

Municipal Bankruptcy & Disclosure

Roundtable Transcript

September 13, 2010

Ron Bernardi: Good afternoon. And thank you for joining us today for a roundtable discussion on two topics that are at the forefront of the municipal bond marketplace today – municipal bankruptcy, or Chapter 9, and the disclosure requirements of municipal bond issuers. Joining us today are two experts in their respective fields. To my immediate left, Mr. James Spiotto. Jim is a partner in a law firm based here in Chicago, Chapman & Cutler. Further down the table is Justin Formas. Justin heads up the municipal bond credit research department here at Bernardi Securities. Prior to joining the firm, he served as a research analyst at Standard and Poors. Today's discussion is not meant to be an exhaustive expose, but rather our goal is to provide a base understanding of both Chapter 9 and municipal disclosure requirements, share some of our views on those topics and leave you a little bit better educated and better versed on these two topics. So, Jim why don't we start with you. Give us a definition if you will of chapter 9 and a brief historical perspective of chapter 9 and municipal bond defaults.

James Spiotto: As we all know today given the downturn in the economy one of the things that is in our minds is "can the municipalities, given that downturn, have sufficient revenues to pay their obligations and if not what do you do?" Chapter 9 actually, historically, started from the depression times during the 1930s when municipalities were faced with all sorts of anilating lawsuits because they didn't have enough funds to pay what became due and they wanted a way of sort of stopping all the litigation – giving themselves a fresh start and adjusting the debt to what they could afford. And so we came up ultimately with a right mix in the 1937, which allowed municipalities to do a municipal debt adjustment. Which meant for the municipality that had debts that they couldn't pay, would have a court sit to determine...to have a plan, that only the municipality could bring, no creditor could put them in, could come up with a plan on how they were going to do that pay that – they weren't paying necessarily everything in full – but what they could pay on each of their on their obligations and the plan had to be reasonable and fair for the creditors. Since 1937 when we enacted that, there's been only 618 Chapter 9s. By and large in the last 50 years, they've been small special tax districts. They've been a graceful way to end a municipal entity that has outlived its usefulness. Large municipal issuers, with a few exceptions, have stayed away from Chapter 9. New York City had problems in 1975. They found the National Assistance Corporation as a way of solving their problems. They had defaulted on their bonds and then refinanced and paid them all off. So historically large issuers of municipal debt have not filed, we have a few exceptions. Orange County went in in 1994, mainly because, it wasn't because they weren't a wealthy county, but what they didn't have was a willingness to pay. They didn't want to raise their sales tax, one more percent point higher, equal to what LA County did, and instead they chose Chapter 9. As far as defaults go, the easiest way to view them is what the rating agencies came out with. Rated municipal debt defaults at about 1/100th the rate of rated corporate debt. Since recent history 1979-2008, one of the rating agencies, noted that there were only 54 rated municipal defaults, while as far as rated corporates, there was over 1,700.

Ron Bernardi: Let's turn our attention for a moment to the preferences that various creditors have in Chapter 9. As an example, do pension obligations trump current salary obligations in a chapter 9 scenario? More importantly from our perspective, how are bond holders treated, specifically unlimited tax obligation bonds and revenue bonds where there is a specific revenue stream dedicated to that debt service. What happens to them in Chapter 9?

James Spiotto: Chapter 9 is really a means again of municipal debt adjustment, consistent with state law. And so one of the issues with regard to unfunded pensions liabilities or OPEP – or post employment benefits – is that those obligations are pre-petitioned unsecured obligations, if they are a debt themselves. So one of the questions is really a debt obligation – where some municipalities are preparing themselves to argue that it really isn't. And it's merely a general unsecured claim which will be adjusted. Municipal debt comes with special revenues which are revenues from that enterprise or from a special tax source – which is pledged specifically to pay those bonds. And that revenue cannot be interfered with in a chapter 9 proceeding. Likewise, if you have an unlimited tax GO pledge such as an ad valorem tax, that unlimited tax pledge is unaffected by the chapter 9 proceeding. The judge can't reverse or change that.

