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SECURITIES LAW

Public Bond Issuers Seek Costs Caused by Insurers

BY JEFFREY A. BARRACK
Special to the Legal

A recent article by David Weinstein in *Legal* affiliate *The New Jersey Law Journal* explained that the "subprime mortgage meltdown morphed [into] the municipal bond market" when bond insurance companies' credit ratings were downgraded. Weinstein noted that "municipalities, schools, colleges and other governmental institutions that borrow to undertake projects" are forced to pay "higher costs for capital improvements" in the wake of revelations that bond insurers had enormous exposure to collateralized debt obligations, or CDOs, and mortgage-backed securities. Weinstein concluded that higher municipal borrowing costs can potentially lead to higher taxes. This column addresses the issues and identifies certain theories being used by public bond issuers to seek recompense for costs caused by their bond insurers.

HOW BOND AUCTIONS WORK

Auction-rate securities, or ARS, and other forms of variable-rate debt instruments are used by municipalities as a low-cost financing tool. Although ARS have intermediate to long-term maturities, they bear interest at lower short-term rates that reset at predetermined intervals; they are bought and sold through a Dutch auction. Typically the auctions reset interest rates every day, seven days, 28 days, 35 days, 49 days or six months. In the auctions, investors submit bids through a broker-dealer acting as auction agent specifying the principal amount to purchase and the minimum interest rate the investor is willing to accept. The auction agent then sorts the bids by their ascending interest rates until the entire principal amount of the securities available for sale are sold. The lowest rate at which all the securities can be sold establishes the "clearing rate" that applies to all the securities of an offering. If there are not enough bids to cover the securities for sale, an auction is said to "fail," and the rate on the ARS is set at a predetermined "maximum" rate. Nearly $307.2 billion in municipal ARS have been issued since 1988.

ISSUERS MUST BUY BOND INSURANCE

Although municipal bonds have historically been exceptionally safe investments and of high-grade credit quality, credit rating agencies, including the three leading agencies, Fitch, Standard & Poor's, and Moody's, use a dual rating system designed to uniformly rate municipal debt lower than corporate debt with comparable risk profiles. Because lower-rated securities must pay higher interest, municipalities are forced to look for ways to enhance their credit ratings and thereby reduce the interest rates payable on their debt. This is generally done by purchasing bond insurance, whereby an insurer guarantees that it will cover interest and principal payments on the debt if the municipal issuer defaults. The public issuer makes a one-time, up-front premium payment. Weinstein notes that many of the largest bond insurance companies — like Ambac and MBIA — have historically been rated AAA. As a result of acquiring bond insurance, insured municipal bonds are assigned these higher ratings since, regardless of the credit-worthiness of an issuer, insured bonds are given, or "wrapped in," the insurer's rating.

JEFFREY A. BARRACK *is a partner of Barrack Rodos & Bacine. He can be reached by phone at 215-963-0600 or e-mail at jbarrack@barrack.com.*

Unbeknown to issuers and the public, in recent years bond insurers have written policies to insure hundreds of billions of dollars of high-risk subprime mortgage-backed securities and other complex leveraged instruments implicated in last year's collapse of the credit markets. According to a report by S&P, by the end of 2007, bond insurance companies had guaranteed $127 billion of CDOs backed by subprime mortgage securities. While this allowed the bond insurers to achieve higher profits, it put their customers — including the public issuers of the debt they guaranteed — at risk. When the subprime loans underlying these instruments — which have come to be known as "toxic assets" — began to fail, the risk to which the bond insurers were exposed became publicly visible. Concerns grew that bond insurers would not have enough capital to cover their commitments. The exposure resulted in ratings downgrades, beginning in early 2008, for the largest bond insurers, and corresponding downgrades of the otherwise safe securities that these insurers guaranteed.

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THE AUCTION FAILURES

The downgrading of the bond insurers has had a severe impact on the market for municipal ARS and other variable-rate municipal bonds. Certain institutional investors in auction and variable-rate securities are not permitted to own securities whose ratings fall below a certain level. The pool of investors also dried up out of fear that, because of the ratings downgrade, these securities would lose liquidity in the marketplace. Concerns about the credit-worthiness of the insurers also prompted broker-dealer agents, who often supported the ARS market by placing bids to prevent a failed auction, to cease their proprietary intervention. These factors led to a sharp decline in demand for ARS in 2007 and a collapse of the ARS market in the first quarter of 2008.

In testimony before the U.S. House of Representatives on Feb.14, 2008, Eric Sirri, director, division of markets of the Securities and Exchange Commission, explained: "Recent downgrades of bond insurers have caused many holders to desire to sell bonds insured by companies who have recently been downgraded or who may soon be. In addition, many holders of bonds insured or supported by the credit of insurers whose ratings have not been threatened now wish to sell — which may be due to a general loss in confidence in the municipal auction-rate market. As a result of these factors, among others, we understand that sellers of municipal auction-rate securities have often far exceeded buyers in auctions, resulting in auction failures."

