Recent Bankruptcies and Defaults Raise Concerns Over General Obligation Bonds

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FirstSouthwest

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Why Is There Increased Focus on Bankruptcy and Default in Municipal Market?

Much has been discussed in the media and elsewhere about distressed municipal credits and the impact of defaults and bankruptcy on the municipal market. This paper is intended to give the lay person an understanding of the background and effects of such distressed credits.

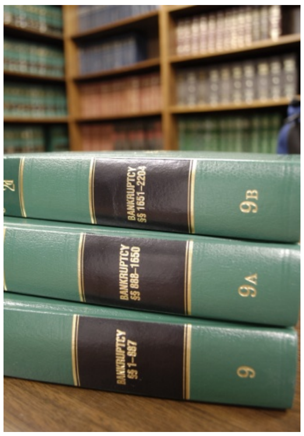
In November 2011, Jefferson County, AL became the largest municipal government ever to file for Chapter 9 bankruptcy in U.S. history. This action came as no surprise to most members of the municipal finance community, as tales of the County's financial turmoil and defaults on its obligations, against a backdrop of corruption charges that resulted in a number of convictions and guilty pleas, were fodder for both the general and financial media. It was not the first case of municipal bankruptcy to occur in recent years. In May 2008, the City of Vallejo, CA ("Vallejo") also made national news when it filed for Chapter 9 protection. Since then, in addition to Jefferson County, other municipalities have filed or attempted to file for bankruptcy, most notably the cities of Central Falls, RI and Harrisburg, PA. Additionally, on June 26, 2012, the City of Stockton, CA's city council voted to file for Chapter 9 bankruptcy, following the unsuccessful conclusion of a mediation process designed to help California municipalities avoid bankruptcy. With a population of 291,707, according to the 2010 U.S. Census, it will become the largest city to ever file for Chapter 9 protection in U.S. history.

Four years after Vallejo's filing and seven months after that of Jefferson County, why does the municipal market appear to be more concerned than ever about the issues of default and bankruptcy? Jefferson County had been in default on $3.14 billion of sewer enterprise revenue warrants, as well as variable rate general obligation ("G.O.") warrants that are currently held by banks. However, April 1, 2012 marked the first time it failed to make payments on fixed rated G.O. warrants held by traditional investors. (These warrants do carry municipal bond insurance.) Under the Federal Bankruptcy Code ("the Code"), G.O. bonds and warrants are treated as "unsecured debt" and the holders of such obligations as general creditors. Such debt is subject to the automatic stay provisions of the Chapter 9 of the Code. *That is*, unless the pledge securing the G.O. debt constitutes a first lien on ad valorem or other tax revenues under state statutes. As it turns out, this is not the case with respect to Jefferson County's G.O. warrants. On the covers of the G.O. warrants' official statements, they are described as "general obligations of the County for the payment of which its full faith and credit have been irrevocably pledged." The official statements further disclose that "[r]evenues available for debt service…include ad valorem taxes, sales, business license and occupational taxes and other general fund revenues," but "[n]one of these revenues are, however, specifically pledged to the payment of debt service..." In other words, Jefferson County's warrants are payable out of all legally available funds in the County's general fund, but there is no specific lien on any particular asset or tax revenue stream.

The security offered by plain vanilla G.O. pledges is eroded by the fact that counties in Alabama do not have "Home Rule" powers under the state's constitution—meaning, a county generally cannot levy a new tax or increase the rate of an existing tax without the permission of the Alabama Legislature.

On May 16, Alabama's legislature refused to consider legislation that would have enabled Jefferson County to raise approximately $60 million of additional tax revenue, which may impact its ability to make G.O. warrant payments coming due later this year.

Jefferson County's historic default has caused a number of participants in the municipal market—investors and issuers alike—to call into question the true meaning of a G.O. pledge. Is a general obligation bond the "gilt-edged" security we have always believed it to be? It has become increasingly important to ask this question in light of issues of default and bankruptcy.



Federal Bankruptcy Code

This section is intended to give a general background of the history of the Federal Bankruptcy Code with respect to municipal securities and is not intended to be definitive, dispositive or to be interpreted as giving legal advice.

Federal bankruptcy law for municipalities was first passed by Congress in 1934 and is presently located in Chapter 9 of the Code. Its purpose is to protect fiscally distressed municipalities from their creditors and enable them to negotiate plans for restructuring their debt. Its intention was to provide relief to municipalities that were unable to repay their debt during the Great Depression and, as a result, were facing litigation. Enacting the legislation was challenging, as the 1934 legislation was declared unconstitutional by the U.S. Supreme Court and replaced with another version in 1937. The problem with the initial legislation was the Tenth Amendment to the U.S. Constitution (known as the "states' rights" amendment), which stipulates that powers not specifically delegated to the federal government are vested in the states. Because there are no specific provisions for municipal bankruptcy in the U.S. Constitution, Chapter 9 of the Code gives the bankruptcy court very limited powers in the context of municipal bankruptcy, with state laws continuing to have significant powers. According to Moody's Investor Service, as of January 19, 2012, 16 states specifically authorize their municipalities to make a Chapter 9 filing, 12 authorize it on a conditional basis, 21 do not specifically authorize it, and one (Georgia) prohibits it.

