises.

Thank you.



Rec. 1:45 pm
10/25/75

THE WHITE HOUSE
WASHINGTON

October 25, 1975

MEMORANDUM FOR THE PRESIDENT

FROM: JIM CANNON *Jme*
SUBJECT: New York City

I asked Dick Dunham to come over this morning to discuss a possible resolution of the New York City problem.

Dick and I felt it would be appropriate for him to summarize his views for you, and a copy of his memorandum is attached.

CC: The Vice President
Mr. Rumsfeld
Mr. Hartmann
Mr. Seidman
Mr. Greenspan

THE WHITE HOUSE

WASHINGTON

October 25, 1975

MEMORANDUM FOR: JIM CANNON
FROM: DICK DUNHAM
SUBJECT: New York City

It is my recommendation that the Administration propose a new statute which would govern the situation in New York City. This statute should not use the words bankruptcy or default but would be called something like, "A statute providing for the reconstitution of municipalities' debts."

The main features of this statute would be:

1. It would parallel the existing Chapter 11 of the Federal bankruptcy laws.
2. It would reference the existing Chapter 11 in such a way that the existing state law which gave New York City permission to petition the Federal court under Chapter 11 could be used.
3. The essential feature would be that it would by-pass the existing provision of Chapter 11 which requires that permission of 51% of the creditors is required in order to effectuate a voluntary reorganization of debt. This feature would avoid the present problem of trying to find the note and bond holders and the fact that so much of the paper is in the form of bearer certificates.
4. On petition of the city, the Federal judge would authorize the reconstitution or conversion of the existing three billion dollars of short-term notes into the three billion dollars of long-term Big Mac bonds. The Big Mac authorization is now for a total of five billion dollars of bonds, of which two billion have been sold.

5. The court would designate the state Emergency Financial Control Board to act as trustee and/or enforcer of the three-year financial plan already adopted by that board this week and hold them accountable for accomplishing the balancing of the budget over a three-year period. You will recall that the three-year financial plan adopted by that board includes in its plan the assignment of sufficient revenues to finance the debt service on the five billion dollars of Big Mac bonds.
6. The purpose, therefore, of this statute would merely be to effectuate and legitimize the state plan which has already been adopted. This plan cannot be accomplished at the present time because of the inadequacy of existing Federal statutes governing "bankruptcy of municipal corporations" and the failure of the financial community or investors to accept that board's plan and reopen the market.
7. There are two elements of the New York City debt situation that this plan would not solve:

The first of these is the financing of the legitimate short-term cash flow needs of the city other than the accumulated three billion dollars of deficit mentioned above.

There are two possibilities: First, if the Big Mac plan is in effect legitimized by this Federal statute and action of the appropriate Federal court, it is quite possible that the financial markets would be reopened to the city for legitimate short-term financing on a tax-anticipation basis of the city's short-term cash flow needs.

Second, if this reopening does not occur, the statute could provide for the issuance of trustee certificates under the authority of the Federal court to get over the one, two or three-year period while the city budget is being balanced and the accumulated deficits paid off.

The Federal court would not have and, in my opinion, should not have, any direct enforcement powers over the management decisions required to accomplish the three-year financial plan and the budget actions necessary to accomplish that plan. The Federal court could, by statement or by its order, designate the Emergency Financial Control Board as its trustee or representative.

If, however, the trustee certificates mentioned above were used to finance the legitimate short-term cash flow needs of the city which, in normal course, turn over every 30, 60 or 90 days, it would get direct enforcement powers by refusing to permit the issuance of new certificates during the course of the period that they were needed.

8. The second problem that is not covered, as I understand it in either the three-year plan adopted by the Emergency Board or in this scenario, is the financing of the cash requirements of the capital budget. The capital budget has always been financed by 40-year bonds with the property tax as the basic and underlying guarantee. By virtue of the fact that the markets have been closed to all issues of the city of New York, the expenditures generated under former capital budgets are not now being financed on a long-term basis and therefore constitute a working drain on the current revenues of the city. This sum amounts to, on the average, about 1.5 billion dollars for each of the next three years.

If these actions discussed in this memorandum are successful and the market is reopened to New York City securities, the problem, of course, disappears.

It should be pointed out that the cash requirements of the capital budgets decrease quite rapidly over the next two and three and four-year periods and that capital expenditures discussed in this section were generated by authorizations of the last decade. The city and the state board have cut the capital budget extensively and, as I understand it, have not authorized any new starts.

Jim, this is not a completely staffed-out proposal and I do not know all the legal issues on either the Federal or the State side.

In addition, I would want to have some more understanding of the State's three-year financial plan for the city that I now have before it was finalized.

Therefore, please consider it an outline of a method which provides for an orderly bankruptcy proceeding without calling it that and thus may avoid more radical and undesirable Congressional actions such as guarantees.

[Oct 25, 1975]

Second, I propose that the Federal Government act now so that if the leaders of New York permit a default, it will be orderly and limited in impact. A chaotic struggle among the City's creditors and even among its employees would seriously complicate the City's problems. Unfortunately, present Federal law is inadequate to deal with this problem. Therefore, I will tomorrow submit to the Congress special legislation providing the Federal Courts with sufficient authority to carry out an orderly reorganization of the City's financial affairs.

How would this work? The City, with State approval, would file a petition with the Federal District Court in New York under a proposed new Chapter XVI of the Bankruptcy Act. The petition would state that the City is unable to pay its debts

as they mature and that the City desires to work out an adjustment of its debts with its creditors.

The Court will accept jurisdiction of the case and provide

for an automatic stay of suits by creditors so that the essential

MUNICIPAL
employees can be paid and essential
functions of the City will not be disrupted. ~~This stay, essentially,~~

~~an injunction, would continue until the proceeding is terminated.~~

This will enable an orderly plan to be developed whereby the

PLAN OF PAYMENT (?)
City can work out a (composition) with its creditors. This might

take the form of payment in full but over a longer period of time,

or it might involve payment for less than the full amount due

the creditors.

While the City is working out a compromise with its

creditors the essential governmental functions of the City

would continue.



The proposed legislation will include provision that as a condition of the City petitioning the Court, that the City must file a good faith plan which will not only provide for partial payment of its creditors but which will also establish the fiscal affairs of the City on a sound basis within a reasonable period of time.

In order to meet the short term needs of the City the Court will be empowered to issue debt certificates covering new loans to the City which would be paid out of future tax revenues ahead of other creditors.

Thus, the legislation I am proposing will do three essential things. First, it will prevent, in the event of a default, all City funds from being tied up by lawsuits. Secondly, it will enable an orderly plan to be developed for partial payment

of New York's creditors over the long term. Thirdly, it will enable some new borrowing secured on a priority basis by future tax revenues.

Let us not dilude ourselves that this proposed legislation will in and of itself put the affairs of New York City in order without the need for some hard measures to be taken by the officials of New York City and State. Our careful examination has indicated, however, that those measures are neither beyond the realm of possibility nor beyond the demands of reason. If they are taken, New York City will, with the assistance of the legislation I am proposing, be able to restore itself as a fully solvent operation within a short period of time.

October 25, 1975