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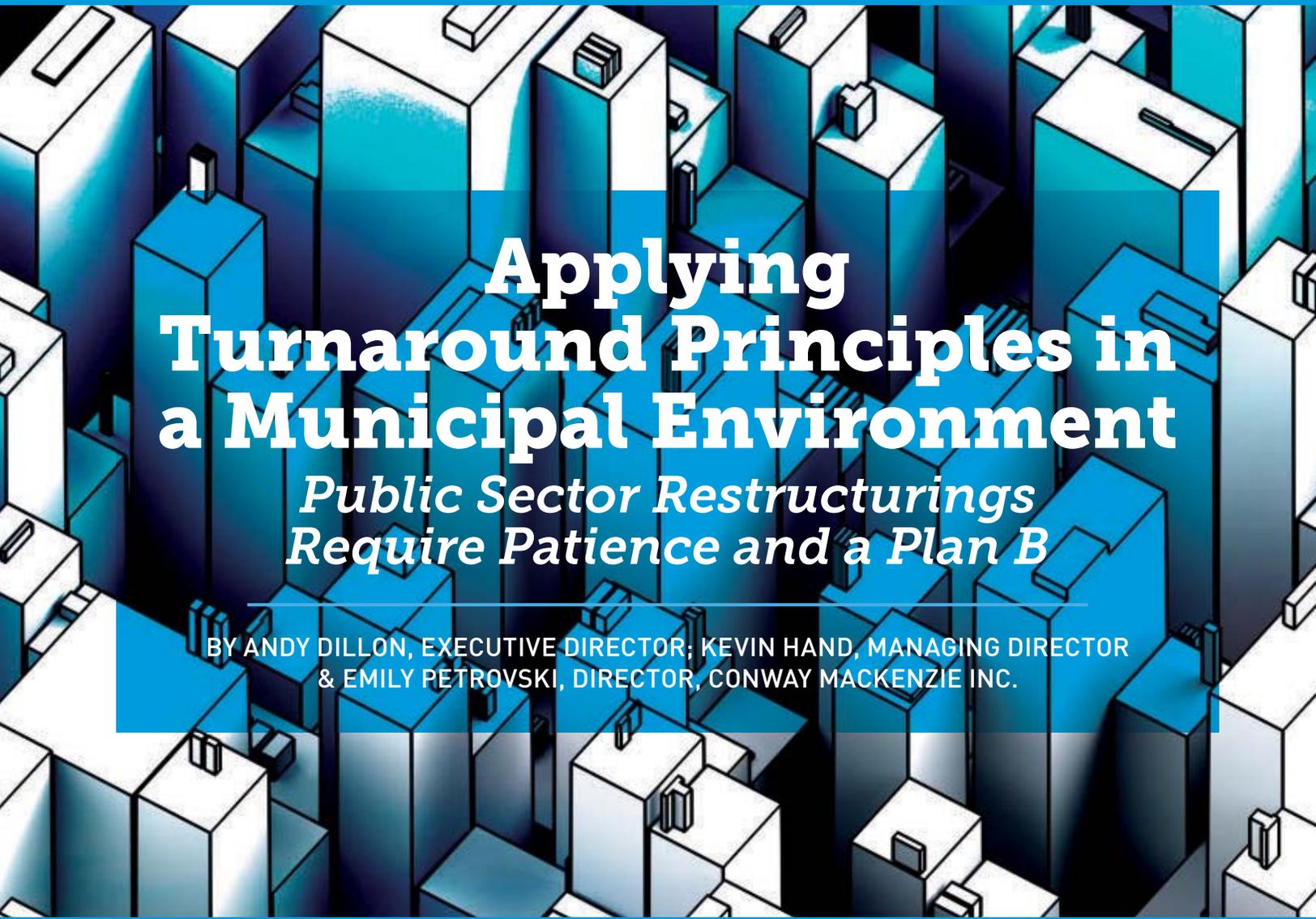
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Applying Turnaround Principles in a Municipal Environment