In addition to the requirement of state authorization to file for bankruptcy, the municipality must satisfy other preconditions in order to qualify for Chapter 9 protection, including proof of the municipality's insolvency; establishing that it "desires to effect a plan to adjust such debts;" and showing that (i) a majority of each class of creditors has agreed to a plan, (ii) that it has tried to negotiate in good faith with its creditors but has failed to reach an agreement with a majority of each class, (iii) negotiations with creditors are impracticable, or (iv) the municipality reasonably believes that one of its creditors is about to attempt to obtain a preferential transfer.

One of the aspects of federal bankruptcy law pertaining to municipalities that some may find surprising is the fact that Chapter 9's automatic stay on municipal obligations *does not* apply to "special revenue" bonds. Special revenues include receipts from projects or systems primarily used for transportation, water, sewer and other utilities or other municipal systems. They might also include certain types of excise taxes or taxes collected in the context of tax increment financing. As a result, holders of special revenue bonds may have a greater likelihood of being fully repaid than holders of unsecured G.O. bonds that do not have the benefit of a dedicated pledge of revenue or first lien on tax revenue, although case law is evolving.

Unlike corporations, municipalities cannot be forced into bankruptcy. There are no provisions allowing states to file for bankruptcy under the Code.

Different States, Different Outcomes

As the case studies below demonstrate, bankruptcy does not automatically result in default and default does not automatically result in bankruptcy. Also, the root causes of both vary from case-to-case. More importantly, state laws that might impact municipal bankruptcy run the gamut. Some of these laws may provide more protection to holders of G.O. debt than others.

Central Falls, RI


Rhode Island State House

Rhode Island provides an example in which state law provides great protection to G.O. bondholders. The City of Central Falls filed for bankruptcy in August 2011, with required state approval. The primary cause was an overwhelming pension and retiree health care burden. The City had previously tried to negotiate benefit cuts with its employees. After filing, it rejected all of its collective bargaining agreements and its unions thus became unsecured general creditors. One month prior to filing, the Rhode Island's General Assembly passed legislation stating that G.O. bonds and notes issued by Rhode Island municipalities have a statutory first lien on ad valorem and general fund revenues, regardless of whether it is stated in the documents or proceedings authorizing their issuance. Rhode Island law also provides a state intercept mechanism to ensure that certain G.O. bondholders (school construction) are paid. Central Falls has not defaulted on the payment of any of its G.O. debt. It is our understanding that the City has reached new agreements with all but one of its collective bargaining units. Since its filing, the City's financial condition has demonstrated some improvement and it is anticipated that it will emerge from Chapter 9 later this year.

Harrisburg, PA

Municipal bankruptcy filings in the Commonwealth of Pennsylvania are very rare, due to a law that imposes a number of preconditions on such filings. However, this did not prevent the City of Harrisburg from failing to make a $5.3 million debt service payment on its own G.O. bonds that were due on March 15, 2012. The City had previously defaulted on its guarantee of about $65 million of debt service payments on bonds issued by the Harrisburg Authority for a failed incinerator project, despite the fact that the bonds are "unconditionally guaranteed" by a pledge of the City's "full faith credit and taxing power,"

according to official statement covers. Municipalities in Pennsylvania must comply with the provisions of the Commonwealth's Financially Distressed Municipalities Act ("Act 47" or "the Act") prior to seeking Chapter 9 relief. The Act empowers the Pennsylvania Department of Community and Economic Development to designate a municipality as "financially distressed," if it meets certain conditions. The primary purpose of Act 47 is to provide distressed municipalities with time to develop a fiscal recovery plan with the assistance of a state-appointed recovery plan coordinator. Harrisburg filed an Act 47 petition and was designated as "financially distressed" in December 2010. It cited its inability to meet its obligations with respect to its guarantee of the incinerator bonds in its filing. The City subsequently rejected three different recovery plans, which triggered legislation that ultimately resulted in its being placed in receivership. The City proceeded to file for bankruptcy in October 2011 in an attempt to invalidate its receivership status. The case was dismissed because the Commonwealth had specifically denied Harrisburg the right to file a Chapter 9 petition. On June 26, 2012, the City filed a lawsuit contending that the Pennsylvania's receivership law violates due process under the U.S. Constitution, and is also in violation of the Commonwealth's constitution. The City is seeking relief from a new recovery plan that would result in the sale or lease of the incinerator and other city assets to raise cash, as well as an earned income tax increase and renegotiation of labor agreements.

