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14 **UNITED STATES BANKRUPTCY COURT**  
15 **EASTERN DISTRICT OF CALIFORNIA**  
16 **SACRAMENTO DIVISION**

17 In re: ) **Case No. 08-26813**  
18 )  
19 CITY OF VALLEJO, CALIFORNIA, ) **Docket Control # WS-002**  
20 )  
21 Debtor. ) **Chapter 9**  
22 )  
23 ) **AMICUS CURIAE BRIEF IN SUPPORT**  
24 ) **OF MOTION OF CREDITOR NATIONAL**  
25 ) **PUBLIC FINANCE GUARANTEE**  
26 ) **CORPORATION FOR AN ORDER**  
27 ) **DECLARING THE AUTOMATIC STAY**  
28 ) **INAPPLICABLE OR, IN THE**  
 ) **ALTERNATIVE, GRANTING RELIEF**  
 ) **FROM THE AUTOMATIC STAY**  
 )  
 )  
 ) **Date: September 16, 2010**  
 ) **Time: 10:00 a.m.**  
 ) **Dept: A**  
 ) **Judge: Hon. Michael McManus**

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**TABLE OF CONTENTS**

INTERESTS OF THE *AMICUS CURIAE*..... 1

PRELIMINARY STATEMENT ..... 2

I. INTRODUCTION ..... 3

II. THE SIGNIFICANT ROLE OF STATE CREDIT ENHANCEMENT PROGRAMS IN MUNICIPAL FINANCE..... 4

III. THE VLF ENHANCEMENT PROGRAM IS A STATE CREDIT ENHANCEMENT PROGRAM SPECIFICALLY DESIGNED TO PROVIDE A SECONDARY SOURCE OF RECOVERY TO DEBT HOLDERS ..... 9

IV. ALLOWING THE VLF ENHANCEMENT PROGRAM TO FUNCTION AS INTENDED UNDER STATE LAW IS CONSISTENT WITH BOTH THE BANKRUPTCY CODE AND LONG STANDING BANKRUPTCY LAW JURISPRUDENCE..... 10

V. CONCLUSION..... 14

**TABLE OF AUTHORITIES**

**Cases**

*Beiger v. IRS*,  
496 U.S. 53 (1990)..... 13

*Butner v. United States*  
440 U.S. 48 (1979)..... 11

*Gordon v. United States (In re Sissine)*,  
210 Bankr. LEXIS 1887 (Bankr. N.D. Ga. May 27, 2010) ..... 12

*In re Ambassador Group, Inc. Litigation*,  
738 F. Supp. 57 (E.D.N.Y. 1990) ..... 3

*In re California Trade Technical Schools, Inc.*,  
923 F.2d 641 (9th Cir. 1991) ..... 13

*In re Frank Mossa Trucking, Inc.*,  
65 BR 715 (Bankr. D. Ma. 1985)..... 12, 13

*In re Lyle*,  
324 B.R. 128 (Bankr. N.D. Cal. 2005) ..... 13, 14

*In re Pelham Fence Co., Inc.*,  
65 B.R. 924 (Bankr. S.D.N.Y 1986)..... 11-12, 13

*In re Pigott*,  
330 B.R. 797 (Bankr. S.D. Ala. 2006)..... 12-13

*In re Roxford Foods Litigation*,  
790 F.Supp. 987 (E.D. Cal. 1991)..... 2

*Jones v. IRS (In re Jones)*,  
359 B.R. 837 (Bankr. M.D. Ga. 2006)..... 12, 13

*Keller v. Keller (In re Keller)*,  
185 B.R. 796 (9th Cir. BAP 1995)..... 11

*National Petrochemical & Refiners Ass'n v. Goldstene*,  
2010 WL 2228471 (E.D. Ca. 2010)..... 2

*Neonatology Assoc. P.A. v. IRS*,  
293 F.23d 128, 132 (3rd Cir. 2002) ..... 2

*Norfolk Southern Ry. v. Consol. Freightways Corp. (In re Consol. Freightways Corp.)*,  
443 F.3d 1160 (9th Cir. 2006) ..... 11

*Old Republic Nat'l Title Ins. V. Tyler (In re Dameron)*,  
206 B.R. 394 (Bankr. E.D. Va. 1997)..... 13

1 *Quiller v. Barclays American/Credit, Inc.*,  
727 F.2d 1067 (11th Cir. 1984) ..... 3

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3 *Scripps GSB I, LLC v. A Partners, LLC (In re A Partners, LLC)*,  
344 B.R. 114 (Bankr. E.D. Cal. 2006)..... 11