Public Sector Restructurings Require Patience and a Plan B

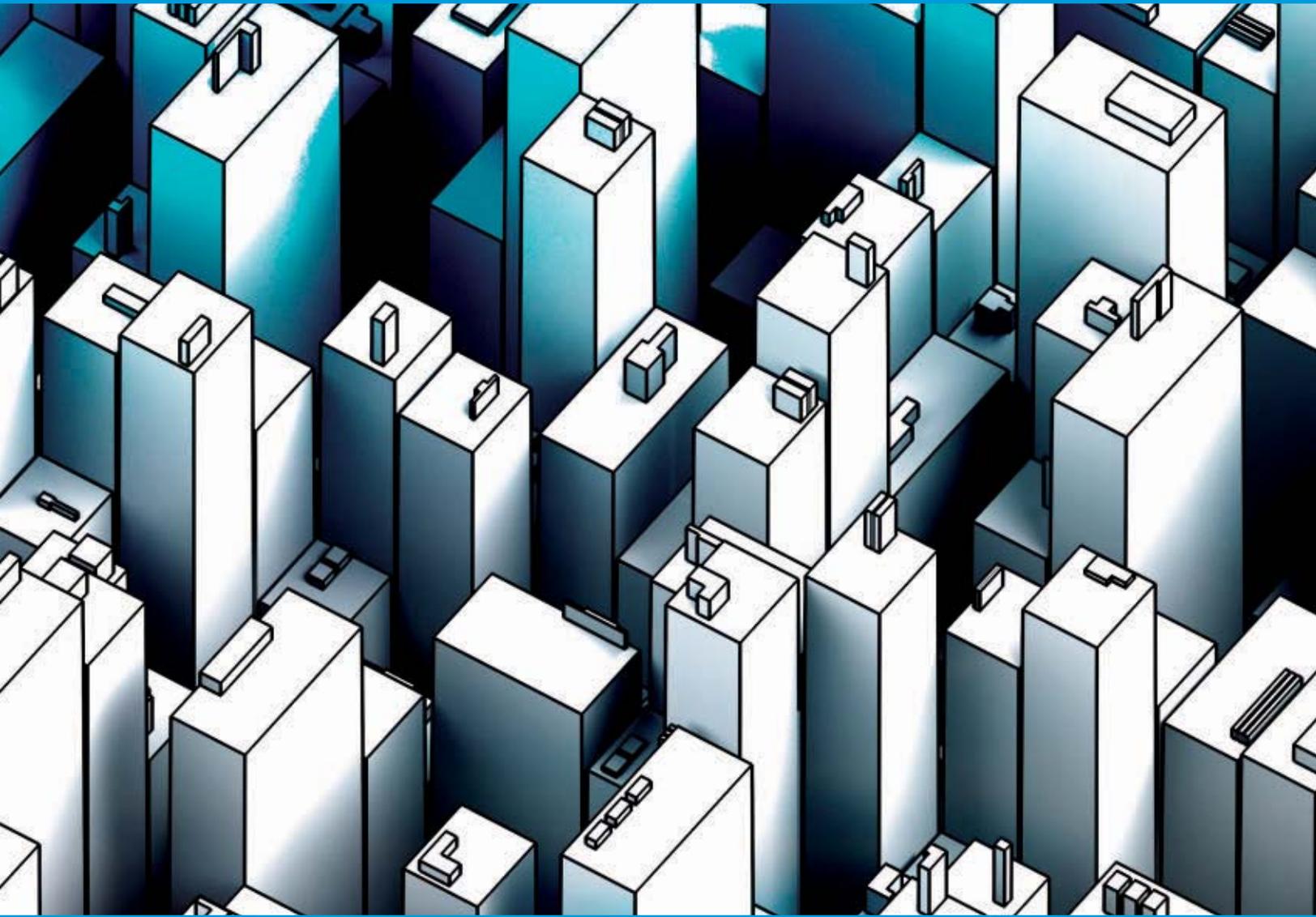
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Restructuring a city, school district, county, or other public sector body presents unique challenges that turnaround professionals likely haven't encountered in the private sector. While many of the same turnaround principles apply, the environment is different and thus the approach taken must also be different from a private sector engagement. This article discusses differences between public sector turnarounds and the more common private sector turnarounds.

The first and most significant difference is that how decisions are made in government differs drastically and usually takes longer than expected. Even when a decision appears to have been made, one should not assume that it will stick. Thus, there should always be a Plan B. What may appear to be a common sense solution to a particular problem generally has at least one constituent with some level of influence opposing it. Often, the constituent can block the measure, undermine it or, at

minimum, stall its implementation. Effective professionals understand these realities and, as a result, are more patient, deliberate, and collaborative in executing reform measures in a public sector restructuring.

Exercising patience allows the professional to build stronger ties to the myriad public sector officials and employees whose support is ultimately needed for implementing change. Even in Michigan, where emergency managers with vast



powers lead most public sector turnarounds, some level of consensus from the various constituents is generally sought. In states that don't have emergency managers, the decision-making process can be even more difficult and protracted.

