

THE BOND BUYER

Wednesday, October 3, 2012 | as of 7:53

PM ET

[Commentary](#)

Letter to the Editor: Stockton's Restricted Funds Healthy, General Fund Not
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Stockton's bankruptcy has generated much discussion — and some misinformation — regarding local government finances in California.

Most local governments pool their cash from restricted and unrestricted funds for short term investment purposes, while tracking balances in each individual fund. Restricted funds carry legal limitations for use like utility funds, gas taxes, assessments, etc. Unrestricted funds are typically accounted for in the general fund, and are used for activities like police and fire services.

In times of financial stress, particular attention to the cash flow of that fund is warranted. General fund revenues typically do not come evenly through the year, while expenses do. It is common practice that during the “dry” cash flow periods, the general fund's cash flow is financed during the year by other restricted funds, but it is important to remember that restricted funds must always be repaid during the same fiscal year. At a given time, a city's pooled cash balance may be large, but the preponderance of the cash may be in restricted funds. The city's restricted funds may be healthy, while the general fund is insolvent, as in Stockton's case.

Absent voter approval, Article XVI, Section 18 of the California Constitution (the “Debt Limit”) prohibits cities from entering into indebtedness that exceeds the resources available in that year.

There are three exceptions that have been recognized by the courts: 1) long-term leases; 2) special fund obligations; and 3) obligations imposed by law.

There is no Debt Limit exception for indebtedness created by borrowing from restricted funds beyond the current fiscal year. A surprising number of finance professionals and senior managers seem unaware of this rule, while others may knowingly ignore it. The pressure to incur such internal indebtedness is greatest when a city's general fund is distressed and experiencing underlying structural problems.

After gutting Stockton's services and employee compensation over three years, and an independent review of its financial position, Stockton determined it could not operate its general fund in conformance with the Debt Limit and also satisfy its duty to provide for the health and safety of its citizens. Stockton has the second lowest police staffing of any large city in the nation and has the tenth highest crime rate. Reductions in expenses necessary to comply with the Debt Limit required the City to impair contracts, including bond debt, labor agreements and certain retirement benefits. The City tried to resolve these issues through mediation. While the City did reach agreement with 8 of 9 unions, there were no agreements with other major creditors. The City was then forced to file for bankruptcy to allow it to impair contracts and reduce general fund expenditures. This included a painful elimination of the retiree medical insurance program, a \$540 million dollar inherited unfunded liability, as well as

impairments to certain general fund debt obligations.

Stockton management and elected officials have stated publicly that the City cannot and will not use restricted funds (such as water and sewer enterprise funds) to backfill the insolvent general fund. Debt obligations associated with those enterprise funds continue to be paid in full and the City is in compliance with all covenants related to those obligations.

Unfortunately, the rating agencies have responded with rating downgrades for bonds financed by these restricted funds. Their stated concern is that the “legal firewall” may be adequate but Stockton may not have the “willingness to pay” debt; however, there is no evidence this is true.

First, the City has more than adequately demonstrated that its general fund does not have the ability to pay its debts due to severe insolvency. Stockton has made extremely large and painful cuts to labor and retiree benefits. Further reductions to health and safety services would move Stockton from lean to dangerous. Moreover, the City clearly is eager and willing to pay its non-general fund debt and has not attempted in any way to undermine the legal firewall between restricted funds and the general fund.

It is unfortunate that citizens, employees, retirees and general fund bond creditors have been harmed in this situation. However, the City has been steadfast in its commitment to follow the law, treat creditor classes fairly, adopt a balanced budget every year and, most importantly, provide for the health and safety of its citizens.

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