VIII. RISKIEST MUNICIPAL SECURITIES

Municipal Securities Requiring Additional Care

The author believes that it is important to place risks associated with municipal securities issues in an appropriately directed context. As the author already has stated repeatedly, significant proportions of municipal securities—those supported by unlimited tax general obligation credits[479] or by the revenue credits of well-established traditional government enterprises—are safe.[480] Very few of those securities will default even if their issuers experience significant financial distress.

[479] See Seymour, "California GO Investors Are in for a Bumpy Ride" (Bond Buyer Online Jan. 19, 2010) ("'California will honor its obligations, but it will take us on a roller-coaster ride,' said Tom Dalpiaz, a portfolio manager at Advisors Asset Management. 'You have to recognize that if you invest in California state GOs, it's going to be a roller-coaster.' … Since 1990, Standard and Poor's has changed California's rating 13 times. … Despite all the bad news, few analysts expect California to default on its bonds. … Nevertheless, there may be a point where retail investors in the normally staid municipal bond market grow weary of reading [the] headlines.")

Another Moody's study reported that municipal issuers had a very low default rate, with most defaults occurring in the housing and healthcare sectors. The study added that average recovery rates on defaulted municipal securities significantly exceeded the recovery rates for corporate securities. Moody's Investors Service, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009" (Feb. 2010).

See also Hart, "Moody's: Few Municipal Bonds Defaulted in the U.S. During 1970-2009" (Bloomberg.com Feb. 11, 2010); McGee, "Municipalities Are Set to Handle Upcoming Turmoil, Raters Say" (Bond Buyer Online Feb. 10, 2010) ("in their respective reviews of 2009, Moody's Investors Service, Fitch Ratings, and Standard and Poor's each implied that while strains will certainly continue into the next year or two, municipalities should be able to withstand the financial pressure.")

Hart, "Munis Default Less, Pay Back More Than Corporates, Moody's Says" (Bloomberg.com Feb. 11, 2010) ("The average default rate for Moody's-evaluated investment-grade municipal debt in the five years after issuance from 1970 through 2009 was 0.03 percent, compared with 0.97 percent for similar corporate issues, the New York-based company said today. Of 54 municipal defaults in the period, only three were general-obligation bonds, Moody's said.")

[480] Mysak, "Water Bonds May Be the Secret to Preserving Capital: Joe Mysak" (Bloomberg.com May 19, 2010) ("Investors wary of municipalities' dependence on declining taxes should consider water and sewer revenue bonds. It's a rare water bill that goes unpaid. That's the advice of one bond investor who says that faltering tax collections and rising pension costs are diminishing municipal bonds' allure. … 'A scared seller is my best trading partner,' said John Wilen of Frisco, Texas, in an e-mail last week. Wilen is an individual investor with a special interest in munis. … So what's he buying now? Water and sewer revenue bonds, because 'everyone pays their water bill.' The water bonds he

In the author's view, the California Municipal Bond Advisor correctly discounted predictions of disaster affecting municipal securities. According to the Bond Advisor[481]—

> A year ago we featured a headline posing this question: "Are We Really Entering a 'New Age' for Munis or Just a Bad Cycle?" Although we concluded it was a "little bit of both," the Bond Advisor took a strong

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has been buying are from medium to large cities, and from water agencies that serve multiple communities. With enough looking, you can still find 5 percent yields, he wrote.")

Despite Mr. Wilen's optimism regarding the strength of water revenue bonds, a caution was published in a Bond Buyer commentary to the effect that "many [systems] have failed to assess the financial risks associated with the replacement costs of underground infrastructure." The commentary continued with the view that—

> Water main breaks, sink holes, and flooding are disrupting drinking water services and causing property damage and economic losses all across the nation. For the past decade organizations like the American Water Works Association have declared the age of renewal and replacement is upon us.
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> To keep up with population growth and movement, the United States installed underground water infrastructure in three main time periods: in the 1800s, from 1900 to 1945, and post-1945. Pipes constructed in each of these three eras will all start to fail at nearly the same time over the next couple of decades for a number of reasons, ranging from age and soil conditions to inadequate design and poor installation.
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> Additionally, the life span of the materials used has become shorter with each new investment cycle. The main hot spots for these failures are in the industrialized population growth centers after World War II.
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> * * *
>
> In the past decade, the required investments have not been made. In 2009, the American Society of Civil Engineers gave the U.S. drinking water infrastructure a rating of D-minus.
>
> The issue is more a funding problem than an engineering one. …
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> * * *
>
> If a utility chooses to ignore the problem or continue to defer capital replacement projects to avoid basic rate increases, the investment gap will significantly rise and the costs of the projects will increase, creating a larger future liability for the ratepayers and weakening the overall financial strength of the utility. Baird, "The Unfunded Liability in the Closet: Aging Water Systems" (Bond Buyer Online June 1, 2010)

[481] California Municipal Bond Advisor, "First We Look Back at a Year that Brought 'Normal' Back … or Did It?" vol. 26, no. 3A at 1-2 (Jan. 2010).

stance against the uninformed "anti-muni bond" crowd that came out of the woodwork in 2008 and early 2009. This is what we wrote in January 2009: "We would just caution investors to be careful about the Chicken Littles who are saying that this is finally it, and the sky is definitely going to fall on muni bonds. It won't.

Why did we have to make that observation? You may recall in December 2008 there was a renewed "panic" of sorts that prompted a tremendous lemming-like rush into U.S. Treasuries. The result was jaw dropping, as some tax-exempt yields soared for a brief time to more than double the rates on Treasuries. …

> "Absent a complete breakdown of civilized society, because of nuclear war or a plague that wipes out every living being in California, the predictability of bond payments on 'traditional' munis remains one of the few things you can count on. Obviously there are riskier sectors in the municipal market, whether land-secured deals or stand-alone rural hospitals … ."
>
> California Municipal Bond Advisor

The "panic" also brought a lot of muni bond kooks out of the woods. Some of them are still on the loose even as we speak.

