Canary in the Coal Mine? Jefferson County Alabama Not a Likely Harbinger of Future Municipal Defaults

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There have been a lot of dire predictions about impending municipal defaults over the past several months that have seriously frightened many investors. One prediction (made on national television[1]) was that 50 to 100 large cities and counties would default over the next 12 months—representing hundreds of billions of debt in default. Let's look at the facts to date:

In the 15 weeks since that prediction there have been three defaults of local governments representing a total of $68 million. For the prediction of "hundreds of billions" to be correct there would have to be $5.4 billion in defaults per week for the remaining 37 weeks. This seems highly improbable, given that the most municipal defaults ever in a year were only $12 billion and that state and local government revenue collections are improving due to a stronger economy.

Nevertheless, with each default, clients ask: Is this the first of many; in other words, is this the canary in the coal mine?

This question is likely to be asked with increasing frequency this summer if Jefferson County Alabama, a large county with $4.2 billion in debt, files for bankruptcy protection under Chapter 9 of the US Bankruptcy Code. This would be the largest municipal bankruptcy ever, surpassing Orange County California in 1994.

In our view, Jefferson County Alabama's situation reflects a unique set of circumstances which have little or nothing to do with the ongoing fiscal problems of states and municipalities across the nation—and which in no way foreshadows future bankruptcies and/or defaults. Here's why:

Two basic issues have driven Jefferson County to its current predicament: 1) a recent ruling by the Alabama Supreme Court declaring the county's occupational tax unconstitutional; and 2) the use of bribery to entice a public official to use financial derivatives to such an extent that it led to the default of the county's sewer bonds three years ago.

If the first issue is not addressed quickly it could easily lead to bankruptcy. This stems from legal problems surrounding its occupational tax, which traditionally has provided about one third of the county's general fund revenues. A few weeks ago this tax was declared invalid by the Alabama Supreme Court due to "process issues." The Court found that the official published notice about the tax did not give the public sufficient notice of how the law would affect them. Any possible resolution of this problem will require time for the state legislature and the county to act. While Chapter 9 is designed to give the county time to both cut spending and arrange for a valid replacement for the lost tax, the county has long tried to avoid bankruptcy and will certainly seek another solution. However, according to its own reports, the county will run out of cash by July and perhaps it will also run out of the time necessary to implement a solution other than bankruptcy.

The second issue occurred years ago when the county financed an upgrade to its sewer system through $3.2 billion of new borrowing. During this process a series of controversial interest rate swaps were approved by the former Jefferson County Commission President. These were intended to lower interest payments, but instead had the opposite effect, dramatically increasing the county's debt burden. The interest rate swaps have been the subject of much investigation, indictments, and criminal charges. The sewer system bonds defaulted in March 2008 which has clearly tarnished the county's reputation, but has not yet seriously impacted its general

[1] "60 Minutes," December 19th, 2010

fund financial position.

Aside from the already defaulted sewer debt, the county has $310 million of general obligation and lease debt which is seriously threatened by a possible bankruptcy filing. Bernstein owns none of this debt.

The county also has about $695 million of school warrants secured by a dedicated sales tax. Our research has found that under the special revenue provisions of the Chapter 9 Act, this debt should remain unaffected by a Chapter 9 filing, although there have been so few municipal bankruptcies over the years that the law in this regard is not completely settled. Bernstein clients currently hold a small amount—$765,000—of these school warrants in a few individually managed accounts, most of which mature in January 2013. Bernstein has not purchased any of these bonds in its short and intermediate duration mutual funds.

We believe the above description of Jefferson County's problems makes a compelling case that its situation is unique and not at all a precursor to a wave of municipal bankruptcies or defaults that will sweep the nation. In our view, as Jefferson County works through its problems over the next several months, amid what is likely to be a media circus, it will be increasingly important to remember that that it is not the proverbial canary in the coal mine. ■

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