4 *United States v. Whiting Pools, Inc.*,  
462 U.S. 198 n. 8 (1983)..... 11

5

6 **Statutes**

7 11 U.S.C. § 541(a)(1)..... 11

8 California Government Code § 37351.5..... 9, 14

9 California Government Code § 37351.5(a) ..... 4, 9

10 California Government Code § 37351.5(a)(3)..... 9, 14

11 California Tax Code 11005..... 9

12 **Other Authorities**

13 5 *Collier on Bankruptcy*, P 541.03 (16th ed. 2010) ..... 11

14 5 *Collier on Bankruptcy*, P 541.09[2] (16th ed. 2010) ..... 13

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1 **INTERESTS OF THE *AMICUS CURIAE***

2 The National Federation of Municipal Analysts (“NFMA”) is a not-for-profit association  
3 of over 1,000 members, primarily research analysts, who evaluate credit and other associated  
4 risks in the bond market.<sup>1</sup> These individuals represent, among other entities, mutual funds,  
5 insurance companies and other purchasers of tax-exempt and taxable debt securities, as well as  
6 broker/dealers, bond insurers, rating agencies and financial advisors.

7 The United States bond market accounts for a significant proportion of the country’s  
8 capital market, with over \$34.7 trillion in outstanding securities as of December 31, 2009.  
9 NFMA members are actively involved in the assessment and purchase or sale of bonds and other  
10 debt securities issued by municipal or other governmental entities or instrumentalities, a subset  
11 of the bond market involving over \$2.8 trillion in outstanding securities as of December 31,  
12 2009. NFMA members are involved in virtually every investor’s decision to purchase bonds  
13 issued by states, cities, towns, counties, districts, or by public authorities issuing on their behalf.  
14 Such bonds finance long-term capital expenditures, including the acquisition of public lands and  
15 the construction and improvement of libraries, police stations, fire stations and other public  
16 buildings, bridges, roads, water and sewer systems and other infrastructure, student loans for  
17 higher education; low-income and mixed-income housing; hospitals, nursing homes and assisted  
18 living facilities; schools, colleges and universities, museums, social services agencies, solid  
19 waste disposal facilities, airports, docks and wharves, mass commuting facilities, hazardous  
20 waste facilities, high-speed intercity rail facilities, manufacturing facilities, hotels, recreational  
21 facilities and the like.

22 The NFMA infrequently files amicus briefs, and only in cases, such as this one, that have  
23

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24 <sup>1</sup> NFMA was established in 1983 to promote professionalism in municipal credit analysis and further the  
25 skill level of its members through educational programs and industry communication. The NFMA  
26 furthers this goal by providing informed perspective regarding legal and regulatory matters relating to the  
27 municipal finance industry, and facilitating the flow of information between investors and issuing entities.  
28 The NFMA includes six constituent societies: (1) the Boston Municipal Analysts Forum; (2) the  
California Society of Municipal Analysts; (3) the Chicago Municipal Analysts Society; (4) the Minnesota  
Society of Municipal Analysts; (5) the Municipal Analysts Group of New York; and (6) the Southern  
Municipal Finance Society, as well as members unaffiliated with such societies.

1 important implications for municipal debt purchasers generally. The NFMA files this brief in  
2 support of the Motion (defined below) filed by movant National Public Finance Guarantee  
3 Corporation (“National”).

4  
5 **PRELIMINARY STATEMENT**

6  
7 The National Federation of Municipal Analysts (the “NFMA”), by and through its  
8 undersigned counsel, respectfully requests the Court to consider the within brief as *amicus curiae*  
9 (the “Amicus Curiae Brief”) in support of the Motion of Creditor National Public Finance  
10 Guarantee Corporation for an Order Declaring the Automatic Stay Inapplicable or, in the  
11 Alternative, Granting Relief from the Automatic Stay, dated August 10, 2010 [Docket No: 760]  
12 (the “Motion”)<sup>2</sup>.

13  
14 Amicus briefs are appropriate, and courts should consider such briefs when “the amicus  
15 has unique information or perspective that can help the court beyond the help that the lawyers  
16 from the parties are able to provide.” *National Petrochemical & Refiners Ass'n v. Goldstene*,  
17 2010 WL 2228471, 1-2 (E.D. Ca. 2010); *see also Neonatology Assoc. P.A. v. IRS*, 293 F.23d 128,  
18 132 (3rd Cir. 2002) (dismissing arguments that an amicus must have a pecuniary interest or be  
19 totally impartial and holding that “[e]ven when a party is well represented, an amicus may  
20 provide important assistance to the court”); *see also In re Roxford Foods Litigation*, 790 F.Supp.  
21 987, 997 (E.D. Cal. 1991) (“Generally, courts have exercised great liberality in permitting an  
22 amicus curiae to file a brief in a pending case, and, with further permission of the court, to argue  
23 the case and introduce evidence .... There are no strict prerequisites that must be established prior  
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<sup>2</sup> Capitalized terms used herein but not otherwise defined herein shall have the meaning ascribed  
28 to such terms in the Motion.