Ron Bernardi: It's disturbing to me the state of affairs in Harrisburg, PA as it relates to the willingness to pay, and ability to pay. In the situation of Harrisburg, PA, what remedies do bondholders have?

James Spiotto: They have a number of remedies. And we have to sometimes take a step back. Whenever a municipality is having financial difficulties, they normally reach out as NYC did in 1975 to get help from the state. Cleveland in 1978. Because they need help and they can't do it themselves. And it's not atypical that if a municipality is having problems there's a little bit of kabuki theatre in all of it. The municipality, and its municipal officials, will be making various statements that may be more theater than reality. So when you hear Harrisburg and their officials say we're not going to pay our GO debt, that's a cry for help. And Gov. Rendell knows well that the commonwealth is there to help – he stepped in and said we're not going to suffer the pain or the stigma, not only to Harrisburg but to PA cities, towns and villages of not paying an obligation – we're going to provide some funding and we want to see you, Harrisburg, to get your act together. And we'll help you get started. Because municipalities, whether it be a local governmental body or a state, need that access to the market, to the municipal market because it's a cheap source of financing and it's been that source of financing that has built the wonderful infrastructure which we as a country have benefitted. And Chapter 9 is merely a last resort, rarely used, and is there as a sort of contrast to what ultimately, hopefully will be the solution.

Ron Bernardi: In this country we have a long history of laws that protect contractual rights. In your view, does Chapter 9 protect bondholders in that regard and will the state courts do likewise?

James Spiotto: It's always a good question to ask again, and again, so that we take a look both at the history – which historically courts have not chosen to interfere with, or adversely affect municipal debt because of the sacred relationship between the municipality and the municipal market and the need the municipality is recognized for that cheap access to capital which other wise would deprive them of the ability to do the infrastructure and provide the essential governmental services that everybody desires. However, going forward, given the real problems we have with unfunded pension of over a trillion dollars or the problems of infrastructure with short tax dollars, or how do we transcend the need for public safety with the dollars that we have which may be too little. All those questions raised it again, and the question

is will bond debt get shorted so that others get paid. And the real answer to that is historically and practically it should be no, because the municipalities need that access, they'll do almost anything to make sure they pay it so that the next time they need to borrow money, the market will be there, there won't be a cost for admission or a higher price in order to obtain credit.

Ron Bernardi: Now as we all know, one of the best actions a municipality can take to ensure easy access to the capital markets at a low interest rate is to disclose on a regular, timely, and accurate basis, the condition of their financial situation. And we can tell you over the years here at Bernardi Securities we've been frustrated many times because this doesn't happen and we've had to adjust our credit research process when that does occur, because we've concluded here, no doubt there is a direct connection between poor disclosure and future credit problems. So Justin as a lead in, why don't you share with us...give us a brief historical perspective of how municipal disclosure has evolved municipal market in recent years and specifically give us a few examples how it has improved after a credit crisis or two, whoops, many years ago, Orange County, Jefferson County more recently.

Justin Formas: I think municipal disclosure dovetails nicely to what you were discussing. I think dating back to the early 1930s, municipalities were given jurisdictional interference exemption essentially by the Securities and Exchange Commission – and really what that did was alleviate them from being registered securities while they still have to disclose what they were... essentially their financial condition, it really took several more decades pretty much until maybe the 1970s with the New York City financial crisis, for most people to realize that in fact misleading or not disclosing municipal disclosure documents that that was really...municipals were not exempt from the fraud provisions under both the Securities Act of 1933 and SEC acts of 1934. I think even going a little bit further under that 1975 act, certainly by making municipalities responsible for fraud provisions there were several amendments within that specific legislation that really went a long way into actually maybe hurting municipal disclosure going forward. You talk about the Tower Amendments, which really limited the regulatory enforceability for municipals.

Ron Bernardi: How relevant in your view is the Tower Amendment to the municipal marketplace today? I ask that question of both of you.

