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WHAT IF THE MUNICIPAL BOND MARKET IS THE NEXT BUBBLE TO BURST?

WHY GOVERNMENTAL RISK POOLS SHOULD TAKE STEPS *NOW* TO PROTECT THEMSELVES

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Securities fraud claims have long plagued public companies and their directors and officers. The cost to defend and settle these claims often runs to many millions of dollars—sometimes hundreds of millions. Not surprisingly, liability insurance for directors and officers of public companies is often the most expensive insurance available in the marketplace.

For participants in the municipal debt market, securities claims have been far less frequent. That may be changing. The growing number of defaults and other signs of weakness in the municipal debt market suggest that the exposure to securities claims may be increasing for public entities and those associated with municipal debt offerings. If so, are governmental risk pools exposed to significant financial risk that is well beyond what they previously contemplated in providing coverage to their members?

This prospect presents a significant challenge for pools that protect governmental entities, schools and officials. Some governmental risk pools may want to assist their members with securities claim exposure, but they may not recognize the severity of this exposure and therefore don't adequately price for it. Many pools already exclude coverage for securities claims, but these exclusions may not be broad enough to prevent triggering a defense obligation. That defense obligation alone can expose the pool to millions of dollars in legal fees and other expenses.

A flood of securities claims from failed municipal bond offerings is not likely. But the threat of securities claims arises from their severity not their frequency. For a governmental risk pool that finds itself providing securities claim coverage to a member, the losses from just a single claim could significantly impair its surplus, putting the pool's very survival in jeopardy. That can be true even if the coverage is limited to defense costs.

What follows are some thoughts on this exposure, why it might be increasing and what governmental risk pools and their boards may want to consider in evaluating and responding to it.

Parallels Between the Real Estate Market Bubble and the Current Municipal Bond Market

Many experts continue to advocate municipal bonds as a safe investment. Echoing the bullishness that preceded the recent real estate bubble, the rating agencies reassure investors by citing the low default rates of the past as evidence of the improbability of defaults in the future.

To be sure, there are many types of municipal bonds. While some certainly are safer than others, some of that safety is illusory. For instance, general obligation bonds are backed by full faith and credit of the government issuers and are believed to be nearly default-proof in the same way bundles of real estate loans were thought to be a safe bet. In the case of government-issued debt, however, this safety depends on the belief that governments won't default—a belief that is built upon on their ability to raise taxes in order to service the debt. However, that view is not based on the actual fiscal soundness of many municipal issuers. Nor does it account for the fact that governments in financially distressed areas may be unable to raise taxes to pay off bondholders. Consideration of these factors suggests that the perceived relative safety of some general obligation bonds is illusory and the risk of default or rating downgrade higher than commonly assumed.

Just as they had with real estate, other experts point to geographic diversity as a way to avoid the risk of an isolated municipal bond default. After all, they say, not every state is experiencing the same budget pressure as California, Illinois, Nevada and New York, to name a few.

The fiscal pressure faced by state and local governments is causing more and more of them to access the bond market to fund expenditures and meet long-term promises, such as pension obligations. The question is do these governmental borrowers resemble the subprime real estate borrowers? That group took out loans they couldn't afford, often assuming that real estate values would increase so they could refinance or sell the loans. Are today's municipal borrowers taking cash and relying upon future economic rebound to provide them the tax revenue to repay the debt? In addition, Wall Street is encouraging more "creative" financing in the municipal debt market. Interest rate swaps, derivatives and other complex types of financial transactions are becoming more common. This is also similar to earlier failed mortgage debt strategies.

The federal government is also fueling the growth. In the real estate market, Fannie Mae and Freddie Mac effectively acted as middlemen between the government and the real estate transactions that fueled the bubble. In the municipal bond market, the federal government provides direct support for borrowing by state and local governments through its Build America Bonds program.

As a result of these and other factors, the size of the municipal bond market, which currently stands at about $2.8 trillion dollars, continues to grow.

Signs of Increasing Distress Ahead for the Municipal Bond Market

The signs of distress in the municipal bond market are increasing. Defaults, while still low, have been rising steadily over the past three years, increasing from $348 million in 2007 to $8.15 billion in 2008 and $6.35 billion in 2009. As was the case with the various real estate-backed securities, Wall Street is both selling the municipal bonds and betting against them by selling credit default swaps as a hedge.[1]

A growing chorus of voices is predicting that the municipal debt market will be the next bubble to burst.[2] They cite a number of distressing facts, including: continuing unemployment; softness in the real estate market, which depresses real estate tax revenue;

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consumer spending restraint, which depresses sales tax revenue; significant under-funding of state pension and Medicare obligations, while the promises associated with both continue to grow; and increasing leverage of state finances from borrowing to deal with these and other fiscal problems. Even those who disagree with the direst predictions see trouble ahead.[3]

Many of these municipal bond market "bears" ask the following question in one form or another: If it gets bad enough and public officials are faced with a choice of angering bondholders by defaulting or angering taxpayers by some combination of higher taxes and reduced benefits to public sector employees, which is more likely given what we know about our politics? It wasn't that long ago that Cleveland, New York, and Orange County, to name just a few, defaulted on their obligations. Recently, former Mayor Riordan predicted that Los Angeles is headed for bankruptcy.[4]

Two recent developments seem to support the views of the municipal bond bears.