1 to qualifying for amicus status; an individual seeking to appear as amicus must merely make a  
2 showing that his participation is useful to or otherwise desirable to the court.”).

3           Given the scarcity of chapter 9 precedent, these proceedings have been closely followed  
4 in the municipal marketplace. The NFMA is uniquely qualified to provide the court with the  
5 financial and economic context of the dispute between the parties, and this Amicus Curiae Brief  
6 will apprise the court of the potential ramifications in the national municipal finance marketplace  
7 which could be implicated by its ruling in this matter. The NFMA’s involvement will not delay  
8 the adjudication of the Motion in any way.

9  
10           This Amicus Curiae Brief outlines the critical role of state credit enhancement programs  
11 across the country, such as the VLF Enhancement Program (as defined below), at issue in this  
12 case. The dispute underlying the Motion directly involves the enforceability of state credit  
13 enhancement programs in the event of a bankruptcy of the primary obligor and as such warrants  
14 consideration of the broader impact on municipal finance markets. *See, e.g., Quiller v. Barclays*  
15 *American/Credit, Inc.*, 727 F.2d 1067, 1071 (11th Cir. 1984) (courts "should consider [the]  
16 actual operation of a contract [in dispute] in the commercial world...."); *In re Ambassador*  
17 *Group, Inc. Litigation*, 738 F. Supp. 57, 63 (E.D.N.Y. 1990) (court specifically takes into account  
18 the impact of its decision on the relevant market). The Amicus Curiae Brief provides the  
19 Court with essential market information, both within California and throughout the  
20 country, in order to assist and inform the Court in its decision

21  
22  
23 **I. INTRODUCTION**

24           The NFMA, by and through its undersigned counsel, strongly urge this Court to allow the  
25 Motion. Denial of the Motion will have a potentially devastating impact on access to capital for  
26 cities, towns, counties, school districts and other municipalities in California, as well as in at  
27 least 23 other states across the country, as it will inject great uncertainty into long held  
28

1 fundamental capital market expectations about the protection provided to debt holders by state  
2 credit support programs. The availability and enforceability of state credit support programs  
3 such as the VLF Enhancement Program (defined below) are essential to provide municipalities  
4 with access to credit and to reduce the costs of such credit, by providing a secure secondary  
5 source of recovery to the debt holders if the primary obligor defaults on its obligations. Debt  
6 holders rely on the availability and enforceability of such secondary credit support to mitigate  
7 credit risk associated with the primary obligor, including the risk of the primary obligor's  
8 bankruptcy.

9 Recognition of secondary credit supports such as the VLF Enhancement Program as  
10 independent of and not implicated by the bankruptcy of the primary obligor is consistent with  
11 both the Bankruptcy Code and long standing bankruptcy law jurisprudence. By statute,  
12 California has made it clear that the VLF Enhancement Program is intended to provide  
13 secondary credit support to pay defaulted debt service for qualifying municipalities. California  
14 Government Code § 37351.5(a). The City of Vallejo, California (the "Debtor," or the "City")  
15 chose to participate in the VLF Enhancement Program with respect to its 1999 COPs. Despite  
16 the City's acknowledged default on the 1999 COPs, the Controller has not made the VLF  
17 Support Payment.

18 The NFMA files this Amicus Curiae Brief because of its great concern that departing  
19 from basic bankruptcy court jurisprudence which recognizes the enforceability of secondary  
20 credit support in a bankruptcy of the primary obligor -- particularly here in a chapter 9 case of  
21 first impression and great notoriety -- will have an impact far beyond the case sub judice.

22  
23 **II. THE SIGNIFICANT ROLE OF STATE CREDIT ENHANCEMENT PROGRAMS  
24 IN MUNICIPAL FINANCE**

25 Cities and other municipalities generally borrow money through the issuance of public  
26 debt in the capital market. State credit enhancement opens doors to this market for  
27 municipalities. A municipality turns to credit support to both provide it access to the capital  
28 market and to reduce the cost of its capital. Credit enhancement in the municipal marketplace



1 takes several forms, but they all share a common characteristic - providing a secondary source of  
2 funds to pay the debt service obligations if the municipality defaults. Availability of a secondary  
3 payor or source of funds in cases where the primary obligor defaults provides the debt holder  
4 with greater assurance that the debt service will be both timely and fully paid. This reduction in  
5 risk through a secondary credit source unaffected by the primary obligor's financial difficulties is  
6 the reason why debt issued with credit enhancement enjoys higher credit ratings and lower  
7 interest rates.