Leslie Norwood, managing director and associate general counsel for The Securities Industry and Financial Markets Association, in testimony before the House Committee on Financial Services on Sept. 18, 2008, explained: "As problems in the mortgage market spread into the mortgage securitization market in 2007, faith in the monoline insurers who insured mortgage bonds and collateralized debt obligations began to waiver. Investors became wary of being exposed to anything with the potential for downgrades, including any securities insured by the monoline insurers and third-party credit enhanced bonds in general. Because of the critical role the insurers and third party credit enhancers play in the auction rate securities market, demand for ARS began to decline sharply, ultimately resulting in failures across the auction rate securities market; in spite of the fact the underlying credit ratings of ARS issuers have remained high."

MUNICIPALITIES BEAR BRUNT OF ECONOMIC IMPACT

As Weinstein notes, for public issuers — even those whose financial health remains strong — this dislocation in the ARS market has caused steep increases in the cost of capital. When an auction fails, the issuer is obligated to pay a predetermined maximum interest rate, which in some cases may be higher than 20 percent, until an auction is successful. Alternatively, the issuer may refinance the security with a different type of financial instrument — typically at a higher interest rate than had previously been the case — and, accordingly, must pay the associated refinancing costs. When refinancing, public issuers generally book as a loss the unamortized insurance premium that had been paid at the time the original security was issued.

Although the ratings downgrades of bond insurers have been most prominently associated with the failure of the auction-rate securities markets, the downgrades have had a substantial impact on variable-rate debt markets generally. As insurer ratings declined, banks providing liquidity facilities refused to renew them, municipal issuers were required to pay higher interest rates to reflect the higher perceived risk, or remarket efforts failed, causing bonds to be tendered and bear interest at a bank rate. Municipalities sought to refinance variable-rate debt on more favorable terms. But there are costs associated with refinancing debt, including the cost of obtaining new liquidity commitments from banks to fund the ongoing payments to public bond investors. As Weinstein notes, "banks … are obtaining higher fees for the letters," adding to the increased cost of capital that public entities have been forced to incur.

'WHAT'S A CITY TO DO?'

These facts give rise to a number of legal theories being asserted in the courts. Municipal issuers entered into insurance agreements with bond insurers to acquire insurance from AAA-rated insurance companies for which they paid substantial up-front premiums. Under these circumstances, the bond insurers arguably had a duty to avoid, or at the very least a duty to disclose, their enormous exposure to risky subprime debt, which threatened their liquidity and their ability to fulfill their contractual obligations to public issuers. Indeed, while bond insurance companies have marketed themselves on the basis of their high ratings, they appear to have sacrificed the interests of their customers for their own increased profits.

Consequently, public issuers have asserted claims against their bond insurers in state and federal courts seeking damages caused by the insurers' misrepresentations and omissions related to their creditworthiness and concealment of the enormous exposure they faced with the CDOs and mortgage-backed securities they guaranteed. Their claims include breach of contract, based on the insurers' "wrap defaults" and concealment of the huge exposure they faced with respect to risky subprime debt; common law fraud, based on bond insurers' material misrepresentations and omissions regarding their true financial condition and negligence.

Damages to public issuers of bonds are straightforward. The credit downgrades of the bond insurers, and the uncertainty surrounding their claims-paying ability, led to the failure of auctions for auction-rate securities, which under the terms of the instruments resulted in dramatic increases in the interest rates due on those securities. Thus, an issuer's damages can be measured by the increased interest costs that it was contractually required to pay. Issuers also suffered

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similar damages as variable interest rates rose in response to the lower ratings of the insurers. When they could do so, municipalities refinanced the debt represented by these securities. Damages may include the expenses incurred in refinancing, such as underwriting fees, counsel fees, insurance premiums, and the like, and costs associated with obtaining new credit and liquidity commitments from banks.

TAKING INSURERS TO COURT

After Connecticut Attorney General Richard Blumenthal detailed the underlying facts in a regulatory action against the three leading rating agencies, some California, Louisiana and Massachusetts public debt issuers took their claims against the bond insurers to court. Blumenthal explained that: "Connecticut's cities and school districts have been forced to spend millions of dollars, unconscionably and unnecessarily, on bond insurance premiums and higher interest rates." Weinstein notes that such costs could result in "increasing our tax bills." But public issuers that incurred increased interest expenses or other costs upon the downgrade of an insurer guaranteeing its variable-rate debt are also considering, and pursuing, legal remedies against bond insurers to recoup from the insurers instead. By doing so, public issuers with losses sustained as a result of downgrades to their bond insurers' ratings may serve the public welfare by seeking recompense through private litigation, promoting the philosophy of transparency through disclosure thereby. •