Understanding of Muni Bond Market Is Essential for Municipal Restructurings

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The Securities Industry and Financial Markets Association estimated the value of what can be called standard commercial corporate bonds in the market at the end of last year at about $9.8 trillion, about a quarter of the total bond market volume at the time. A much smaller component of the market are bonds that can be generally classified as municipal or governmental bonds, which, at about $3.7 trillion in outstanding value, accounted for about one-third of the corporate bond market as of the end of the year.

By dint of their daily exposure to the restructuring process, turnaround professionals should be all too familiar with the nuances and strategies associated with the corporate bond market and the fairly straightforward approach to dealing with corporate bond debt in connection with any commercial enterprise's capital structure. Although most casual observers might think that the "muni market" is just a smaller, more compact version of the corporate bond market, they couldn't be more misinformed.

Turnaround professionals who hope to succeed in the rapidly evolving niche of municipal workouts and restructurings must have a firm understanding of the muni market and the often substantial differences of these instruments as compared to corporate bonds. Many muni bond market observers find that, more and more, the complexities of that market, plus the array of instruments being offered that are called "muni bonds," easily give rise to confusion.

For example, the *Wall Street Journal* reported several years ago on the largest municipal bond default of 2011, which involved $229 million in long-term debt for an entity known as The Clare at Water Tower, a 53-story continuing care retirement community near downtown Chicago. The bonds had been issued by the Illinois Finance Authority (IFA), one of the nation's largest self-financed entities principally engaged in issuing taxable and tax-exempt bonds. The agency makes loans and provides investment capital for business and industry, as well as for nonprofit organizations and local units of government. The agency's chair and executive director are also responsible for overseeing and supervising all Illinois municipal and governmental insolvencies.

Because in a typical year only about $1 billion worth of bonds default in the $3 trillion municipal bond market, the default on The Clare's municipal bonds represented almost 30 percent of all likely muni bond defaults in 2011.

There were several problems with the paper's understanding of the situation, however. Although called a "muni bond" on the street and by the market, and issued by IFA under the auspices of the state of Illinois, The Clare's bonds weren't technically municipal bonds at all. They carried no promises or payment obligations by the state. Such bonds are not issued on behalf of a governmental unit, but rather as an incentive to the private sector to foster economic development within a defined geographic area. Although they are issued by a governmental unit and offer certain tax benefits, repayment of such bonds is the responsibility of the private parties on whose behalf they are issued.

Four broad categories of what are termed "municipal bonds" are offered in today's debt markets, each with a different use and purpose. Each also often carries a different underlying repayment obligation. These four broad general types of municipal bond instruments are general obligation bonds (GOBs); revenue bonds; conduit or private bonds, which were the type of bonds involved in The Clare's bond default; and certificates of participation (COPs).

General Obligation Bonds (GOBs). The classic municipal bond is the GOB. "Your grandfather's municipal bond," it is, in form, structure, and interest paid, still remarkably similar to GOBs issued in the mid-1920s, when the instruments were first heavily issued. GOBs are probably the safest instrument anyone can buy in the municipal market or, for that matter, in the debt markets, and its interest coupon reflects that.

Although there are many rationales for issuing these bonds to support municipal debt, the single most important is that tax collections occur periodically, while governmental expenditures occur continually. As a result, it is not uncommon for municipalities and other governmental units to issue GOBs in advance of tax collections and to guarantee them with their "full faith and credit."

It is this guarantee that makes GOBs unique. Implicit, if not explicit, in the full faith and credit promise is the borrower's commitment to raise taxes and/or generate other revenue sufficient to cover the amounts owed under the bonds. Defaults of rated GOBs are extremely rare. The last state to default on its GOBs was Arkansas during the 1930s, and within a year it promptly remedied that default, paying the bonds in full plus all interest. Municipal GOB defaults are also extremely rare. Although the current spate of Chapter 9s does

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have a component of default on some GOBs that are part of these matters, compared to the entirety of the market, these are still an infinitesimally small percentage of the amount issued.

Even among some of the most infamous municipal financial crises of the past 40 years—New York City in the 1970s, Miami in the 1980s, and, in the 1990s, Philadelphia; Orange County, California; and New Orleans in the aftermath of Hurricane Andrew—a common thread is that none defaulted on their GOBs, either in principal or interest payments, during their periods of distress. Such is the sacrosanct nature of their full faith and credit guarantee and their need to maintain ready access to the market to fund their daily government operations that issuers will do just about anything to ensure that GOBs are paid.

Revenue Bonds. A second type of municipal bond is commonly referred to as a revenue bond. Revenue bonds are secured by a stream of cash presumably to be thrown off by the development they finance. Bonds issued to finance a tollway, bridge, or other infrastructure development project are common revenue bonds.

Repayment of revenue bonds relies not on an issuer's full faith and credit, but rather on the income stream generated by the project financed by the bonds, and the collateral for revenue bonds is generally limited to this income stream. Projections to the contrary notwithstanding, if the revenue generated by the development ultimately is insufficient to fund the revenue stream predicted under the revenue bond indenture, then the development often finds its way into an insolvency.

