

2008: Vallejo Under Financial Stress

In 2008 the City of Vallejo, CA. was suffering from severe financial stress caused by recurring budget deficits in its general fund. The City found it difficult to bring its budget into balance because 74% of the budget consisted of expenses for police and firefighter salaries and pension obligations which had been growing out of control. City officials attempted to renegotiate labor contracts and benefits, but were unable to generate enough cuts to balance their budget. The deficit for 2008 was \$4.3 million, with a projected deficit for 2009 of \$16 million. According to a recent Wall St Journal article which appeared on March 26, 2010 "salaries for police captains were over \$300,000 per year, and firefighters averaged \$171,000 a year. These same workers could retire at age 50 with a pension that guaranteed them 90% of their final year's pay."

Vallejo Enters Bankruptcy

On May 23, 2008 the City of Vallejo filed a petition for protection under Chapter 9 of the U.S. Bankruptcy Code. According to the law firm Orrick, Harrington, & Sutcliffe in order to file bankruptcy a municipality must meet the following criteria:

1. It must be a political subdivision of the state. A state is not allowed to file for bankruptcy.
2. State law must allow a municipality to file for bankruptcy. About half of the states in the U.S. do not allow municipalities to file bankruptcy.
3. The municipality must be insolvent which means they are not able to meet their current obligations or won't be able to meet them in the next year.
4. The municipality must desire to effect a plan to adjust its debts.
5. The municipality must show it has tried to negotiate unsuccessfully with creditors.

In September 2008 the Bankruptcy Judge Michael McManus determined the City of Vallejo met these conditions, and the Bankruptcy Appellate Panel affirmed his decision on June 26, 2009.

Collective Bargaining Agreement Is Rejected

On March 13, 2009 the judge ruled the City could reject the Collective Bargaining Agreements it had with various city unions, and the City of Vallejo began to renegotiate its contracts with public employees including firefighter and police.

Vallejo's Bankruptcy Workout Plan Affects Bondholders

On December 22, 2009 the City came up with a Bankruptcy Workout Plan which called for no principal or interest payments to be made for three full years beginning January 15, 2011 through January 15, 2014 on outstanding debt. This affects all bonds that are secured by the General Fund. Bonds with dedicated revenue streams are not affected by the moratorium on debt service payments. The bonds that are still paying interest are secured by water revenues, special assessments, and special taxes. Bonds for related entities are also not affected by the Workout Plan. These include Vallejo Sanitation and Flood Control District, Vallejo Redevelopment Agency, and Vallejo Housing Authority. These are all separate legal entities from the City of Vallejo.

Why Vallejo Is Important To Bondholders

During the last 40 years most Muni bond defaults have been for housing and healthcare bonds. There have only been 3 general obligation bonds which were rated by Moody's that have defaulted during this period. Perhaps the best known case is for Orange Co., CA which defaulted on its debt, because of excessive exposure to derivative trades in its investment pools by rogue trading by the county treasurer. Bondholders were eventually able to recover 100% of both principal and interest. Jefferson Co., AL defaulted on its bonds in April 2008, because of excessive exposure to variable and auction rate securities swaps which caused a large liquidity deficiency for the county when their swaps didn't work out.

The bankruptcy filing for Vallejo is quite different. It is the result of poor governmental planning with the City lacking the political will to negotiate affordable contracts with public workers, and also making them promises they are not able to keep. Public employees and bondholders alike are watching this case with interest. Numerous municipalities across the country have significant unfunded liabilities for both pensions and healthcare benefits. This case is, thus, important to see if bankruptcy for a municipality is a way to make these liabilities more affordable for its taxpayers.

Vallejo: Has Bankruptcy Paid Off?

It is clear bankruptcy has not been a silver bullet for Vallejo, and the costs have been significant. Since filing for bankruptcy, Vallejo's tax revenues have fallen 20% with further expected declines likely in 2011-2012. The City has not had the political will to reduce existing pension costs. These costs will leave the City

facing projected annual deficits of \$23-\$27 million once retirement costs are fully recognized. There has been a stigma for residents which makes Vallejo a less desirable place to live. This is reflected in falling property values, reduced services, and a higher crime rate. The City has also been shut out of the credit markets, and will be unable to raise funds for an extended period. The City has made progress in renegotiating labor contracts, but the cost has been high.

We believe other municipalities will look at this case with mixed feelings, and will realize bankruptcy is an option of last resort. It is not a panacea for getting rid of unfunded pension liabilities. Most municipalities are not in the dire straits which Vallejo is in, which means they are not eligible to file for bankruptcy. Fears of widespread use of bankruptcy by municipalities to lower unfunded liabilities are overblown. On a positive note for taxpayers, this case sends a clear message to organized public workers. In a bankruptcy situation their existing contracts are all up for renegotiation. This should make them more willing to negotiate on more favorable terms with municipalities in the future.

Lessons To Be Learned For Bondholders

This case provides several lessons for investors. First, Muni bondholders should realize security selection has never been more important than it is now. Improper security selection can be very punishing to investors. Next, bond investors cannot assume general obligation bonds are more safe than revenue bonds. When a municipality experiences extreme stress and enters bankruptcy, bonds with dedicated revenue streams are superior to claims on the general fund. Also, some municipal entities may lack the political will to make sound financial decisions. Even though municipalities are required to balance their budgets, there may be some situations which make it extremely difficult for them to do so. Many budgetary problems need long term solutions, but politicians are only willing to provide short term fixes. In addition, since states are not able to declare bankruptcy, it is difficult for investors to know which type of bonds have priority over other general fund obligations such as payroll and vendors. Laws will vary from state to state. For example, in California payments for schools have priority over debt service, which has priority over all other general fund expenses. Finally, the Muni market is a fragmented market of over 50,000 different issuers. It is not possible to make general statements re-

garding the creditworthiness of all Munis. Pundits which make generalizations about the Muni markets should be treated as suspect. Instead, investors should be more like loan officers who realize that each borrower has different abilities to service their debt. They should consider off balance sheet obligations, wealth levels, and debt per capita before purchasing the issuer's general obligation securities.

Conclusion

The Muni market is not a good do-it-yourself market. Proper security selection is beyond the scope of most individual investors. We also believe the financial situation of the City of Vallejo shows the danger of blind reliance on default studies, which is not a good policy in today's environment. These studies cover a time period where most municipalities did not experience the amount of financial stress which they will be facing during the next couple of years. This stress may be caused by declining tax revenues, higher costs of providing healthcare, or unfunded liabilities associated with public employees. Instead, we plan to place more emphasis on revenue bonds with secure revenue streams and less emphasis on some general obligation bonds. This strategy is similar to the one we have used for California Muni bond investors. We will continue to seek out general obligation bonds of high wealth areas, and issuers with low debt per capita levels, and a willingness to make difficult budget decisions. But, we will also place increasing emphasis on essential service revenue bonds where the issuer has a monopoly on the services they provide.