8 State credit enhancement programs are not unique to California. In its recent report on  
9 state credit enhancement programs, Standard & Poor's ("S&P") identified 34 separate state  
10 credit enhancement programs across 24 states, representing thousands of debt issues involving  
11 billions of dollars in public debt nationwide.<sup>3</sup> Like the VLF Enhancement Program, such  
12 programs support multiple debt issues for multiple municipalities in each state. For example, the  
13 State of Texas established a Guarantee Program for School District Bonds in 1983 to provide  
14 payment to debt holders from a designated state fund should the primary obligor on the debt  
15 default. This program supports numerous public debt issues in Texas and as of June 30, 2010  
16 supported approximately \$50 billion of public debt for school districts.<sup>4</sup> Similar programs in  
17 Pennsylvania were established to support financing for various school improvement projects.  
18 The Pennsylvania 150 School District Intercept Program and the Pennsylvania School District  
19 Fiscal Agent Agreement Intercept Program each provide credit support for approximately two  
20 hundred municipalities representing approximately \$25.8 billion in public debt.<sup>5</sup> These are but a  
21 few examples of the scores of programs across the country similar to the VLF Enhancement  
22 Program where states have elected to provide credit support if the primary obligor defaults in  
23 order to increase their municipalities' access to affordable public debt.

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24  
25 <sup>3</sup> Standard & Poor's, *State Credit Enhancement Programs*, Nov. 13, 2008, at 26. This report is attached  
to National's Motion as Exhibit G and is incorporated herein by reference.

26 <sup>4</sup> See Texas Permanent School Fund, Bond Guarantee Program Summary, pg. 1 (June 30, 2010), located  
at [http://ritter.tea.state.tx.us/downloads/web\\_disclosure\\_08092010.pdf](http://ritter.tea.state.tx.us/downloads/web_disclosure_08092010.pdf).

27 <sup>5</sup> See *Moody's Assigns Negative Outlook to Three Pennsylvania School District State and Intercept*  
28 *Programs in Conjunction With Revision of Commonwealth's Outlook*, Moody's Investors Service, Aug.  
27, 2009.

1 The VLF Enhancement Program at issue in this case supports much more than just the  
 2 1999 COPs. The following is a list of other outstanding debt in California supported by the VLF  
 3 Enhancement Program:

Issuer/Primary Obligor	Issue Name	Original Par Amount
City of Vallejo, CA	Series 1999 COPs	\$4,815,000.00
	Series 2000 COPs	\$12,786,942.00
City of Chula Vista, CA	Series 2003 Ref COPs	\$11,320,000.00
City of Susanville, CA	2002 City Hall Revenue Bonds	\$2,270,000.00
Butte County, CA	Series 2003 COPs	\$5,150,000.00
Del Norte County, CA	Series 1999 COPs	\$7,015,000.00
Humboldt County, CA	Series 2003 Ref COPs	\$17,815,000.00
Mendocino County, CA	Series 2001 Refunding COP Bonds	\$7,965,000.00
Contra Costa County, CA	Series 1998A Refunding Lease Revenue Bonds	\$24,695,000.00
City of Hawthorne, CA	Series 1997 COP Capital Improvement Refinancing	\$9,950,000.00
	<b>TOTAL</b>	<b>\$103,781,942.00</b>

20 In addition to the VLF Enhancement Program, since November, 2008, California maintains two  
 21 other state credit enhancement programs, supporting public financing for health care and school  
 22 district improvements.<sup>6</sup>

23 The importance of state credit enhancement programs will only increase. As the Court is  
 24 likely well aware, burdened by significant fixed costs and decreases in their revenue base, many  
 25 municipalities are struggling to meet ongoing demands including funding essential capital  
 26

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27  
 28 <sup>6</sup> Standard & Poor's, *State Credit Enhancement Programs*, at 26.

1 improvement projects.<sup>7</sup> At the same time, the economic downturn has left traditional monoline  
2 bond insurers and other institutional providers of credit enhancements unable or unwilling to  
3 provide common forms of credit enhancements such as bond insurance and letters of credit  
4 which have traditionally provided municipalities with the means to access the public debt market  
5 at lower costs. Over the past few years the number of monoline bond insurers has dramatically  
6 decreased and the amount of new municipal debt that is supported by the remaining monoline  
7 bond insurers has dropped from 57% in 2005 to 9% in 2009.<sup>8</sup> Unable to fund these capital needs  
8 from internal sources and faced with being shut out of access to the public debt market,  
9 municipalities are likely to become increasingly reliant upon these state credit enhancement  
10 programs to provide them with access to capital at affordable interest rates. If, as a result of the  
11 court's ruling on the Motion, serious questions are raised as to the validity and enforceability of  
12 such support in the event of a primary obligors' bankruptcy, then municipalities across the  
13 country will likely suffer the consequences of being shut out of the capital markets, or of having  
14 to pay substantial premiums for that access, thereby negating the intended benefits of such state  
15 credit enhancement programs.