Vallejo and Stockton, CA

The City of Vallejo, CA entered into Chapter 9 proceedings in May 2008, after it determined it would no longer be able to meet its contractual obligations with labor unions. Like Central Falls, upon achieving Chapter 9 status, the City rejected its collective bargaining agreements. The City continued to make payments on its "special revenue" bond debt, including water revenue bonds and tax allocation bonds.

However, it defaulted on its unsecured certificates of participation ("COPs"), which were payable from general fund revenue. Most of the COPs were variable rate obligations, secured by a bank letter of credit, that were tendered to the bank by investors. The remainder had the benefit of municipal bond insurance. In the end, the City negotiated settlements with the bank and the bond insurer. The bank took a loss of over 40% on the COPs it held, while the bond insurer accepted payment deferral. Under state law, the City was unable to reduce its liability with respect to a state-run pension system. However, it was able to increase employee and retiree contributions to health benefit programs. Following significant lay-offs and severe service reductions, the City emerged from Chapter 9 in November 2011.

The City of Stockton, CA also began experiencing financial pressures during recent years, stemming from high labor costs amid economic declines in property tax revenues. On February 28, 2012, its City Council voted to suspend payments on three series of lease revenue bonds issued under the auspices of the Stockton Public Financing Authority to finance parking facilities, a building acquisition, and other capital improvements. (Two of the three issues are protected by credit enhancement.) Under the terms of the trust indentures and lease agreements securing the lease revenue bonds, the bond trustee has exercised its right to take control of several of the city's leased assets, including three parking garages and the municipal building.

On January 1, 2012, Assembly Bill 506 ("AB 506") took effect, which requires distressed public entities to undergo a mediation process with its creditors prior to filing for bankruptcy. Municipalities can bypass the mediation requirement with the approval of its governing body by declaring a fiscal emergency and allowing ample time for public consideration. On the same date that the City decided to skip its debt service payments, it also voted to begin mediation proceedings. Under AB 506, a mediation period typically runs 60 days, but can be extended to 90 days. On May 21, 2012, the City and its creditors agreed to extend the mediation period to 90 days through June 25, 2012. On June 5, 2012, Stockton's city council authorized its city manager to file for Chapter 9 bankruptcy in the event mediation proved to be unsuccessful. On June 26, the city council did, in fact, vote to file for bankruptcy. The City's bankruptcy attorneys are expected to file before the June 30 conclusion of its 2011 fiscal year. The City plans to withhold payments on its general fund obligations during the fiscal year ending June 30, 2012.

In all but one of the cases we have examined in which issuers opted not to make debt service on G.O. or general fund obligations, the securities were enhanced by municipal bond insurance and/or bank liquidity facilities. Bond insurers have lived up to their obligation to make debt service payments. With respect to variable rate obligations, investors generally tender the securities back to the bank liquidity provider and they become what are known as "bank bonds."

Rating Implications

State bankruptcy laws are generally not a major factor in determining municipal bond ratings—that is, not until a credit has been determined to be under extreme fiscal stress and there is a real possibility of default and/or bankruptcy. An occurrence of one or the other usually leads to a rapid rating decline to the speculative grade rating universe. Additionally, a "selective default" will usually result in a significant downgrade of the issuer's G.O. rating. For example, if an issuer opts not to make a payment on an appropriation-backed or moral obligation debt, such as a lease revenue bond, the impact on its G.O. bond rating can be very severe. A technical default—i.e., failure to meet a provision of the bond documents, such as a rate covenant—can also have negative rating implications. Defaults appear more likely to occur in cases in which the use of bond proceeds is far removed from the municipality's purpose of existence, such as with hotel and sports facility projects, as well as jails in which bond repayment is dependent upon receipt of charges paid by other governments.