These are the commentators who said there would be widespread municipal bond defaults and bankruptcies in 2009. These are the commentators who suggested smaller muni bond investors should "sell low" at exactly the wrong time. These are the commentators who were fixated on "total return" and didn't have a clue about why an income-oriented investor would focus on "income" from a portfolio, not some goofy month-to-month "total return" scorecard.

* * *

In response to the kooks, let us quote the Bond Advisor from our story a year ago: “While lower credit ratings and soaring yields meant that we all took a bath in 2008 on paper, we also must repeat something we said a year ago: The muni market won’t be ‘boring’ this year except in one important sense—as always, almost all tax-exempt bonds for ‘traditional’ purposes should be repaid on time and in full. ‘Boring’ can still be good.

* * *

In January 2010 we repeat the comment again. Absent a complete breakdown of civilized society, because of nuclear war or a plague that wipes out every living being in California, the predictability of bond payments on “traditional” munis remains one of the few things you can count on. Obviously there are riskier sectors in the municipal market, whether land-secured deals or stand-alone rural hospitals, that fall outside this “traditional” label. …

* * *

We continue to remind investors that, on a “corporate” rating scale weighting default risk, many single-A or even triple-B municipal bonds would probably deserve a double-A or even triple-A credit rating. …

That is not to say that there will be no increase at all in municipal securities defaults, even among "traditional" municipal securities issuers. Moody's concluded[482] that the credits of municipal issuers was "very strong" and that the issuers would continue to make their debt service payments despite financial pressures in the near-term. Moody's did acknowledge that there could be some increase in defaults and bankruptcies, but not likely extensively.

Although there are valid arguments as to risks of market price movements and regarding potential benefits to issuers from mimicking certain corporate disclosure practices, perhaps short of a tornado that destroys an entire community,[483] it is virtually impossible to cause one of the traditional municipal securities issues to default.[484] Thus, while there are quite valid assertions associated with municipal securities pricing in favor of more timely information flows and disclosure of additional details regarding

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[482] Moody's Investors Service, "U.S. State and Local Governments Remain Inherently Resilient, Despite Growing Pressures—Fundamental Credit Strengths Remain Intact; Severe Stress Expected to be Selective and Idiosyncratic") (Feb. 2010).

See also McNichol, "Muni Defaults May Rise Amid 'Unprecedented Stress' on Finances" (Bloomberg.com Feb. 22, 2010); Temple-West, "Moody's: 2010 Could See a Few More Localities Default Than Usual" (Bond Buyer Online Feb. 23, 2010).

[483] The author thanks Todd Meierhenry, Meierhenry Sargent LLP, bond counsel in South Dakota, for this description of what it would require to cause an unlimited tax-supported bond to default.

[484] Mysak, "Making Money in Default With Munis Means Only GOs: Joe Mysak" (Bloomberg.com Jan. 27, 2010) ("It's a rare government that goes out of business, which is why investors wary of default should buy their bonds. Cleveland, New York and Orange County, California, all defaulted on their municipal debt. All repaid it in full. The trouble is, most municipal bonds aren't governmental, and have no claim to taxes levied. They are municipal bonds in name only, sold by localities to finance everything from real-estate developments to industrial projects. When these bonds default, investors often get pennies on the dollar, not par, or 100 percent."); Seymour, "Rated Government Credits Still Reliable Debtors, Fitch Analysts Say" (Bond Buyer Online Nov. 18, 2009) ("Investors in municipal credit need to make an important distinction between rated government bodies and unrated speculative credits, analysts from Fitch Ratings said at a conference yesterday. While Fitch expects an uptick in defaults among lower-rated and unrated municipal issues, state and local governments with taxing authority and investment-grade ratings remain reliable debtors.")

municipal securities and issues, the risks of default and substantial losses for those owning traditional governmental securities is extremely low.[485]

There are readily identifiable segments of the municipal securities market, however, that are deserving of a much higher level of special attention by offering participants, investors and regulators than those owning market segments sometimes receive at present.

> "While more bonds in the municipal market have gone into default lately, most of the defaults haven't been on bonds issued by the cities and counties that most people think of as municipalities. Instead, non-profits and private companies—which typically lack the financial reserves or revenue-raising power of local governments—have been hardest hit."
>
> Josh Goodman at governing.com

Although the occurrence of municipal defaults is very low on traditional municipal securities, in line with the higher rates of municipal defaults in specific sectors dependent upon the performance of private credits, corporate defaults rose sharply during the financial crisis.[486] The categories of municipal securities that present the more serious risks[487] include: industrial development bonds (IDBs) and other "conduit"

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[485] See beginning at n. 230 and accompanying text for additional discussion regarding the safety of traditional municipal securities, and how the use of dual rating scales, with common symbols but substantially differing rating definitions, contributed to a misunderstanding of the risks of municipal securities.

[486] With respect to defaults in the corporate securities markets, see Keogh, "Company Defaults Rise to Highest Since 1981, S&P Says (Update1)" (Bloomberg.com. Dec. 14, 2009) ("The number of global corporate defaults rose to the highest since at least 1981, with 260 issuers failing to pay their debt year-to-date for a rate of 9.77 percent, according to Standard and Poor's.")