Several tollway and water district projects, as well as infrastructure projects of other special districts, have encountered financial problems recently because their initial projections for revenue bond-type financing were simply too rosy. It is these types of revenue bond-financed developments that have generated most of the classic municipal bond defaults and, to a large extent over the past 80 years, have been responsible for a majority of municipal insolvencies or Chapter 9 bankruptcies.

Interestingly, once a governmental entity is in Chapter 9, revenue bonds are pretty much limited—just as they are outside of Chapter 9—to the recapture of the revenue stream from the development they financed. This revenue stream, however, is first designated to pay the bondholders and is often virtually untouchable by other creditors in a Chapter 9. So, in a Chapter 9, it's just possible that, at least as to collateral, revenue bondholders may fare better than those holding GOBs, which are not collateralized but are generally only subject to the full faith and credit of the governmental entity.

Conduit Bonds. About 30 years ago, conduit revenue bonds, or private bonds, became common. These are bonds issued by a state or a development agency authorized by the state, but are private debt rather than public debt. They are customarily issued to aid nonprofit entities (e.g, hospitals or colleges) or to foster economic development by allowing the issuer to take advantage of tax-exempt financing. If they are applicable to a for-profit entity, their most typical use is as industrial revenue bonds.

Conduit bonds are not guaranteed by a state, are not issued under the full faith and credit of a government entity, and typically are not tied to the revenue stream of the development. The state that issues them has no financial obligation whatsoever for their repayment. In reality, these bonds are simply a tax-exempt form of financing offered to private developers and citizens to foster economic development.

As was the case with The Clare, the bonds are held by individuals, there is a third-party indenture trustee, and the impact of any insolvency on these bonds is similar to that regarding corporate bonds. Such matters are private, don't involve the state, and are worked out or otherwise dealt with in the context of a Chapter 11—just as occurred in the case of The Clare—not Chapter 9.

Certificates of Participation (COPs). Finally, the newest form of muni bonds popped up in just the last 15-20 years and are generally known as certificates of participation (COPs). These are complicated transactions, but generally, a trust is created and an indenture trustee oversees the assets of the trust. A municipal government or other governmental entity contributes assets to the trust in exchange for cash, promising to pay, thereafter, reasonable rents or usage fees for the assets they have contributed to the trust. With the fees paid for the usage of the property in the trust (e.g., parking garages, recreational facilities, etc.), the trust is then to make periodic distribution to its beneficiaries, the holders of the COPs.

However, in most cases, there is no full faith and credit guarantee by the governmental entity that contributes its assets to the trust to continue funding the use of those assets beyond when the municipal government deems them useful. Nor are there any guarantees by the state of any of the underlying indebtedness. In general, the beneficiaries of the trust must look, in the end, to the collateral for repayment of their obligations if the governmental entity decides in its own discretion that it no longer needs the assets contributed to the trust or will no longer pay for their usage.

Buying Time

What is the turnaround professional to take away from this brief tour of the muni bond market? First and foremost, they should know the specific type of bonds with which they are dealing. Given the volume of municipal conduit bonds being offered in the market today—they account for about one-third of new issues—chances are good that a Chapter 9 scenario isn't even applicable to many situations involving muni bonds. Although there are some tax consequences to default and in connection with any possible conveyance of the property, that's generally much more manageable than a true municipal insolvency proceeding.

If a bond is a revenue bond, on a good day, downhill, and with a strong wind at their backs, the best these bondholders are likely to achieve in a default scenario is access to the income stream from the development, and they should start from there. But turnaround professionals deal every day with revenue realities that wind up not matching revenue expectations, and there's a well-known template for the initiation of bargaining in that set of circumstances.

From a municipal bond perspective, it's not conduit bonds, revenue bonds, or COPs that cause the greatest difficulty, it's the treatment of and dealing with GOBs. As mentioned earlier, municipal finance officers and professionals will go to the greatest lengths possible to avoid triggering a default on their GOBs.

The primary reason for this is both operational and financial; that is, these

government units need continual access to the municipal debt market if they ever hope to conduct and discharge the obligations and duties incumbent on a municipal government. The second reason is political. All too often, turnaround professionals lose sight of the manifest political component involved in this process. The way to win elections and remain in office is not to attract negative publicity and generate voter anger over continuing financial mismanagement.

Turnaround professionals should resist the temptation to view municipal restructuring through the prism of the Chapter 11 bankruptcy process. In reality, the two are quite dissimilar. However, there are some tremendous advantages that a turnaround professional can bring to the situation, such as the knowledge—and how to act on it—that while most standard commercial corporate bonds have an average amortization period of between three and five years, the average amortization period for most GOBs is closer to 12 years. Clearly, if one is trying to extend or refinance GOBs prior to a default, the fact that their amortization schedule is almost triple that of most commercial bonds means that a practitioner can find a number of ways to put off a day of reckoning and rework the debt to buy some time.

This article could go on at length about how all of this applies in the context of a Chapter 9, but municipal filings are, and will continue to be, such rare occurrences that a working understanding of the municipal bond market is probably a better place to begin for most turnaround professionals. That, combined with the fact that most Chapter 9s that do occur are likely to involve nonpopulated special districts and special projects largely arising out of revenue bond financing, should give turnaround professionals a better sense of where their efforts can be directed toward making an impact in this arena.

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