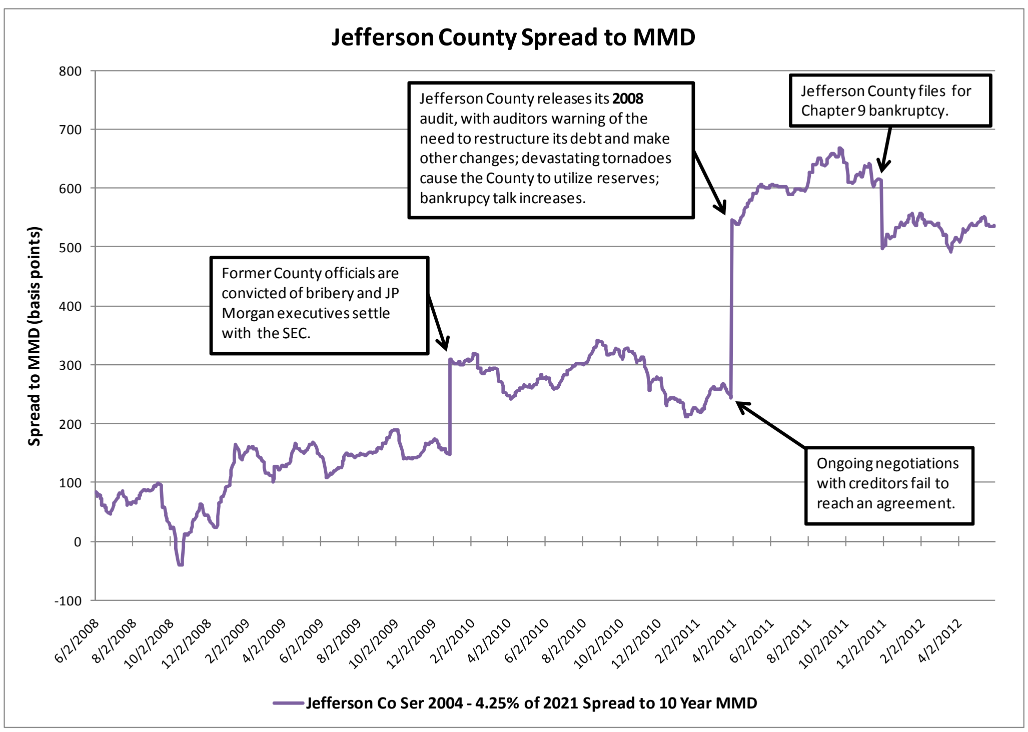
The rating agencies have surveillance mechanisms in place to evaluate credits in the interim of bond sales. Like the rest of the public finance community, the rating agencies also get some of their information from the news media and the Municipal Securities Rulemaking Board's ("MSRB's") Electronic Municipal Market Access Service ("EMMA"), which posts "material event" filings. However, political dysfunction that leads to discussions of default or bankruptcy cannot be predicted.

The rating agencies often do make a distinction between unlimited tax G.O. bonds, limited tax G.O. bonds, general fund obligations and obligations subject to appropriation.

Market Implications

Headlines about recent municipal defaults and bankruptcies, as well as possible additional such occurrences, have impacted the market as a whole, initially based upon a financial commentator's prediction of massive defaults in December 2010. The municipal market recovered from an initial sell off, with certain sectors continuing to be impacted as discussed below. Municipal analysts are undoubtedly paying closer attention to language in official statements describing bondholder security. Since the collapse of the bond insurance sector, these investors are generally evaluating state and local credits on a case-by-case basis.

It appears that the main segment of the market that is being penalized as a result of Jefferson County's bankruptcy and defaults are local government issuers in the state of Alabama—especially those located in or near Jefferson County. A May 2012 "Bloomberg Brief" on the municipal market noted that, in March 2012, a Birmingham Water Works Board tax-exempt bond issue sold with a 53 basis point differential over a similarly rated credit at the ten-year maturity. Birmingham is the county seat of Jefferson County.



California lease revenue bonds have also experienced some pushback from investors. Market participants have become more acutely aware of exactly what revenues are specifically pledged to the payment of debt service, as well as the limitations of an annual appropriation pledge and the inherent risk that the bondholders' interests may not be exercisable at the very time the investor needs it.

Conclusions

A distinction between unlimited and limited tax G.O. bonds, from a market participant's perspective, implies that, in the event of default in required payments of principal or interest, the holders of G.O. bonds typically have certain rights to compel a tax levy or a legislative appropriation. However, as governments seek to fund projects within G.O. capacity limits, which are often tied to the size of the tax base, this could be challenged, but not without significant market implications.

Jefferson County's default on its fixed rate G.O. warrants and other recent events may ultimately lead to mandates from investors for a more robust description of the security being pledged and a discussion of bondholders' rights and remedies in the context of the municipality filing under Chapter 9. If investors are dissatisfied with the level of information in official statements and legal documents, they are likely to demand greater yield or opt not to purchase the bonds at all. There has not been as much of a developed history of municipal bankruptcies as there has been in the corporate market, where Chapter 11 or 7 filings take place. In municipal bankruptcy proceedings, the results with respect to bondholder rights have been vastly different, making it difficult to predict the likely outcomes if future instances occur. Perhaps, the question of "how secure is a general obligation pledge?" can be determined only on a case-by-case basis, with a view to state statutes and case law. The one lesson past legal proceedings have taught us is that this is, in fact, a "states' rights" issue.

The national situation with respect to defaults and bankruptcies is a very fluid one. However, such occurrences are, in fact, rare. FirstSouthwest will continue to inform its clients of any significant new developments.