[487] See Goodman, "Just How Strong Are Muni Bonds?—Municipal bonds are usually thought to be a risk-free investment. Turns out that's not always the case" (Governing.com Aug. 1, 2009), stating—

> While more bonds in the municipal market have gone into default lately, most of the defaults haven't been on bonds issued by the cities and counties that most people think of as municipalities. Instead, non-profits and private companies—which typically lack the financial reserves or revenue-raising power of local governments—have been hardest hit.
>
> Some special-purpose government entities are suffering too. In Florida, dozens of community development districts have entered defaults that total billions of dollars. These districts have some taxing authority, but they're very different from what most

financings for private profit-making or nonprofit corporate obligors, new or significantly expanded governmental revenue based enterprises (such as Jefferson County's sewer system, Menasha, Wisconsin's steam utility, Alameda, California's telecom system, and Harrisburg's solid waste facility),[488] housing and healthcare securities,[489] land-based securities[490] (known somewhat pejoratively as "dirt bonds"),[491] charter schools, and other

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> people think of as governments. They're essentially developer-created vehicles for paying off the costs of roads and utilities. As home sales have decreased and home prices have dropped, many of Florida's community development districts have been unable to pay their debts.

[488] See also Seymour, "Las Vegas Monorail Is a Mess—Bonds in Default; No Fix in Sight" (Bond Buyer Online Jan. 6, 2010) ("The forecasts were way off."); Ward, "Las Vegas Monorail Co., Seeks Chapter 11 Protection" (Bond Buyer Online Jan. 15, 2020).

[489] UBS Wealth Management Research, "Education Note—Municipal bond defaults and bankruptcy: an overview" at 1-2 (Apr. 2, 2009); Moody's Investors Service, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009" (Feb. 2010).

Kaske, "Major CCRC Developer in Chapter 11—Erickson Facilities Have $510 of Muni Debt Outstanding" (Bond Buyer Online Oct. 22, 2009) ("Approximately $510 million of tax-exempt and taxable municipal debt remains outstanding on various Erickson properties, according to spokesman Mel Tansill."); Kaske, "A Second Erickson CCRC Defaults Due to Failure to Make Payments" (Bond Buyer Online Oct. 28, 2009) ("A second Erickson Retirement Community facility outside of Chicago is in default on its 2007 tax-exempt bonds … ."); Shields, "Redwood Capital Acquires All But Three of Bankrupt Erickson's CCRCs" (Bond Buyer Online Dec. 24, 2009).

[490] Although it is fashionable for market participants to refer to land-based bonds as "land-secured" bonds, the author believes that to be a marketing effort that creates an aura of greater security than those bonds have typically.

The bonds are *not* "secured" directly by "land." They are secured by the issuers' pledges of payments to be made by developers and other property owners of special taxes or special assessments. The issuers generally have an ability, subject to conditions, to pursue remedial action against the land in the event the special tax or assessment payments are not forthcoming, but there are no mortgages or other direct security in the form of land securing the bonds. Investors are not able to sell the land and collect sale proceeds in order to extinguish liabilities against the land. The remedial action that issuers may take is far different and, at least during the important development phases, generally less effective than pursuant to mortgages. For example, generally only delinquent installments of special taxes or assessments may be collected. Investors are unable to accelerate the debt.

In other words, as is so common in the municipal securities market, the term "land-secured" is more of a sound bite than a substantively accurate description of the security for the bonds. For institutional buyers of the bonds, it likely matters little. For retail buyers, the misleading character of the term can be more serious.

[491] Sigo, "Florida CDD's Have Dirt-Bond Problems" (Bond Buyer Online Sept. 3, 2009); McDonald, "Muni Defaults Top $4 Billion Amid Real Estate Swoon (Update1)" (Bloomberg.com Oct. 14, 2009) ("Builders who issued tax-exempt bonds backed by special assessments to finance infrastructure for residential developments aren't paying the debt as houses go unsold and the value of land declines,

according to [Jack Colombo, of the Distressed Securities Newsletter]"); Sigo, "Districts in Distress—More Florida CDDs May Be in Default" (Bond Buyer Online Nov. 12, 2009); Sigo, "Dirt Bonds Drying Up in Florida—More CDD Defaults Likely, Report Says" (Feb. 10, 2010) (citing report by Interactive Data Corp.); Interactive Data Corp., "Update on Florida Dirt Bonds & the Credit Crisis" (Feb. 2, 2010) ("Of the approximately $5.6 billion of special assessment secured 'dirt bonds' under surveillance by Interactive Data's team of municipal credit analysts, about $2.4 billion, or over 40%, either drew against their debt service reserves or failed to make interest payments in November. This represents a large increase from May 2009 when 80 districts with approximately $1.7 billion in bonds outstanding experienced similar difficulties. The affected bonds consist of 184 series that were nearly all issued between 2004 and 2007 at the height of the Florida real estate boom, and represent 96 districts geographically dispersed across Florida, although about 25% are concentrated in the Tampa area.")

Hart, "Eaton Vance Dumps Dirt Bonds as Florida Land Districts Default" (Bloomberg.com March 9, 2010) ("the debt fell to a third of face value last year. … 'It's the single biggest default wave in the history of municipal bonds,' said Richard Lehmann, [publisher of the Distressed Deb Securities Newsletter tracking defaults], who defines default as failing to pay debt service or tapping into reserves to do so. 'There are about 78 more districts with $2.7 billion of bonds on our watch that are likely to go into default this year.'"); Collins, "Defaults Signal Bursting Muni Junk Bubble After Surge (Update2)" (Bloomberg.com March 10, 2010) ("About $2.4 billion of Florida's so-called dirt bonds, or debt to finance real-estate developments, used reserves or failed to make interest payments in November, up from $1.7 billion in May, according to Interactive Data Corp. That's the largest amount on record and 'reflects an increasing trend,' said Edward Krauss, an analyst for the Bedford, Massachusetts-based firm … .'")