16 State credit enhancement programs are designed to provide debt holders with an  
17 independent payment source and to provide greater assurances that the debt will be timely and  
18 fully paid regardless of the financial circumstances of the municipality. While each program has  
19 its own unique attributes, all of them typically include an independent revenue stream expressly  
20 made available to protect against any default by the primary obligor.<sup>9</sup>

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23 <sup>7</sup> See, e.g., Romy Varghese, *Harrisburg Defaults as Localities Struggle*, Wall Street Journal (September  
24 1, 2010), available at <http://online.wsj.com/article/SB10001424052748703467004575464040052875592.html?KEYWORDS=Harrisburg+Defaults+as+Localities+Struggle>; Mark Gongloff, *Small-Fry Munis*  
25 *Likely to Struggle*, Wall Street Journal (March 20, 2010), available at  
26 [http://online.wsj.com/article/SB10001424052748703580904575131490000070002.html?KEYWORDS=](http://online.wsj.com/article/SB10001424052748703580904575131490000070002.html?KEYWORDS=Small-Fry+Munis+Likely)  
[Small-Fry+Munis+Likely](http://online.wsj.com/article/SB10001424052748703580904575131490000070002.html?KEYWORDS=Small-Fry+Munis+Likely); David von Drehle, *In the U.S., Crisis in the Statehouses*, Time magazine (June  
17, 2010), available at <http://www.time.com/time/nation/article/0,8599,1997284,00.html>.

27 <sup>8</sup> See Patrick McGee, *Bond Insurers Fall Through the Floor, Assured Excepted*, The Bond Buyer, Feb 8,  
2010, at 9A.

28 <sup>9</sup> Standard & Poor's, *State Credit Enhancement Programs*, at 26.

1 State credit enhancement programs “provide protection to the bond purchaser while  
2 providing the issuer with a better credit position.”<sup>10</sup> These widely used state credit enhancement  
3 programs “provide a credit suitable to an otherwise weaker underlying governmental unit when  
4 there is a need for the local government to access the capital markets.”<sup>11</sup>

5 State credit enhancement programs are typically created by statute and take several  
6 forms. A program backed by a general pledge from a state will typically receive a credit rating  
7 on par with debt backed by appropriations from such state and its credit rating will generally  
8 move in tandem with such state’s credit rating. Other state credit enhancement programs may be  
9 structured to provide for withholding from a source of State aid to pay debt service.<sup>12</sup> State  
10 enhancement programs structured through a withholding mechanism are generally rated by S&P  
11 at a level one notch off of the state’s general obligation (“GO”) rating. For example, if a state  
12 has a GO rating from S&P of “AA”, the debt issued under a state withholding program would  
13 likely be rated “AA-.” That enhanced rating is higher than the debt would have received absent  
14 the state credit enhancement.<sup>13</sup> The enhanced credit ratings result in lower interest rates and  
15 lower debt service payments for the municipality.

16 Given the scarcity of chapter 9 precedent generally, these proceedings have been closely  
17 followed in the municipal finance marketplace. Denying National’s Motion would destroy long  
18 held and justified confidence in the enforceability of secondary state credit enhancements in the  
19 face of the primary obligor’s bankruptcy -- the precise situation in which they are intended to  
20 function. If state credit enhancement programs such as the VLF Enhancement Program are  
21 unable to operate as intended in the face of a chapter 9 of the primary obligor, municipalities will  
22 inevitably bear higher borrowing costs, if they are able to access the municipal credit market at  
23 all. With increasingly tighter budgets and access to the credit markets generally challenged,  
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25 <sup>10</sup> Cal. Debt and Inv. Advisory Comm’n., 2007 Ann. Rep., at 15, available at  
26 [http://www.treasurer.ca.gov/cdiac/reports/annual/2007\\_annual.pdf](http://www.treasurer.ca.gov/cdiac/reports/annual/2007_annual.pdf) (as of August 25, 2010).

27 <sup>11</sup> See Harold B. Burger, *State Credit Enhancement Programs for School Districts and Municipalities*, in  
28 *The Handbook of Municipal Bonds*, at 1133 (Sylvan G. Feldstein & Frank J. Fabozzi, eds. 2008).

<sup>12</sup> See *id.* at 1134.

<sup>13</sup> Standard & Poor’s, *State Credit Enhancement Programs*, at 2.

1 access to an enforceable state credit enhancement program may be one of the few mechanisms in  
2 the future by which a municipality is able to afford to finance essential public works and  
3 community development projects.