The constituents of public sector turnarounds that must be factored into the decision-making process include, among others, the elected CEO, the legislative body (or boards for school districts or authorities), state officials,

civil service employees, unions, influential political operatives, voters, businesses, and creditors. Some level of agreement among these parties is essential, and there is an art to building consensus among these constituents. A brash, private-sector professional who is impatient and dismissive of one or more of these constituents will likely fail to advance the restructuring effort.

The common view held by the entrenched beneficiaries of the status quo in government is that they will

outlast the "highly paid consultant" or even an elected CEO intent on fixing the dysfunctional government he/she was elected or appointed to repair. Most likely, the turnaround consultant will be merely the most recent in a series of well-intended advisors who failed to effectuate change. The most effective advisors understand the "art of the possible" when it comes to implementing government reform measures.

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There is always the exception to the rule, and there may be circumstances in which implementing real, dramatic change is possible. However, effective turnaround professionals understand that those situations are rare, and they have a Plan B (a revised version of the restructuring initiative) to fall back on to reach a consensual deal.

Governments do not exist to generate a profit or surplus. Governments view themselves as entities that exist to provide services, such as public safety, health, education, transportation, utilities, etc., to their constituents. The part of the equation that governments are beginning to appreciate more is that they are supposed to provide these services efficiently and at a reasonable and sustainable cost. This is an area in which the restructuring professional can provide a value proposition.

Also, many states do not allow their local governments to access Chapter 9 of the U.S. Bankruptcy Code, and thus any restructuring must be consensual. Recent events in Puerto Rico highlight the challenges this presents. In addition, many state constitutions prohibit any reduction in pension or healthcare benefits, even when those changes have been negotiated with the participants, as was recently observed in Illinois. Even when Chapter 9 is available, because there have been so few of these cases, the “rules of the road” are not well defined. This makes predicting the likely outcome of a Chapter 9 proceeding difficult and the negotiations with all interested constituents more challenging. For obvious reasons, in most instances liquidating the government for the benefit of the creditor obligations is not an option.

Lastly, it is also wise for turnaround professionals to avoid the media when engaged in a public sector turnaround engagement. Inadvertent comments can lead to negative headlines that upset the client. If it is necessary to speak to the media, a turnaround professional should make sure to advise the client in advance and coordinate with their press people to ensure everyone is on the same page.

governmental units often don't know how much cash they have and don't prepare cash-flow forecasts or perform monthly or quarterly closings. They also don't understand the full extent of their liabilities. Turnaround professionals may be stunned by the lack of visibility they initially encounter regarding the true financial condition of a public sector client. Often a great deal of effort must be put into creating consolidated financial statements. In many instances, job one is to understand the basics.

Governments can typically stay afloat longer than private sector entities because they can access the municipal debt market and can defer capital expenditures and payments to pension plans. They can also tap into other pots of money that reside in the myriad related entities that often have better cash flow than the general fund. Understanding the interplay between the general fund and related funds is essential to developing the restructuring plan.

Options for improving cash flow are the same for the public sector as they are for the private sector, but they are more difficult to achieve. Government's ability to pull forward revenue is limited. Most of the short-term measures that need to be taken are on the expense side of the ledger, or the least attractive option of adding additional debt. Generally, 70 percent or more of a government's expenses are tied to payroll and benefits, which makes instituting layoffs and/or furloughs the primary way to conserve cash. However, most public officials resist this option for as long as possible.

There are several cost reduction measures that should be part of a turnaround professional's playbook. While many of these also apply to the private sector, the following measures tend to have a higher rate of success in the public sector:

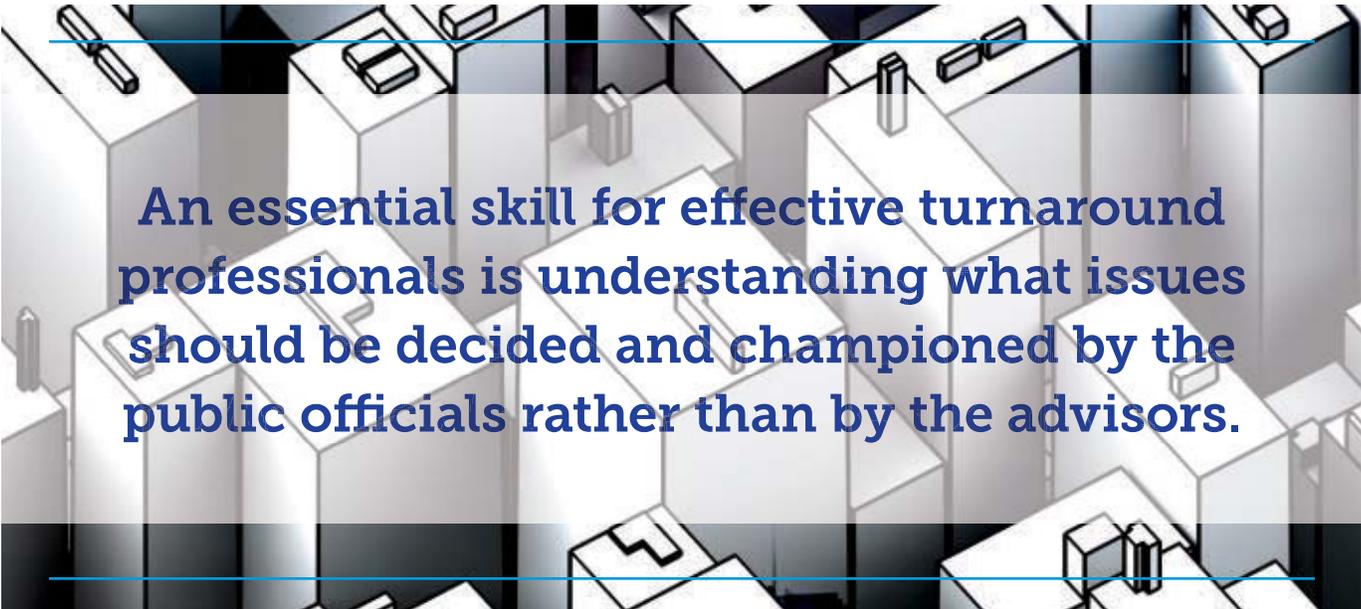
- 1** Ensure healthcare benefit plans are properly designed and have been competitively bid
- 2** Understand how overtime and sick days, leave, and vacation time are accumulated and factored into pensions
- 3** Investigate any unique or special perks, such as end-of-year bonuses, extra pension checks

(the 13th check), sweetheart annuity programs, and college tuition reimbursement plans

- 4** Perform dependent audits to make sure that ineligible dependents are not being covered by healthcare insurance
- 5** Analyze the number of employees on disability and absenteeism rates
- 6** Conduct staffing studies to make sure departments are not under- or overstaffed
- 7** Designate a payday for checks to be issued to each employee in person to ensure that payroll actually consists of people who show up for work
- 8** Determine if liabilities resulting from lawsuits are reasonable
- 9** Look for shared service/outsourcing opportunities for services such as dispatch, solid waste collection, building inspections, maintenance, parks and recreation, and even public safety
- 10** Evaluate whether police and fire departments can be consolidated into a single public safety department
- 11** Determine if proprietary operations, such as golf courses and ice rinks, are losing money

Legacy costs—debt service, pension, and retirement healthcare costs—and their long-term trajectories are the next big issue to understand. The rate of growth of these costs can be dramatic and must be understood to ensure the restructuring plan is sustainable. In Detroit, these costs were projected to grow from 30.8 percent to 63 percent of its general fund in six years, which would have rendered it nearly impossible for the city to provide essential services.

The need to reduce payroll and benefit costs can be mitigated by increasing revenues, which can be a realistic option in the public sector. Increasing revenue can be achieved in several ways: by raising taxes and/or fees, or by making sure the client is collecting



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all that it is entitled to. The latter is where professionals can be most helpful to governmental clients by improving collection activities, market testing fee schedules, and/or making sure infractions of building code and traffic laws are enforced and fines are collected. However, even these efforts can be fraught with risk. For example, a national uproar ensued when Detroit tried to collect millions of dollars in unpaid water bills by threatening water shut-offs. Even the United Nations chimed in on that issue.

An essential skill for effective turnaround professionals is understanding what issues should be decided and championed by the public officials rather than by the advisors. One of those is whether to raise taxes. However, there is still a role for the turnaround professional, which is to help determine whether raising taxes will improve long-term revenues for the client. Increasing taxes without also increasing or improving services can, and likely will, lead to population loss over a long period of time. This triggers a series of negative outcomes, including lower property values, reduced customer base for businesses, and eventually business closures.