Lehmann, "The Collapse in Florida Dirt Bonds" 30 Mun. Fin. J. no. 2 at 81, 83 (Summer 2009), adds that "To date, some 109 Community Development Districts (CDDs) have defaulted on $3.4 billion of municipal bonds. Another 90 or so districts are expected to be added to this total before the crisis has passed in two or three years (see flirdacddreport.com for more details. … " the article continues—

> Adding to the CDD problem is the fact that most housing development in Florida is not done via CDDs but, rather, through construction loans from banks. Thus, it is fair to say that the magnitude of the distressed debt problem in Florida is several times the dollar volume of CDD defaults. This aspect of the problem means that banks will be in the position of restructuring their loans with the developers in order to complete distressed projects. By restructuring, I mean of, course, reducing the debt obligation in order to make the house prices cheaper. This, in turn, puts CDD-backed projects at a huge disadvantage, because the tax assessments cannot be reduced without restructuring the bonds, and that normally takes a bankruptcy judge.

Matt Fabian stated in MMA Weekly Outlook (Nov. 16, 2009)—

> Fears of state and local credit trauma are worsening across the board, although there remains no evidence of actual impairment among safe sector paper. By contrast, the Florida land secured sector is falling apart; last week, 62 districts disclosed either a payment default (33) or reserve fund draw (29) with respect to their 11/1 interest payment. These numbers should continue to rise in the next few weeks.

Devitt, "Omaha SIDs Take Turn for the Worse" (Bond Buyer Online June 2, 2010) ("Sanitary improvement districts have long been a key infrastructure development tool in Omaha. However, the districts are increasingly distressed amid the region's lifeless housing market, and many are starting to have trouble paying back the debt they issued at the peak of the housing boom five years ago. A small but popular tax-exempt market that is unique to Nebraska, sanitary improvement district debt is similar to so-called dirt bonds in Florida and other states. The debt finances infrastructure improvements for new subdivisions and is paid off with special assessments levied against the new homes. … Five years municipal securities issues dependent, directly or indirectly, upon the performance of private parties.[492]

> "Fears of state and local credit trauma are worsening across the board, although there remains no evidence of actual impairment among safe sector paper. By contrast, the Florida land secured sector is falling apart … ."
>
> Matt Fabian, Municipal Market Advisors

Confirming those municipal securities risks, Joe Mysak of Bloomberg News provided the following data[493]—

> As far as defaults go, most are by community-development districts in Florida, on bonds that were used to finance real-

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ago, amid the housing boom, Omaha-based developers were launching SIDs with confidence, local market participants said. 'Things were looking pretty good in 2005, and there were a fair amount of districts started,' [Todd Engle, managing director at Omaha-based Kuehl Capital Corp.] said. 'If you were a developer in 2005, you thought, "Gee whiz the world will never stop turning," and it did.' … 'The districts having issues—whether they got worked out or [went into default]—has probably been under 5% up until this point. That's probably going to change going forward,' [John Kuehl, senior vice president and SID manager at D.A. Davidson & Co.] said. 'We've lost two to three years of building.' The collapsed housing market has left many of the new subdivisions largely empty. With no new homeowners, the districts cannot pay the special assessments backing the debt, which is now coming due.")

Preston and Green, "Bond Defaults Stalk Michigan's Wealthiest as Home Prices Crash" (Bloomberg.com June 23, 2010) ("Michigan's auto-industry collapse, which led to the worst home-price drop among U.S. states, has forced some of its wealthiest and fastest-growing communities to seek state aid to prevent municipal bond defaults. … Local governments have sold about $1.5 billion of bonds backed by special tax assessments, said Eric Scorsone, senior economist with the Michigan Senate Fiscal Agency, a nonpartisan legislative group. The debt is typically backed by property tax assessments for sewers, water lines and other infrastructure for new housing developments. Legislative staff members and local finance officials have created a committee to try to figure out how much of the debt may face default because of the declining assessments, Scorsone said. The first meeting is set for this week. 'It's developed into a problem in newly developed areas,' said Bill Anderson, legislative liaison for the Lansing-based Michigan Townships Association. 'Everybody is trying to figure out how to get through this.' … 'As soon as they would fill one development they'd start another, and then one day it just stopped,' Hardy said. 'Now the ground is not worth what it cost to put the infrastructure in.'")

[492] See, *e.g.*, Temple-West, "Toll Road Is the First P3 Default in South Carolina" (Bond Buyer Online Jan. 15, 2010) ("More than $200 million of toll road revenue bonds issued by the Connector 2000 Association Inc. for a 16-mile toll road in Greenville County, S.C., defaulted on Jan. 1 … ."); Devitt, Cincinnati Mall Fails to Make Last Two Debt Service Payments" (Bond Buyer Online Jan. 29, 2010) ("Suburban Cincinnati's largest mall has failed to make its last two debt service payments—and is not expected to make its upcoming payment in February … .")

See also Belson, "Stadium Boom Deepens Municipal Woes" (nytimes.com Dec. 25, 2009).

[493] Mysak, "Bankruptcies Show States Recovering From Recession: Joe Mysak" (Bloomberg.com June 30, 2010).

> estate projects during the property boom. In 2009, a total of 122 of these districts defaulted on $3 billion in bonds, almost half of the $6.4 billion in munis that went bust.

Given the outcome in the Vallejo bankruptcy,[494] obligations payable from governmental general funds (as opposed to unlimited tax general obligation securities) also deserve a closer look, and if the obligations are payable on an annual appropriation basis (as opposed to the abatement structure used in California), then an even closer examination is warranted.