4  
5 **III. THE VLF ENHANCEMENT PROGRAM IS A STATE CREDIT**  
6 **ENHANCEMENT PROGRAM SPECIFICALLY DESIGNED TO PROVIDE A**  
7 **SECONDARY SOURCE OF RECOVERY TO DEBT HOLDERS**

8 In 1990, California established a credit support program specifically to provide public  
9 debt holders with a secondary source of payment from VLFs should the primary obligor default  
10 on its obligations (the “VLF Enhancement Program”). California Government Code  
11 § 37351.5(a). VLFs are fees assessed and paid to the State by all licensed motor vehicle owners  
12 in the State of California. As the VLFs are collected, they are deposited into a separate account  
13 at the State level and are distributed to cities and towns as a form of state aid. Only after  
14 statutory adjustments are made by the State, does the State distribute the net VLFs to qualifying  
15 cities and counties. California Government Code § 37351.5; *see also* California Tax Code  
16 § 11005 (establishing a comprehensive formula to determine the net amount of VLFs to  
17 distribute to cities and counties). One such adjustment is the amount that the Controller is  
18 required to withhold to pay the defaulted debt service of any and all municipalities that have  
19 chosen to participate in the VLF Enhancement Program (the “VLF Support Payment”).<sup>14</sup> As the  
20 statute makes clear, upon a default by the primary obligor, and without need for notice from the  
21 trustee, the Controller is mandated to withhold the VLF Support Payment off the top, and prior to  
22 the distribution to any municipality of the state aid.

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23 <sup>14</sup> California Government Code § 37351.5(a)(3) states:

24 *When the Controller receives notice from the trustee as described in paragraph (2), or the*  
25 *city fails to make any payment under the financing agreement at the time that payment is*  
26 *required, the Controller shall make an apportionment to the trustee in the amount of that*  
27 *required payment for the purpose of making that payment. The Controller shall make*  
28 *that payment only from moneys credited to the Motor Vehicle License Fee Account in*  
*the Transportation Tax Fund to which that city is entitled at the time under Chapter 5*  
*(commencing with Section 11001) of Part 5 of Division 2 of the Revenue and Taxation*  
*Code, and shall thereupon reduce, by the amount of the payment, the subsequent*  
*allocation to which the city would otherwise be entitled under that chapter (emphasis*  
*added).*

1 The VLF Enhancement Program is available to cities or counties with populations greater  
2 than 2500 residents that (a) opt to participate in the VLF Enhancement Program, and (b)  
3 historically have received an allocation of VLFs from the State of at least 2 ½ times the debt  
4 service under the proposed debt issue. The City satisfied all conditions of the VLF Enhancement  
5 Program and irrevocably chose to participate in the VLF Enhancement Program with respect to  
6 the 1999 COPs. The 1999 COPs were marketed and sold to investors on the basis that VLF  
7 Support Payments would be automatically made available to pay debt service on the 1999 COPs  
8 should the City default on its payment obligations. The securities offering document issued by  
9 the City in connection with the 1999 COPs explicitly represented to potential purchasers of the  
10 1999 COPs that the VLF Support Payment would be available “in the event that funds otherwise  
11 available to make any such Lease Payments will not be sufficient” and that under California law  
12 “the Controller is directed to make the City’s apportionments from the [VLFs] to the [1999  
13 Trustee] when the Controller receives notice that funds available to make any [debt service  
14 payment] will not be sufficient or when the City fails to make any deposit of Lease Payments  
15 with the [1999 Trustee].<sup>15</sup>

16  
17 **IV. ALLOWING THE VLF ENHANCEMENT PROGRAM TO FUNCTION AS**  
18 **INTENDED UNDER STATE LAW IS CONSISTENT WITH BOTH THE**  
19 **BANKRUPTCY CODE AND LONG STANDING BANKRUPTCY LAW**  
20 **JURISPRUDENCE**

21 As set forth above, allowing the VLF Enhancement Program to function as intended  
22 comports with the public markets long held expectations regarding the availability and  
23 enforceability of state credit support mechanisms. It is also wholly consistent with the  
24 Bankruptcy Code and fundamental tenets of bankruptcy law jurisprudence.

25 Bankruptcy courts have long recognized a creditor’s ability to satisfy its claims from  
26 assets that are not property of the estate. “Property of the estate” is described in Bankruptcy

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27 <sup>15</sup> See Official Statement, City of Vallejo, Cal., July 1, 1999, \$4,815,000 Certificates of Participation  
28 (1999 Capital Improvement Project), pg. 11. A true and accurate copy of the Official Statement is  
attached hereto as **Exhibit A**.

1 Code section 541 as, among other things, “all legal or equitable interests of the debtor in property  
2 as of the commencement of the case.” 11 U.S.C. § 541(a)(1). While the definition is broad, it is  
3 not all encompassing. See *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204 n. 8 (1983)  
4 (estate property does not comprise interests in which the debtor holds only “a minor interest such  
5 as a lien or bare legal title”); *Norfolk Southern Ry. v. Consol. Freightways Corp. (In re Consol.*  
6 *Freightways Corp.)*, 443 F.3d 1160 (9th Cir. 2006) (citing *Butner v. United States*, 440 U.S. 48,  
7 55 (1979), recognizing application of federal bankruptcy law does not justify the creation of a  
8 new federal common law rule). As stated by Justice Stevens, “Congress has generally left the  
9 determination of property rights in the assets of a bankrupt's estate to state law.” *Butner v.*  
10 *United States*, 440 U.S.at 54.