Justin Formas: Essentially the Tower Amendment today really limits the regulatory enforceability, it essentially has no teeth, and because it has no teeth, municipalities aren't as concerned as whether or not they're going to report correctly or not.

Ron Bernardi: Jim, do you see that lack of enforceability as being a problem?

James Spiotto: The real issue is whether or not they are telling the truth about the securities they're issuing. But the one thing that a true interpretation of the Tower Amendment is that it doesn't interfere with and clearly accuracy and disclosure, and full and fair disclosure of facts should not be in any form circumscribed – and that that's what we need to see. And if we don't see that, it's the anti fraud provision, as Justin said, there's no exemption from that and there are going to suffer the consequences and they can be very harsh if they don't disclose.

Justin Formas: And I think we've seen that recently with City of San Diego for example and the State of New Jersey most recently it was sort of found out dating back several years that their disclosure on

their pension obligations were in fact misleading to investors. And what I felt was a really big step for the SEC was that they brought charges against a specific state, which shows they were willing to make that step forward. What really, I think, and it speaks to the limited teeth, or the limited enforceability is that not only within that filing and the charges from the SEC, no specific political official, none of the investment banks, none of the individuals responsible for that series of disclosures were really called out in any of those charges.

Ron Bernardi: Justin, let's take a minute and I'd like you to address the strengths and weaknesses of past disclosure requirements, and in your view what needs to be improved in that area?

Justin Formas: I think when you talk about the evolution you can see that from an earlier period, the view of what municipal securities were was certainly very narrow. I don't think that any of the early 1930s legislation could have ever predicted that some of the municipalities that are more well known the Orange Counties, the Jefferson Counties, the whoops – it really wasn't conceivable for them early on to even fathom the level of sophisticated transactions that these entities were going to get involved in. And I think that brings up an important point from a disclosure standpoint, in that are they really disclosing to an adequate level, the amount of risk that they are taking on and in these specific transactions you talk about very esoteric financing options that whether or not a municipality has done a thorough job really telling bond investors are what the true risks are in the transactions they're taking on.

James Spiotto: You have to be specifically authorized to be able to file a chapter 9 – there are only 16 states that have specific authorization, three additional that have very limited to specific type of municipal entities within that state. There are two that prohibit it. And there are 22 other states where it's just unclear. And therefore there's no authorization to file. Very rarely do we bring that out in the disclosure statement so that the municipal bond purchaser will know it. In addition, if it's special revenues or a statutory lien, given the Sierra King decision, you'd like to know because if bankruptcy has no teeth, it ought to be spelled out. We're not spelling that out. And I think municipalities can do that.

Ron Bernardi: Justin, with New York City's default on its notes in 1975, how did disclosure requirements change, improve?

Justin Formas: I think that municipal disclosure was once again brought to the forefront of the discussion. Within some of the municipal securities legislation prior to the 1970s, it was really not specified very clearly that a municipality was not exempt from the fraud provisions under the Securities Act of 1933 and the Securities Exchange Act of 1934. Sort of subsequent to an SEC investigation into New York City's financial crisis – really the outcome of that was that municipalities were in fact not exempt from those fraud provisions, and did have to report honestly, and could not mislead.

James Spiotto: There is a real need for the municipal analyst and the municipal credit analysis as to what is and what isn't. And we really need to sort of get people to analyze "Is this really the fact, or is it puffery by the municipality – and how much of it is reality?" There's an old statement in the case law that "sunlight is the best disinfectant," and I think credit analysis is that sunlight.

Ron Bernardi: We've long held here at Bernardi Securities that improved disclosure practices coupled with good surveillance techniques goes a long way towards minimizing credit issues down the road. The

fact of the matter is disclosure brings clarity – good and bad. And good clarity encourages investors to commit their capital. Bad clarity scares them away. And either way those are very healthy messages, in our view, to be sent to the municipal issuer.

Thank you very much for joining us this afternoon. Appreciate your thoughts.

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