EXAMPLES OF TRANSACTION STRUCTURES
<u>OFTEN NEEDING ADDITIONAL DUE CARE</u>

- Conduit Financings for Private Parties
    - Industrial Development Bonds
    - Conduit Financings for Nonprofit Housing, Health Care, Educational & Other Entities
- Land-Based Financings for Development Projects
    - Special Tax Supported Bonds
    - Assessment Bonds
    - Tax Increment Bonds
- Charter Schools
- Municipal Enterprise Bonds Dependent Upon Success of Private Projects (*e.g.*, Parking for Shopping Malls, Convention Centers Associated with Hotels, PPP projects)
- Start-Up or Significantly Expanding Municipal Enterprises

There are preliminary signs that certain parties acknowledge the importance of focusing on these more troublesome areas. For example, SEC Commissioner Elisse B. Walter, stated[495]—

> Next, I believe that Congress should permit the Commission to apply the registration and disclosure standards to non-governmental conduit borrowers that would apply if they issued their securities directly without

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[494] See beginning at n. 2046 and accompanying text regarding the Vallejo bankruptcy.

[495] Walter, "Regulation of the Municipal Securities Market: Investors Are Not Second-Class Citizens" (Oct. 28, 2009).

> using municipal issuers as conduits. This is something the Commission has long advocated and I fully support the recommendation. Commercial entities responsible for debt obligations under a conduit borrowing arrangement should be subject to the same level of disclosure obligations as a corporate issuer directly obtaining financing in the public securities markets. The fact that the bonds are tax-exempt does not change the fact that these are private obligations in which investors look to a private entity for repayment.

Meanwhile certain issuer representatives were quoted as stating that they "were not opposed to Walter's suggestion that the SEC be given authority to require nongovernmental borrowers in conduit deals to meet the same corporate-style registration and disclosure requirements that would have applied if they directly sold bonds to the market."[496]

While there certainly are broader issues regarding municipal securities law and disclosure, the author firmly believes that both sides in the debate regarding greater regulation of the municipal market should place much more significant focus upon the specific categories of municipal securities that repeatedly have proved most troublesome on an historical basis and continue to do so (see the nearby box).

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[496] Hume, "Tower Talk Riles Issuers—SEC Commissioner Stirs Controversy" (Bond Buyer Online Oct. 30, 2009) ("[Jeffrey Esser, chief executive officer of the Government Finance Officers Association] and others … were not opposed to Walter's suggestion that the SEC be given authority to require nongovernmental borrowers in conduit deals to meet the same corporate-style registration and disclosure requirements that would have applied if they directly sold bonds to the market.")

Indeed, to the author, much of the broader debate regarding municipal disclosure, while not trivial, is occurring as if in a vacuum, with neither side giving due recognition to the existence of serious problem areas within the larger municipal securities market requiring actual and more concentrated attention.

For example, although the SEC's Chairman cited[497] rising defaults in "municipal" securities in 2008 ("In 2008, 140 municipal issuers defaulted on $7.6 billion in bonds"), the bulk of those defaults are not with respect to securities supported by governmental credits, but rather by corporate and other private credits in conduit, land-based or similar securities structures dependent upon the success of private parties.

Frank Hoadley, Capital Finance Director of the State of Wisconsin and Chairman of the Debt and Fiscal Policy Committee of the Government Finance Officers Association, found it "very distressing" for Chairman Schapiro to cite the default data because such securities "reflect nothing more than a credit default by a private-activity entity." Mr. Hoadley "added that he hopes the SEC will distinguish between the two types of borrowers."[498]

Neither side has looked closely at the Tower Amendment, which contains certain regulatory restrictions relating to "issuers of municipal securities, but says nothing regarding private obligated persons.[499]

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[497] See n. 625 and accompanying text regarding the Chairman's remarks.

[498] Ackerman, "SEC Chief, Issuers Differ Over Tax-Exempt Defaults" (Bond Buyer Online June 25, 2009).

[499] See beginning at n. 1025 regarding the elusive "spirit" of the Tower Amendment.

Demonstrating the attention deserved by readily-identifiable market sectors and by regulators, Municipal Market Advisors published the following data, which MMA drew from a Fitch Ratings report on municipal securities defaults by sectors (total=100%)[500]—

Sector	% of Total Defaults
Corporate-Backed IDBs	31.9
Housing	25.1
Long Term Care	19.1
Land Secured	10.2
Hospitals	5.5
Utilities	3.5
GO & Lease	1.8
Public Facilities	1.2
Transportation	1.0
Education	0.8

Yet, despite the ease of identifying the "problem" categories of municipal securities, for reasons the author completely fails to comprehend, the raging debates by regulators in the market have focused for years, and continue to focus, almost solely, even if not quite, on disclosure practices of the entire market, including more timely financial reporting by general governments issuing tax and traditional revenue supported securities. Once again, while the author believes that timeliness of financial reporting is a valid and important issue, more specifically directed attention by all parties could produce even more productive results—vastly more productive—in terms of prevention of investor losses in municipal securities defaults.

[500] Municipal Market Advisors, "Corporate Ratings for Munis" (Jan. 17, 2008).

Additional Care Makes a Difference—
Case Study in the Benefits of Paying Attention[501]

Having identified certain categories of municipal securities that are widely and readily recognized as presenting significantly higher levels of risks than do traditional municipal securities, it is useful to examine one of those categories—land-based financings—in greater detail in terms of how responsibly structured, investigated and administered can lead to better outcomes. The author does this by contrasting land-based securities practices in California and Florida.