11 A debtor’s property rights come into the estate subject to all of the conditions, restrictions  
12 and limitations that attached to those property rights under state law prior to commencement of  
13 the bankruptcy case. See *Scripps GSB I, LLC v. A Partners, LLC (In re A Partners, LLC)*, 344  
14 B.R. 114 (Bankr. E.D. Cal. 2006); 5 *Collier on Bankruptcy*, (16th ed. 2010), P 541.03, pg. 541-  
15 15, 16. To the extent that an interest in property is limited in the hands of a debtor prior to  
16 commencement of the bankruptcy case, it is equally limited as property of the estate. *Id.*; see  
17 also *Keller v. Keller (In re Keller)*, 185 B.R. 796, 800-801 (9th Cir. BAP 1995) (property rights  
18 which the debtor holds subject to reserved jurisdiction of the State Family Court remain subject  
19 to modification by the State court even after the debtor files bankruptcy).

20 The great weight of bankruptcy law jurisprudence compels a determination that the VLF  
21 Support Payment is not an asset of the City and therefore, unavailable for use by the City. In  
22 *Pelham Fence*, the debtor, a construction contractor entered into a contract that required it to  
23 comply with a New York law to pay its workers a prevailing rate of wages. *In re Pelham Fence*  
24 *Co., Inc.*, 65 B.R. 924 (Bankr. S.D.N.Y 1986). The debtor defaulted on its obligation to pay the  
25 prevailing wages to one of its employees and the New York Department of Labor sought to  
26 withhold the debtor’s contract funds to withhold that portion of the debtor’s funds that the state  
27 preliminarily determined to be the debtor’s obligations under the New York law. The custodian  
28

1 complied with the notice and withheld approximately \$57,000 from the debtor. Thereafter, the  
2 debtor filed for bankruptcy protection and the Commissioner for the New York Department of  
3 Labor brought an action in the bankruptcy court seeking confirmation that the stay did not  
4 prevent the Commissioner from bringing an action against a debtor's custodian for the withheld  
5 funds in order to pay the former employee. The Court held that the debtor had no rights to the  
6 withheld amounts as such amounts were not part of the debtor's bankruptcy estate. 65 B.R. at  
7 927-928. The Court found that because the State had a specific law which required the custodian  
8 to set aside funds to force the debtor to comply with its statutory obligations and such funds were  
9 to be paid to the Commissioner for the benefit of the harmed employee, the withheld funds were  
10 never property of the debtor's estate. *See also In re Frank Mossa Trucking, Inc.*, 65 BR 715, 718  
11 (Bankr. D. Ma. 1985) (holding withheld funds by the Department of Labor for deficiencies in  
12 amounts due the debtor's employees under a contract with the United States Postal Service not  
13 property of the estate as the withholding provision in the statute created a trust fund for the  
14 benefit of the employees and the Department of Labor was authorized to distribute the withheld  
15 amount to the debtor's former employee).

16 Similarly, other courts have held that a debtor has no interest in property subject to a  
17 statutory withholding of a debtor's interest in a tax overpayment. *See, e.g., Gordon v. United*  
18 *States (In re Sissine)*, 210 Bankr. LEXIS 1887 (Bankr. N.D. Ga. May 27, 2010) (debtor never  
19 had an interest in the tax refund and the tax overpayment did not become part of the debtor's  
20 estate because the funds were properly withheld by the IRS to satisfy pre-existing tax liabilities);  
21 *Jones v. IRS (In re Jones)*, 359 B.R. 837 (Bankr. M.D. Ga. 2006) (court held debtor's property  
22 interest in a tax overpayment only includes the amount in which the overpayment exceeds any  
23 pre-existing tax liability and the pre-existing liability was paid to IRS); *In re Pigott*, 330 B.R.  
24 797, 800 (Bankr. S.D. Ala. 2006) (same). These cases confirm that the debtor's right to a tax  
25 overpayment is limited as a matter of statutory law by the amount the IRS is required to withhold  
26 and the debtor's interest is only to the extent of any net tax refund. The court in *Sissine* aptly  
27 noted that to disregard this statutory withholding requirement would provide the debtor with an  
28