First, the Securities and Exchange Commission ("SEC") recently announced the settlement of securities fraud allegations against the State of New Jersey arising out of a series of municipal bond offerings between 2001 and 2007 totaling over $26 billion.[5] The core of the SEC's claim was that New Jersey failed to disclose the significant underfunding of its pension obligations.

Second, the Town of Harrisburg, Pennsylvania recently avoided defaulting on a general obligation bond—the safest type of municipal bond—when the state agreed to accelerate certain payments due to the town.[6] Before the bailout, the mayor made clear that she would default before cutting services.[7]

A Securities Claim Scenario

So what happens when widely held investments fail? Class-action securities lawsuits follow quickly on the heels of such failure. With the real estate meltdown, the targets in these suits have included financial institutions and their directors and officers, rating agencies, Fannie, Freddie and the Wall Street banks that created and sold the various securities backed by or pegged to real estate loans. Many of these claims are still working their way through the courts and will be for many years.[8]

Securities claims are not your garden variety lawsuits. Securities litigation is expensive, very expensive. The law is complex and the facts of a securities claim can be extremely complicated. The alleged damages, which tend to be tied to the total securities offering, often run well into the tens or hundreds of millions of dollars, or more. Big exposure and complicated claims bring with them expensive attorneys. Defense costs alone can run to many millions of dollars without a securities suit ever getting to trial. It is not unusual for securities attorneys' hourly rates to approach and even exceed ***one thousand dollars per hour.***

While federal regulation of a municipal debt offering is lax compared to a public company securities offering, federal and state anti-fraud laws may apply with equal force to municipal debt offerings. As a result, municipal issuers and the public employees and officials who participate in their offerings are potential targets for securities suits if bondholders suffer losses as a result of defaults or downgrades.

What makes this litigation so different? Here is a scenario:

- A municipal bond is downgraded following disclosure that the projected revenue stream needed to support the debt service won't be as large as projected.
- The value of the bond plummets following these events. The issuer may or may not default. (It doesn't matter for purposes of whether a claim can be made. It is enough that the value of the investment has declined.)
- Bond purchasers file suit under state and federal securities laws alleging misrepresentations in connection with the offering. These suits typically include individual and class actions. Suits can be filed in federal court, state court, or in both federal and state court, simultaneously.
- The defendants include the bond issuer, the municipal entity associated with the offering, underwriters, bond counsel, accountants, broker dealers and individuals associated with each of these.
- The suits seek to recover damages and/or rescind the offering.
- All the defendants retain separate defense counsel.

- The federal suits are consolidated before a single judge. The state suits remain in one or more state courts.
- The plaintiffs' counsel jockey for control of the litigation. In the class action, a lead plaintiff is identified and its counsel takes the lead, perhaps filing a consolidated amended complaint that could run to a hundred pages or more.
- The defendants file motions to dismiss the complaints asserting a variety of threshold legal defenses.
- While these motions are pending, discovery is stayed, pursuant to one of the many provisions of the Private Securities Litigation Reform Act of 1995 that make securities litigation different from other civil litigation. This slows down progress of the litigation, although attorneys' fees continue to accrue.
- If the motions to dismiss are granted, the plaintiffs are given one or more opportunities to file an amended complaint. Motion practice repeats itself with each new complaint. This can often take several years if multiple amendments are permitted.
- If after several tries at amendment the motions to dismiss are granted without leave to amend, there likely will be an appeal. This too can take up to a year or more.
- Assuming some of the case goes forward, either after a motion to dismiss is denied or after a dismissal is reversed on appeal, discovery begins. In some cases, however, discovery may be limited to class certification issues.
- Following this discovery, the parties will then brief the issues of class certification. Depending on the outcome, further appeal is possible.
- Assuming a class is certified, the case will proceed to full merits discovery (if full merits discovery hasn't started already). This will include voluminous document and deposition discovery and the retention of a variety of types of expert witnesses.
- At the conclusion of discovery, the defendants likely will move for full or partial summary judgment. If granted, another round of appeals would be likely.
- If some of the case is not dismissed on summary judgment, the case will proceed to trial or, as is more typical, mediation and settlement.
- The entire process can play out in a year or so or, more typically, take many years in the event of multiple motions and appeals.

Not too appealing, is it?