In the early to mid-1990s, California assessment and Mello-Roos (special tax) bond issues experienced significant rates of default.[502] Stephen Heaney of Stone & Youngberg LLC described how California and California practitioners reacted in order to improve practices, as follows—

> One aspect of California practice would be the actions taken by the State following the recession in the 1990s. These actions required issuers to adopt policies and procedures before bonds could be issued, required that value to lien ratios be at least 3 to 1 or, alternatively, required a super-majority vote of the legislative body affirming special circumstances, in approving the issuance of bonds. Also, the work of the California Debt and Investment Advisory Commission (CDIAC) during that time led to the

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[501] The author's analysis in this section was strongly influenced by presentations at the 2010 Annual Conference of the National Federation of Municipal Analysts by Stephen E. Heaney, Managing Director, Public Finance, Stone & Youngberg LLC; John Ruiz, Principal, Maxcy Development Group; and Timothy P. Sullivan, President, Sullivan Group Real Estate Advisors.

[502] California land-based financings in the 1990s led to numerous SEC and State enforcement actions against issuers, financial advisors and officials, underwriters and officials, and developers.

> promulgation of guidelines (published in 1991) for Mello-Roos bond offerings and then guidelines for appraisals.[503] CDIAC's work represented a significant improvement since the guidelines provided some "best practices" for issuers to use in Mello-Roos offerings. The appraisal guide virtually eliminated the use of retail appraisals, which were not unheard of in the late 1980s. Market participants came together with regulators, or at least quasi-regulators, to improve the landscape for investors going into this recession.

Following the painful experience of the 1990s, California finance practitioners began to pay closer attention to certain factors in their transactions. Those factors included, among others, the aggregate level of taxation that homeowners would be required to pay, the value-to-lien ratios that would be imposed upon properties, due diligence and disclosure regarding developers' financial and operational capabilities and intentions to develop their properties, and the timing of issuer responses to developer tax and assessment payment delinquencies. Even in the 1990s and earlier, assessment and Mello-Roos bond issues would not have been completed in California for undeveloped properties without appraisals (and associated demand studies) prepared in order to gauge the value-to-lien ratios of the properties.

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[503] Mr. Heaney is referring to CDIAC's **GUIDELINES FOR MELLO-ROOS FINANCING** (1991) and **APPRAISAL STANDARDS FOR LAND-SECURED FINANCINGS** (1994) (later updated in 2004).

See also CDIAC's **DISCLOSURE GUIDELINES FOR LAND-BASED SECURITIES** (1996).

Texas also has many land-based financings subject to strong State oversight, with low default rates. To date, the State of Florida has not exercised such supervision.

In the current fiscal crisis, although both California and Florida have experienced especially unfortunate real estate performance with rapidly declining residential values, the California experience stands in sharp contrast to land-based performance in Florida's community development districts.[504] Florida's delinquency and default rates have been particularly disturbing.[505]

Although residential real estate experience in Florida and California is similar, there are substantial differences in land-based financing practices that assist in explaining differences in municipal securities default.

The default differences are demonstrated in the following data compiled by Matt Fabian of Municipal Market Research—

Par (and #) of Loans Currently Impacted in Notices of Payment Defaults and Severe Credit Impairments (SMM)

Sector	All Notices	Default	Reserves	Other
Florida Land Secured	$2,518 (131)	$1,458 (78)	$845 (36)	$205 (17)
California Land Secured	$363 (24)	$17 (2)	$110 (12)	$237 (10)

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[504] A summary report on Florida CDDs in June 2010, stated—

> Florida CDD Report Overview
>
> There are 600 Community Development Districts in Florida, 438 of which were begun in 2003 through 2008. They have issued $6.5 billion in municipal bonds to finance their infrastructure. Since the collapse of the housing market, over 155 of these districts are in default on $4.7 billion of bonds and, in many cases, the project developer is in financial distress as well. This represents 73% of all the CDD debt presently outstanding. Since some 204 of these projects were launched in 2006 through 2008, many have not yet completed their infrastructure build out, so they have not yet defaulted. However, given the slow turnaround in housing this is often only a matter of time. We estimate that at least another 60 projects could default before a turnaround occurs, thereby raising the total default rate to 85%. In a historical sense, the Florida CDD default wave is the single biggest municipal default event both in terms of number of issues and dollar amounts. (floridacddreport.com as of June 2010).

The foregoing analysis utilizes as a definition of default "a failure by the bond issuer to make timely scheduled payments to the trustee of the debt."

[505] See also n. 491 regarding recent defaults in Florida community development districts.

The following are examples of common factors differentiating practices in the two states in recent years—

- In California, districts were created, governed and managed through local jurisdictions; in Florida, districts were created, governed and managed as a part of developers' larger businesses

- In California, local jurisdictions adopted policies regarding creation and management of districts; in Florida, developer controlled boards generally did not adopt such policies

- In California, taxes and special assessments were collected on the property tax bills (most County Tax Collectors would not accept partial payments or payments of one tax bill item without full payment of all items on the bills); not so in Florida

- In California, real estate appraisals with market/demand/absorption studies were routine; in Florida, appraisals generally were not utilized, so that developer absorption estimates and associated financial projections often were optimistic

- In California, financing generally was provided in phases as development progressed and funding was needed; in Florida, phasing was not used, with funding occurring in early stages of development

- In California, multiple developer/builder ownership often existed at the time when the securities were issued; in Florida, ownership of the land was concentrated at the time of issuance

- In California, land-based districts did not acquire land from developers; in Florida, developer-controlled districts acquired land from developers for uses such as open space, lakes and parks (thus providing developers cash flow, often from securities sale proceeds), with that land value included in aggregate valuation estimates

- In California, appraised value-to-lien ratios (assuming completion of the financed public infrastructure) were generally 3:1 or 4:1 or even more; in Florida, ratios were allowed to fall even below 1:1