1 unjust windfall. 2010 Bankr. LEXIS at 24. Case law holding that funds withheld from a debtor  
2 are not property of the debtor’s estate recognizes that these “withholding” cases are intellectually  
3 no different from cases involving a trust or escrow account. *See Frank Mossa Trucking*, 65 B.R.  
4 at 718. Funds in trust are not estate property, especially if a debtor is neither a settlor, trustee nor  
5 beneficiary. *See Beiger v. IRS*, 496 U.S. 53, 59 (1990) (in the context of a preference action, the  
6 Court ruled that where a debtor does not own an equitable interest in property held in trust for  
7 another, that such interest is not “property of the estate” or “property of the debtor”). “In  
8 general, most courts have held that assets in escrow are not property of the estate. Estate  
9 property is confined to the rights conferred upon the debtor by the escrow agreement, not  
10 property rights in the assets escrowed.” 5 *Collier on Bankruptcy* P 541.09[2], at 541-45 (16th ed.  
11 2010); *In re California Trade Technical Schools, Inc.*, 923 F.2d 641, 646 (9th Cir. 1991)  
12 (holding funds in trust were not avoidable because “property of the estate is only considered  
13 property of the debtor if its transfer would deprive the estate of something which could be used  
14 to satisfy the claims of creditors”); *Old Republic Nat’l Title Ins. V. Tyler (In re Dameron)*, 206  
15 B.R. 394, 402 (Bankr. E.D. Va. 1997) (holding funds or property that a debtor as principal has  
16 transferred to an escrow prepetition are not property of the estate except as might be provided by  
17 the escrow). Following this fundamental black letter principle of bankruptcy law, courts  
18 routinely hold that a debtor does not have an interest in property subject to a statutory  
19 withholding and that the withheld amounts are not property of the estate. *See, e.g., In re Lyle*,  
20 324 B.R. 128 (Bankr. N.D. Cal. 2005); *In re Jones, supra*; *In re Pelham Fence Co., Inc.*, 65 B.R.  
21 924 (Bankr. S.D.N.Y 1986). As the Motion correctly points out, in *Lyle* the court held that  
22 amounts subject to an automatic statutory withholding are not property of the debtor’s estate.  
23 *Lyle*, 324 B.R. at 131. The court in *Lyle* drew an essential distinction that the debtor’s interest in  
24 his tax overpayment did not include the amount of any statutorily required deductions, including  
25 the amount to be appropriated from the tax overpayment to reduce his child support obligations.  
26 *Id.* The court made clear in its holding that property of the estate was the net amount due the

1 debtor after making the statutory deductions required under a federal tax intercept program. *See*  
2 *id.* And *Lyle* is no outlier and in fact follows the great weight of authority.

3 Here, under California law, the City's interest in the VLFs is limited only to any excess  
4 amounts available after withholding the VLF Support Payment. California Government Code  
5 § 37351.5. The VLF Enhancement Program specifically provides that the City's interest in the  
6 VLFs is net of the VLF Support Payment. Subsection (a)(3) of California Government Code  
7 § 37351.5 unambiguously provides that after the City defaults on the 1999 COPs, the Controller  
8 is required to pay to the 1999 Trustee the VLF Support Payment for the benefit of the debt  
9 holders. California Government Code § 37351.5(a)(3). After the City defaulted on the 1999  
10 COPs, the statute provides that the Controller shall distribute to the City only the VLFs after  
11 withholding the VLF Support Payment. *Id.*

12 Applying the line of escrow and trust cases by analogy, the City has no legal or beneficial  
13 interest in the VLF Support Payment. As soon as the City defaults on its obligations under the  
14 1999 COPs, it no longer has any interest in the VLF Support Payment statutorily set aside under  
15 state law solely for the benefit of the debt holders. The State intentionally established this  
16 separate source of funds from the VLFs to be withheld and paid to the 1999 Trustee. As a  
17 separate source of funds set aside for the sole benefit of the debt holders, the City has no interest  
18 and never has access to the VLF Support Payment.

19  
20 **V. CONCLUSION**

21 The NFMA respectfully requests this Court to rule for National on the Motion. State  
22 credit enhancement programs, such as the VLF Enhancement Program, are designed by states to  
23 fill the essential purpose of providing municipalities with lower costs of borrowing and access to  
24 the capital market. In California and across the country, billions of dollars of municipal debt is  
25 issued with state credit enhancement based on the long held understanding in the municipal  
26 marketplace that state credit enhancements provide a secure and secondary source of recovery to  
27 the debt holders if the municipality defaults. With an adverse ruling on the Motion, the capital  
28

1 markets would no longer ascribe value to the state credit enhancement and this Court would  
2 create a precedent which would frustrate the design of these programs to provide relief to cash-  
3 strapped municipalities across the country. To provide comfort to potential providers of capital,  
4 the enhancement vehicle needs to be operational precisely when it is needed most – in the event  
5 of a municipality’s bankruptcy. For these reasons, and because it would be consistent with the  
6 great weight of bankruptcy law jurisprudence, we urge the Court to up-hold the availability and  
7 enforceability of the VLF Enhancement Program.

8  
9 Respectfully submitted,

10  
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