Once residents leave a municipality, it is much more difficult to get them to return or to get new residents to move in. The judge in Detroit's bankruptcy ruled early in the case that raising taxes would be counterproductive

and thus was not on the table. A turnaround professional also must be mindful that there may be state law restrictions on increasing taxes and that doing so often requires holding a referendum. State laws can contain many unique features. For example, in Stockton, California, it is illegal to raise property taxes when property values are falling.

Professionals can also help government entities identify potential asset sales or public-private partnerships (P3s) and manage the negotiation process. Indianapolis, for example, entered into a 50-year P3 with ACS for 3,600 parking meters under which it received an upfront lump sum payment, an ongoing revenue stream, and new parking meters. However, other than the sale of surplus buildings and equipment, these transactions are often met with fierce political opposition and require specialized skills to carry out. The proceeds from asset sales and P3s should never be used to shore up ongoing structural deficits.

Improve Budgeting, Financial Transparency

As mentioned earlier, troubled governments often do not prepare cash flow forecasts or monthly/quarterly closings. This usually stems from system and skill limitations. They have also likely deferred maintenance and neglected capital improvements for many years. Understanding these costs/liabilities is critical to preparing reliable budget projections.

Most governments only pass one-year budgets and thus have limited visibility into near-term budget challenges. Without the ability to look two or three years into the future, there is no pressure to avoid using one-time revenue events to mask recurring structural deficits. As such, all restructuring plans should require two-year, and ideally three-year, detailed budget forecasts with a minimum of a five-year outlook going forward to avoid recurring distress.

Simplify Capital Structure

In most instances, government debt is held by retail investors that number in the thousands and are difficult to locate. In addition, the distinction between secured and unsecured debt is less clear and therefore more complicated to wade through during negotiations and/or a potential bankruptcy. This was a significant issue in the Detroit case, where general obligation and unlimited tax obligation bonds were treated as unsecured debt because no liens had been perfected.

Moreover, the judge ruled that creditors in the same class could be treated differently if doing so was fair and reasonable. This pitted Wall Street (bondholders and insurance companies) against Main Street (retirees). Because the Detroit case was ultimately settled, this ruling did not create precedent, but it has had an impact on the municipal finance market and will impact future restructuring efforts until case law is better defined in this area.



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Simplifying the capital structure is not always easy but may be accomplished through a refinancing transaction. Before pursuing a refinancing transaction, the restructuring professional must fully understand all the expected costs, including potential early debt retirement fees.

The simplest way to improve creditor relationships is with greater transparency of the distressed situation through more frequent communications and with timely financial information. As mentioned earlier, compiling timely financial information is not always a priority in a government environment, so this is an area in which professionals can provide great assistance. Establishing a regular schedule of conference calls ensures that creditors can receive timely updates, even when the updates are not significant. In addition, being forthright about a difficult situation often stabilizes any anxieties of creditors. This can result in the creditors providing concessions to allow the government to implement certain restructuring actions.

Placing controls on specific revenue streams may also improve the creditor relationship. Specific revenues may go directly to a trustee to pay debt first, with the balance then flowing to the government entity.

Stabilize Management

In a corporate environment, entire management teams can generally be removed and replaced, often with little negative impact (and often a positive impact) on the company. In government, absent an emergency manager law, the elected officials cannot be replaced and, usually, most employees are protected by civil service laws that make it especially difficult to reorganize. Additionally, when federal money is involved, such as with transportation, there may be federal laws prohibiting near-term changes to collectively bargained labor agreements.

Moreover, the public sector generally has not provided competitive wages to attract and retain talent. An inability to attract and retain employees can lead to instability, a lack of operating controls, limited institutional knowledge, and little or no long-term planning ability. To attract new employees, governments should provide them with opportunities that they may not get in the private sector. For example, young employees may be able to get more management opportunities and experience earlier in their public sector careers than would be possible for them in the private sector.

To retain employees, one must be able to pay market wages. This

is especially important in the information technology (IT) sector, where changing technology and accessibility needs require more-current technology experience to meet both communication and cybersecurity needs and requirements.

A Critical Component

While there are many unique aspects to public sector turnarounds, most of the same principles used in the private sector still apply. First and foremost, turnaround professionals working in the public sector must recognize the importance of consensus building and therefore must proceed patiently. It is important that these turnaround professionals understand the barriers to implementing change in government. They must also be mindful that sound business judgment must be tempered with what is in the public interest.

Public officials, not the professionals, make policy decisions. Independent and unbiased turnaround professionals can be indispensable advisors to public officials who, by definition, are surrounded by employees with deep-rooted political agendas. Turnaround advisors can be a critical component to implementing necessary change in the public sector environment. ■