Private securities litigation isn't the only threat to municipal bond market participants. A more immediate threat may be from the federal government. The SEC has been very active in pursuing misconduct in the municipal bond market.[9] It has authority to conduct lengthy and expensive investigations, after which it may bring civil charges seeking injunctive relief as well as penalties and disgorgement.

The SEC announced recently that it has created a special unit to focus on misconduct in the municipal bond market.[10] In addition, on March 2, 2010, the SEC and the IRS signed a Memorandum of Understanding detailing their agreement to cooperate and share information in policing the municipal bond market.[11] The settlement with New Jersey noted earlier is an omen of what is likely in store for many municipal bond issuers.

Finally, in addition to private securities litigation and SEC enforcement activity, in the most serious cases, criminal investigations and indictments are a possibility. More often than not, these are coordinated between the SEC and the Department of Justice.

Big exposure and complicated claims bring with them expensive attorneys. Defense costs alone can run to many millions of dollars without a securities suit ever getting to trial. It is not unusual for securities attorneys' hourly rates to approach and even exceed one thousand dollars per hour.

Some Specific Issues for Governmental Risk Pools to Consider in Responding to the Increased Risk of Securities Claims

Are governmental risk pools ready for this exposure? The answer seems to be mixed.

Those pools that are considering coverage for securities claims need to be sure they understand the exposure they are taking on by providing coverage, and what it may mean for them if it is not capped. For pools that seek to provide limited coverage, perhaps through a sublimit for defense and/or indemnity, there are at least two key considerations:

> The limitations must be airtight. That means any sublimit or defense-only provision must be carefully crafted to avoid a way around the intended limitations.

> In addition, a municipal bond offering involves the participation of many parties, including attorneys, accountants, experts and frequently developmental or other entities retained or created for the purpose of effectuating the offering and/or the project that the money from the offering is used to support. If a pool is providing any coverage, it must be careful that its coverage documents do not extend unintended coverage to these entities.

Many governmental risk pools recognize that securities claims present too great an exposure for them to assume. These pools have provisions in their coverage documents intended to exclude coverage for securities claims. But these provisions may not be entirely effective, leaving the pools exposed to potentially ruinous claims.

Excluding the Coverage—Consider the following issues:

First, some securities claim exclusions are triggered by fraud or reckless conduct. This might be good enough to trigger the exclusion under the required state of mind standard for a claim pursuant Rule 10b-5 of the Securities Exchange Act of 1934. Some state securities laws, however, require only proof of negligence to trigger liability. Other claims under the Securities Act of 1933 and some state laws have no state of mind requirement to trigger liability. A securities exclusion with a fraud or recklessness trigger may not permit a pool to deny coverage for such claims, potentially triggering a defense obligation for the entire lawsuit and creating difficult allocation issues when settlement is being evaluated. The better practice is for the exclusion to focus on the securities transaction triggering liability and not the required state of mind, which can vary.

Second, frequently the pool member is not the actual issuer of the municipal bonds. Yet the municipal entity and its employees or officials can still have exposure to a securities claim depending on their degree of involvement in the offering. To be sure, the Supreme Court reaffirmed recently that there is no private cause of action under the federal securities laws for aiding and abetting securities fraud.[12] This doesn't stop the plaintiffs from trying to allege a case of primary liability against secondary actors. In many instances, aiding and abetting liability is available under state law. Furthermore, the SEC, unlike a private plaintiff, does have authority to bring aiding and abetting claims under the federal securities laws. In a case where the issuer is someone other than a member or its officials, a securities exclusion that is limited to claims based on securities *"issued by the member"* likely wouldn't be effective in precluding coverage for a member or its officials who are sued. The better practice, therefore, is for the exclusion not to be limited to offerings by the member.

Third, many securities exclusions make no mention of investigations or enforcement actions by state or federal agencies, such as the SEC. An investigation can take many years and consume significant attorneys' fees to defend. An enforcement action brings with it further exposure to fines and penalties, disgorgement of ill-gotten gains, cease and desist orders and injunctions. As mentioned above, the SEC can bring an enforcement action for aiding and abetting a securities law violation. To be effective, a securities claim exclusion should be broad enough to preclude coverage for investigations and enforcement actions by the SEC (or any similar state agency).

Fourth, at the urging of Wall Street, public entities are engaging in more and more exotic financial transactions, including interest rate swaps and other derivative transactions. Many securities exclusions, however, focus too narrowly on the more traditional transactions involving the issuance of municipal bonds or other traditional forms of debt. A securities exclusion that doesn't contain a broad definition of securities, and otherwise applies to any violation of state and federal securities laws, may not be triggered by these exotic transactions. The best practice is to employ the broadest possible definition of a security—preferably referencing the broad definitions contained in federal law.

