

Memorandum

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“Increasing credit pressures in the U.S. public finance market may result in unique opportunities for buyers of distressed debt.”

Distress in the United States Public Finance Market?

By Jon Kibbe, Brian S. Fraser and Charles D. Thompson II

Even as the U.S. economy struggles to recover from the worst domestic recession in nearly a century, there are signs that the U.S. public finance market is only beginning to feel the effects of the downturn.¹ The last two years have witnessed a massive deleveraging across the economy; it is natural to expect this deleveraging to continue to play out across public entities as shrinking revenues demand austerity and realistic budgets. While it remains to be seen whether stress in the U.S. public finance market will result in numerous defaults by public debt issuers, the increasing credit pressures being felt by such issuers may nevertheless result in unique opportunities for buyers of distressed debt. This memo provides a basic framework for anticipating some issues (and investment concerns) present in the market for U.S. public finance that are either different from, or not present in, private-side restructurings.

PUBLIC ISSUERS ARE HISTORICALLY RESILIENT BUT CREDIT PRESSURES ARE INCREASING

U.S. state and local governments are traditionally resilient. Despite prevailing macroeconomic conditions, Moody's believes that their credit profile remains "very strong."² Indeed, the historical default experience reveals a very limited default experience for municipal debt issuers: since 1970, only 54 defaults have been recorded by Moody's-rated municipal issuers (78% of which were in the healthcare and housing project finance sectors).³

But, while there are signs that the U.S. economy has begun to recover, state and local governments traditionally lag the national economic recovery and may remain financially challenged through 2010, into 2011 and possibly beyond. Many state and local governments face credit pressures due to a variety of factors, including deteriorating revenues, increased spending pressures and weakened balance sheets. This is evidenced by the fact that, in 2009, the ratio of upgrades to downgrades of U.S. municipal bond issuers was the lowest in over 20 years. Moody's, for example, downgraded 100 municipal issuers for every 70 issuers it upgraded (compared to 240 upgrades for every 100 downgrades in 2008). It is likely that the fiscal stress affecting U.S. public debt issuers will worsen as a result of the expected end of the federal fiscal stimulus in 2011.

1 See, e.g., *U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures*, Moody's Investors Service, Feb. 2010; *The Fiscal Survey of States*, National Governors Association and National Association of State Budget Officers, June 2010.

2 *U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures*, Moody's Investors Service, Feb. 2010, at 1.

3 *U.S. Municipal Bond Defaults and Recoveries, 1970-2009*, Moody's Investors Service, Feb. 2010, at 1.

THE RISK OF MUNICIPAL DEFAULT "CONTAGION" REMAINS UNKNOWN

Despite traditionally low default rates, is it safe to assume that defaults will remain rare? Are the factors that contributed to a history of default–avoidance, such as moral obligation and fear of future punishment by the bond market, still compelling? According to a senior policy advisor to the SEC, recent commentary suggests that the combination of overextended revenue sources, deteriorating fiscal restraints and eroding constraints on default could result in "a widespread cascade in defaults."⁴

CHAPTER 9 IS MEANINGFULLY DIFFERENT FROM CHAPTER 11

States, which are unable to avail themselves of bankruptcy protection, are likely to rely first on direct spending cuts to mitigate budget shortfalls, and some may utilize tax and revenue increases, reserve draw-downs and other one-time, temporary solutions.

Unlike states, municipalities (and "instrumentalities" of municipalities)⁵ do have the option of bankruptcy protection – this is specifically provided for by Chapter 9 of the Bankruptcy Code.⁶ The finances of municipalities (and instrumentalities of municipalities) are supported by potentially volatile revenues (such as property and sales tax and, in the case of instrumentalities of municipalities, user fees). Historically, however, municipalities have not availed themselves of bankruptcy protection: as described further below, the high legal hurdles and limited opportunities to use the bankruptcy courts as third-party arbiters make bankruptcy an option that may have limited practical utility to a municipality. Even where a municipality finds that a Chapter 9 filing would be of benefit, it must consider a variety of other factors, including the impact of such a filing on (i) its credit rating, (ii) its ability to obtain (or continue to

maintain) bond insurance, (iii) its future access to credit markets, and (iv) at a more macro-political level, the credit rating of other public municipalities of the state in which it resides.

There are substantial differences between a Chapter 9 bankruptcy and a Chapter 11 bankruptcy, many of which are important to potential investors in distressed public debt.

First, while states themselves are altogether prohibited from filing for bankruptcy (and from being filed against), to be eligible to declare bankruptcy under Chapter 9, a municipality must (a) qualify as a "municipality," (b) have specific state authorization to file (currently prohibited by 26 states), (c) be insolvent, (d) desire to effect a plan to adjust its debts, and (e) negotiate with its creditors pre-petition. In particular, this last requirement—that it endeavor to find a solution with its creditors pre-petition—is an important one.

Second, the policy goals of Chapter 9 differ from Chapter 11. As a general rule, under Chapter 11, a plan must provide that impaired creditors receive a distribution at least equal to what they would receive in liquidation. This "best interests" test is different under Chapter 9. Under Chapter 9, a plan must be in the creditors' best interests, which is construed by the courts to mean that the plan must make "a reasonable effort at payment of creditors," even where doing so requires raising future taxes.⁷

Third, holders of municipal debt are potentially immune from the threat of preference liability in a Chapter 9. If the lien on future revenues is voided as a preference, the result is at odds with public policy and state enabling legislation, which almost invariably provides that pledges of such revenues are effective when made and good against other creditors.