- In California, close attention was paid to the aggregate level of taxation and other fixed charges (such as property owner association fees) on residential properties (usually, significantly below 2%); in Florida, charges were much higher, with the result that homebuyers experienced significant fixed payment burdens

- California bond issues incorporated typical reserve funds based upon maximum annual debt service; Florida bond issues used much lower reserve levels, such as half of annual debt service, thus providing less time for workout activities after tax or assessment payment delinquencies before actual payment defaults on the securities

- In Florida, much riskier series "B" bonds became common in order to fund costs of infrastructure for neighborhoods, rather than for communities; in California, series "B" bonds were not used

- California communities learned from the past to be more aggressive in foreclosing on delinquent properties; Florida districts, being governed and managed by the developers, were less responsive to developer delinquencies

- In California, foreclosures occurred through a judicial sale; in Florida, tax certificate sales were used

Stephen Heaney of Stone & Youngberg LLC drew the following "Lessons Learned" from the structural and procedural differences between California and Florida land-based financings[506]—

1. Governance Matters

2. Policies Are Good for Issuers and Investors Alike

3. Independent 3rd Party Expertise Really Does Add Value

4. Follow Laws/Covenants

5. Earlier Action is Better

6. Seek Experienced Help (Legal/Financial)

[506] Stephen Heaney "Land-Secured Bonds: Different Strokes for Different Folks" presented in slides to the Annual Conference of the National Federation of Municipal Analysts (May 6, 2010).

John Ruiz of Maxcy Development Group identified the following "Common Underwriting Flaws" in Florida community development district bonds[507]—

- Lack of appraisals and market studies
- Land sales from developer to district
- Optimistic absorption and home prices
- Excessive end-user assessment burden
- Dependence on high-density uses
- Lack of phasing
- Unsecured completion guarantees

Mr. Ruiz added the following "Lessons Learned"—

- Establish minimum value to lien ratios
- Require appraisals and market studies
- Limit or prohibit land sales from developer
- Restrict developer control of Board
- Protect assessments

[507] Ruiz, "Florida Community Development District Bonds" presented in slides to the Annual Conference of the National Federation of Municipal Analysts (May 6, 2010).

The author believes that such efforts to identify factors contributing to enhanced securities structures in those market segments readily-identifiable as posing greater risks than other municipal securities represent examples of the kind of work in which market participants and regulators could engage beneficially in order to reduce investor losses in the municipal market.[508]

In other words, Florida municipal securities practitioners ignored sound practices utilized in California (and to varying extents in other states),[509] choosing instead to

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[508] See also beginning at n. 510 and accompanying text regarding the use of expert work products and associated issues.

[509] At least one observer expects California to have higher levels of default in the future. Cohen, "California Mello-Roos Bonds Defaults Likely to Increase" (*thepublicpurse.com* Dec. 18, 2009), states—

> In a recent report about Mello-Roos Community Facility Districts (CFD's) the California Debt and Investment Advisory Commission (CDIAC) stated:
>
> > Despite the potential impacts of evolving mortgage conditions, CFD's have not reported higher default rates, at least through 2007-2008, but have reported a recent rise in the number of their draws on reserves.
>
> * * *
>
> To date CFD's have held their own on the default scene, certainly doing better relative to Florida community development districts which are defaulting in droves. We believe the lag in defaults is too lightly appreciated and there will be an elevated default pattern in the next two years.
>
> Like other corners of the real estate markets, Mello-Roos borrowings soared in the 2000-2007 time period. …
>
> * * *
>
> A few factors slow down the default timeline. First, some counties where Mello Roos predominates, such as Orange (but not Riverside) includes districts in the "Teeter" program. Under Teeter the counties pay 100% of the property taxes to the local agencies and then receive penalty and interest payments. The counties have the right to kick out an agency from the program in the next year, so this source of cash flow is not ironclad. … Second, many CFD's have debt service reserve funds, so reserve draws are an important early indicator of trouble. Finally, many CFD's are less leveraged than special districts in other states. The awareness of payment problems has led financial managers to be pro-active, whether through bond refinancing or more aggressive foreclosure resolution. Given that reserve draws are elevated again we expect to see defaults climb in the next few years … .

accept risks that practitioners in California (and elsewhere) would not accept. Florida land-based securities assumed, in other words, much more the character of land speculation—if land values declined, then investors would lose.

Beyond the focus on transactional participants on the sell-side, one must also ask why savvy institutional investors would accept the almost naked risks of Florida real estate, given the inevitable cycles of the real estate industry.

Expert Work Products[510]

Based upon a lengthy record of historical experience in terms of default statistics, private litigation, and issuer and investor adversities, certain transactions are especially deserving of careful attention and sound independent professional advice to issuers.[511] In riskier municipal securities transactions, when expert feasibility studies, forecasts, projections, appraisals and other expert work products play an especially critical role, issuers (as well as professionals advising the issuers) should pay close attention to key elements of forming a reasonable basis for reliance upon the experts' work.[512]

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[510] The National Federation of Municipal Analysts (NFMA) has a project pending as of this writing entitled "White Paper on Expert Work Products" of which the author is a principal drafter.

[511] See n. 160 and accompanying text.

[512] Such issues are presented, for example, in private litigation discussed beginning at nn. 1830, 1854, 1865 and 1895 and accompanying text.

Certain descriptions of recent trends indicate troublesome retrogressions from former disclosure improvements. The trends, as described, spell difficulties for issuers and underwriters seeking to rely upon "experts" and for investors to whom expert work products are presented as key information forming the basis for investment decisions.