Finally, the successful defense in a securities claim can still result in a significant loss for a governmental risk pool. A pool may take satisfaction in a favorable outcome relative to damages, but still suffer a major financial loss due to the legal defense costs. The federal securities laws impose a higher standard of pleading for a securities claim. This results in many securities claims being dismissed at the preliminary pleading stage. Although Congress is considering a change in the law,[13] changes appear unlikely in the near term, and the current lack of aiding and abetting liability in a private action under the federal securities laws can provide a substantial defense to those state and local entities that aren't the actual issuers of the municipal debt. To prevail on this or any other defense can be very expensive given the cost of the attorneys and the likelihood that plaintiffs will be given multiple tries at pleading a claim.

It's not unusual for a defendant in a securities claim to spend a million dollars or more in defense fees to obtain a dismissal and have it sustained on appeal. For governmental risk pools wanting to avoid the securities claim exposure altogether, this makes it even more important to ensure that the securities claim exclusion is ironclad enough to preclude triggering a duty to defend. Failure to do so can leave a pool that successfully defends a claim with a substantial bill for defense costs.

Conclusion

Securities claim exposure in the municipal bond market has not been on the radar screen of most governmental risk pools because such exposure has historically been quite low. As discussed, there are sound reasons to believe that the exposure is increasing and will continue to increase. If that is so, governmental risk pools would be well advised to evaluate their exposure to securities claims and take appropriate steps to ensure that the exposure is either excluded entirely or limited in a manner that ensures the long-term financial viability of the pool. ■

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Endnotes

[1]California Treasurer Bill Lockyer, apparently concerned about what this practice might be doing to the market for California's bonds, recently asked the Wall Street banks to explain themselves. He published their answers on his website. See http://www.treasurer.ca.gov/cds/index.asp; see also Dennis Santiago, "Investment Banking and California's Municipal Bonds," *The Huffington Post,* April 25, 2010 http://www.huffingtonpost.com/dennis-santiago/investment-banking-and-ca_b_551359.html.

[2]See, e.g., Neil Weinberg, "Is a Municipal Bond Crisis Brewing?," *Forbes,* October 21, 2010 http://blogs.forbes.com/neilweinberg/2010/10/21/is-a-muni-bond-crisis-brewing-nasdaqclms; Nicole Gelinas, "Beware the Muni Bond Bubble: States and Cities Can Fail As Well," April 29, 2010, http://www.manhattan-institute.org; Richard Bookstabber, "The Municipal Market," April 4, 2010, http://rick.bookstaber.com/2010/04/municipal-market.html; Don Schreibner, "It's Time to Sell Municipal Bonds," January 3, 2010, http://www.investmentnews.com/article/20100103/REG/301039991.

[3]See Joe Mysak, "Next Big Crisis Is Unfolding in Muni-Bond Market," Bloomberg, April 9, 2010, http://www.bloomberg.com/apps/news?pid=20601039&sid=aKj_LXH6zUrw.

[4]Richard Riordan and Alexander Rubalcava, "Los Angeles on the Brink of Bankruptcy—What Mayor Villaraigosa Must Do To Save the City," *The Wall Street Journal,* May 5, 2010, http://online.wsj.com/article/SB10001424052748704608104575218392603082622.html?mod=WSJ_Opinion_LEFTTopOpinion.

[5]http://www.sec.gov/news/press/2010/2010-152.htm

[6]See http://www.bloomberg.com/news/2010-09-15/pennsylvania-capital-avoids-default-with-3-3-million-payment-on-1997-bond.html.

[7]See Romy Varghese, "Harrisburg Surrender," *The Wall Street Journal,* September 8, 2010, http://online.wsj.com/article/SB10001424052748703720004575478102686910166.html?KEYWORDS=ROMY+VARGHESE.

[8]For a variety of statistics and information on securities claims and settlements, see generally, Stanford Law School Securities Class Action Clearinghouse, http://securities.stanford.edu.

[9]For a summary of enforcement actions by the SEC from 2004-2009 involving municipal debt securities, see Municipal Securities Cases and materials: Supplemental Text (2004-209 Cases), SEC Office of Municipal Securities, Division of Trading and markets, October 2009, http://www.sec.gov/info/municipal/municase07.htm.

[10]See "SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence," January 13, 2010, http://www.sec.gov/news/press/2010/2010-5.htm.

[11]See "SEC and IRS Agree to Work More Closely Regarding Municipal Bond Enforcement," March 2, 2010, http://www.sec.gov/news/press/2010/2010-30.htm.

[12]*Stoneridge Inv. Partners LLC v. Scientific-Atlanta,* 552 U.S. 148 (2008).

[13]For a discussion of this and other amendments to the securities laws under consideration, see Boris Feldman, "The Coming Counter-Reformation in Securities litigation," *Wall Street Lawyer—Securities in the Electronic Age,* January 2010, Volume 1.

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