⁴ Steven Malanga, *America's Municipal Debt Racket*, *The Wall Street Journal*, June 14, 2010.

⁵ While the term "municipal issuer" is often used to include all issuers of public debt, for purposes of this memo, we are differentiating between states and traditional municipalities (cities, counties, towns, boroughs, villages). An "instrumentality" of a municipality might also be referred to as a special district, and includes school districts, utility districts, port districts, fire districts, library districts and community colleges. A third category includes public authorities, such as turnpikes, airports and water systems.

⁶ 11 U.S.C. §109(c).

⁷ *In re Mount Carbon Metro. Dist.*, 242 B.R. at 18.

Fourth, there is a different treatment of special revenue bonds and general revenue bonds. Under Chapter 9, the automatic stay does not operate to stay the application of pledged special revenues to payment of indebtedness secured by such revenues. As a result, holders of such bonds continue to be paid post-petition.

Fifth, courts resolving Chapter 9 cases are markedly different than those in Chapter 11 cases in determining what is “fair and equitable” to dissenting classes. Under Chapter 11, the definition of “fair and equitable” is at the heart of disputes over collateral value, the appropriate interest rate for the post-confirmation debt secured by liens retained by the secured creditor, and whether plan consideration constitutes an “indubitable equivalent” of a secured creditor’s claims. Under Chapter 9, on the other hand, the “fair and equitable” analysis is not as straightforward because liquidation is not an option, a municipality’s going concern value is not readily ascertainable, and state law may restrict a municipality from granting replacement liens on its property. As a result, the courts have established a subjective “fair and equitable” test that looks to whether the plan “embodies a fair and equitable bargain, openly arrived at and devoid of overreaching.”

Having said all of that, one should not assume that state or municipal instrumentalities are “municipalities” for purposes of Chapter 9. In the Las Vegas Monorail Corporation (“LVMC”) bankruptcy, the Court recently ruled that the debtor is not a “municipality” under Chapter 9, despite its tax exempt status and its function as a public transit system. The Court held that, because LVMC had no power to tax, no power of eminent domain and no sovereign immunity, it was not entitled to Chapter 9 protection.⁸ As a result, LVMC was permitted to avail itself of Chapter 11 protection, significantly altering the prognosis for ultimate recovery by its creditors.

FINANCIAL GUARANTORS ADD ADDITIONAL LAYER OF ANALYSIS

The financial guaranty industry has traditionally insured public debt issuance, especially municipal bonds. However, the financial guaranty industry has been hard hit by the financial meltdown. Today, only one of the traditional bond insurance companies is writing new business. Accordingly, since the ultimate payoff of insured municipal obligations by financial guarantors is now uncertain, investors are free to pursue arbitrage strategies involving more complicated default scenarios which consider the credit risk and expected unsecured claim recovery levels of both issuer and guarantor.

On a related but more subtle point: some bonds are better than others, even when both are uninsured. For example, in agreeing to provide a guarantee for a debt issuance, financial guarantors often build conditions into their guaranteed issuances that are favorable to the guarantor (and, by extension, favorable to bondholders) in times of issuer distress.⁹ Many of these issuer concessions remain available (and vitally important) to bondholders even where the guarantor has been subsequently stripped from the debt.

Accordingly, where a potential investor has faith in the credit of the public issuer of the debt, the presence of a financial guarantor at the origination of the related issuance can provide additional safeguards for the bondholder, protections which remain important without regard to the continuing existence of the guaranty or the creditworthiness of the financial guarantor.

A subsequent memorandum on this topic will consider in more detail the structure of financial guaranty insurance as it relates to public finance, and the framework for evaluating the ultimate weight that should be placed on the existence of a financial guaranty in an investment in public debt.

⁸ *In re Las Vegas Monorail Company*, Case No. 10-10464 (Bankr. D. Nev. April 26, 2010).

⁹ Financial guarantors will endeavor to obtain one or more of the following security features, among others: (i) a rate covenant, whereby the issuer agrees to set rates to generate sufficient revenues to meet a debt service coverage ratio threshold; (ii) a debt service reserve fund, establishing a cash reserve fund to fund debt service payments in the event of a shortfall; (iii) an additional bonds test, which prohibits the issuer from issuing additional bonds unless cash flows are sufficient to meet the rate covenant for both existing and new bonds; and (iv) cash sweeps and lock boxes, which traps cash with a trustee for the purpose of debt service.

CONCLUSIONS

The market for U.S. public debt is likely to recover more slowly than the broader economy and, to the extent that continued fiscal stress impacts the trading price of municipal subsector in particular, opportunities for classic distressed-investing arbitrage may exist. A careful and comprehensive review of the legal documentation of the public debt and any third party guaranty or enhancement is the starting point for any thoughtful investment in this area. However, unlike classic distressed investing, there are a number of complicating macro-issues that transcend the legal documentation, including the relatively undeveloped Chapter 9 precedent, potential defenses to payment that can be raised by issuer and guarantor, and the extremely complex and nuanced political environment that will drive any public restructuring of debt.

At a minimum, as the public debt issuers in the U.S. begin to de-lever and restructure their debt (whether through negotiation with creditors or via Chapter 9), the unique nature of Chapter 9, coupled with traditionally low default rates and high recovery rates among municipal issuers (albeit on less than robust data), will present some unique issues—and opportunities—to buyers of distressed debt.

QUESTIONS

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