In that connection, **ROLES OF COUNSEL** states [at 28-29] that "[e]ven though the full benefits and protections of the statutory due diligence defense" in the 1933 Act "for expertised portions of a registered prospectus may not be available for offerings of municipal securities," still there may be benefits from identifying experts in official statements. **ROLES OF COUNSEL** also notes that the SEC has recognized reliance on experts as a factor in determining the adequacy of due diligence. Nevertheless, **ROLES OF COUNSEL** adds that accounting firms do not wish to be identified as experts and that "consultants providing feasibility reports for hospitals, airports, and other enterprise financings usually decline to be referred to as experts."

In addition, **ROLES OF COUNSEL** states that, in connection with an auditor's "consent letter" an "auditor is required to perform certain minimal procedures prior to providing its consent." When an auditor declines to provide consent, **ROLES OF COUNSEL** suggests a form of disclosure statement for use in official statements to the effect that a consent was not received and that "the independent auditors did not perform any procedures" on official statement information.

The suggested disclosure does not, however, warn investors that the failure of the auditors to consent to the use of their audit report in a disclosure document may be used to assert that the investors cannot make claims for negligence based upon their reliance upon the audit report, regardless of how justifiable that reliance may be. To make matters even less equitable for investors, certain state laws in a number of states may place limitations upon auditor liability to relying investors under such facts and circumstances.

For example, New Jersey Statutes 2A:53A-25 provides as follows—

> b. Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless:
>
> * * *
>
> (2) The accountant:
>
> (a) knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;
>
> (b) knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction; and
>
> (c) directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service[.]

The foregoing information likely is surprising to investors who rely routinely upon expert work products, and represents a wake-up call to readers of expert work products on both the sell-side and the buy-side of municipal securities offerings to become much more pro-active in reviewing expert work products and asking questions about them. If the experts preparing expert work products are unwilling to stand behind their professional work products due to liability concerns, then the question must be asked why investors should be willing to place substantial investments at risk in reliance upon those same work products.

The process of requiring expert consents may lead to higher issuance costs if it causes experts to purchase insurance or simply to charge higher fees to compensate the experts for additional risk, but since expert work products are used in the riskiest municipal securities offerings to induce investor reliance, that due diligence step and the higher costs are warranted so that investors are able to place full reliance with confidence upon the work products. The same may be said for reliance by issuers, underwriters, financial advisors and counsel.

Some issuers, financial firms and lawyers who seek to rely upon expert work products, such as feasibility studies, forecasts, projections, appraisals or other expert work products may fail to review work products carefully.[513] Such a review is a prerequisite for reliance—after all, if one does not know what the document says and what an expert's assumptions, methodology and reasoning may be, it is difficult to rely appropriately upon the expert's conclusions.

STEPS FOR RELIANCE ON
<u>EXPERT WORK PRODUCTS</u>

- Review Work Product & Ask Relevant Questions of & Seek Clarifications from Expert
- Check Expert's Qualifications, Expertise & History
- Obtain Expert's Statement of Compliance with Identified Applicable Professional Standards (or if None, Sound Market Practices)
- Obtain Expert's Identification of All Assumptions
- Obtain Expert's Professional Opinion That All Assumptions Are Reasonable
- Obtain Expert's Statement of Access to Desired Information
- Check Expert's Potential Conflicts (Including Employment, Relationships, Contractual & Payment Arrangements)
- Obtain Expert's Review & Approval of Disclosure Document Descriptions Regarding Expert & Work Product & Upon Expert
- Obtain Expert's Consent to Use of Work Product in Disclosure & to Reliance Upon It
- Provide Information in Disclosure Document Regarding Other Expert Work Products (by the Same or Other Expert(s)) on Substantially the Same Project &, If Relevant, Distinguishing Considerations

[513] In a large number of official statements for health care/assisted living financings, all of which defaulted, the offering documents stated—

> Neither … the Underwriter, nor their counsel, … has reviewed the assumptions and the disclosures contained in the Financial Feasibility Study and found them to be reasonable and appropriate.

Such a statement is an explicit admission that the underwriter did not undertake necessary efforts to form a reasonable basis for belief in the reasonableness of key representations in the offering documents relating to the feasibility of the projects that were to produce revenues necessary for payment of debt service on the bonds.

On the buy-side, analysts relying upon expert work products in making investment decisions—the very purpose of presenting the expert work products in offering documents—may be unaware of important issues surrounding the expert work products.

Issuers and other offering participants may also fail to gain important documented assurances regarding qualifications of the experts and the experts' expertise in relevant subject areas, identification of and compliance with professional standards, identification and reasonableness of the experts' assumptions, the experts' access to desired information, assurances regarding the absence of conflicts of interest of the experts, the experts' review and written approval of discussions in disclosure documents regarding the experts and their work products, existence or nonexistence of other, perhaps less favorable, expert work products regarding the subject matter, or other important matters.[514]

IX. TAXABLE BONDS & DISCLOSURE

The financial crisis brought into play significant changes in federal subsidies and tax laws applicable to municipal finance. Pursuant to the stimulus package enacted in February 2009, the American Recovery and Reinvestment Act of 2009 (ARRA), new forms of taxable bonds were authorized in federal efforts directed toward remediation of the financial crisis.

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[514] For a suggested form of expert certification covering these subject areas for the protection of issuers and other offering participants, see NFMA's White Paper on Expert Work Products" and Doty, "*Securities Law Application to Municipal Finance Transactions—Continued Expansion & a Market in Flux, Part 1*" 28(4) Mun. Fin. J. 63, 98-101 (Winter 2008).

See n. 1849 and accompanying text discussing a case study based upon actual litigation to illustrate certain allegations that may be made with reference to expert work products.