ROCKFLEET financial services

Volume 1, Issue 39

MUNI MARKET UPDATE

December 6, 2010

INSIDE THIS ISSUE:

IS MUNICIPAL BANKRUPTCY AN OPTION?

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Introduction

Should an investor expect bankruptcies to swamp the municipal bond market? How would that differ from defaults? Will it be the Great Recession, or political activism to limit government and reduce taxes, that might bring about bankruptcy or default, or both?

Chapter 9 Bankruptcy

The Tenth Amendment to the Constitution states, in its entirety, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." States' rights continue to be debated, but what is clear is that municipalities are creations of the states and so governed by them, which makes each state unique as defined by its relationship to its local governments. This was clarified in 1934 when the Supreme Court ruled that Public Law No. 251, 48 Stat 798, legislation passed by Congress to provide for reorganization during municipal bankruptcy, was unconstitutional due to interference with the rights (some say sovereignty) of states. Congress then revised the legislation and enacted the Municipal Bank-

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MARKET UPDATE

The U.S. House passed the Democrats' plan to extend Bush-era tax cuts for middle-income taxpayers over the objections of Republicans, who say it would harm the economy by raising taxes for people with higher incomes. The vote would permanently extend lower rates and expanded tax credits on the first $200,000 of individuals' income and the first $250,000 for married couples. Taxpayers with higher annual income would face increased taxes on wages, capital gains and dividends. Republicans say they plan to block the measure in the Senate.

ProPublica aggregated the Federal Reserve's data on more than 21,000 loans and other deals it make through the three emergency programs designed to get banks and other financial firms to start lending again. See the interactive chart.

The final report of President Obama's bipartisan deficit reduction commission proposes to end tax-exempt interest for all new municipal bonds as part of a comprehensive effort to reform the federal tax code. "This would increase capital costs for governments, in particular small governments, and would dramatically reduce state and local government investment in needed infrastructure," said Susan Gaffney, director of the Government Finance Officers Association's federal liaison center. "Additionally, the proposal clearly violates the tenets of federalism, and similar to what occurred in 1986, would mobilize the state and local government community as well as other market participants to maintain the tax-exempt status of municipal securities."

A record amount of Build America Bond

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THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Monday, December 6						
11:00AM	1,685M	UR/NR	T/O Townsend	MA	2011-2017	BQ
Tuesday, December 7						
11:00AM	8,000M	UR/NR	T/O Lowell RZEDBs - TAXABLE	MA	2012-2030	
11:00AM	5,250M	NR/A+	Newburgh CSD	NY	2011-2023	
11:00AM	4,535M	Aa3/NR	West Seneca GO	NY	2011-2025	BQ
11:15AM	19,290M	NR/UR	Butler Area Sewer Auth	PA	2014-2034	BQ
12:15PM	28,500M	Aaa/NR	West Chester ASD	PA	2011-2022	
Wednesday, December 8						
11:00AM	11,700M	UR/UR	Stratford GO Series D	CT	2011-2030	
11:00AM	14,000M	NR/UR	Brick Twp Gen'l Impt GO	NJ	2011-2025	BQ
Thursday, December 9						
11:00AM	5,043M	NR/UR	T/O Dracut Series 2010A	MA	2011-2030	BQ
11:00AM	5,970M	NR/UR	T/O Dracut Series 2010B Rfdg	MA	2011-2022	BQ
11:00AM	8,177M	NR/UR	T/O North Attleboro GO	MA	2011-2025	BQ
11:00AM	6,600M	NR/AAA	Princeton Twp Genl Impt GO	NJ	2011-2022	BQ

Click here for calendar updates.

VISIBLE SUPPLY

30-Day Visible Supply

Negotiated: $14.274B

Competitive: $2.369B

Total: $16.643B

Week of Dec 6, 2010

Tax-Exempt: $7.23B

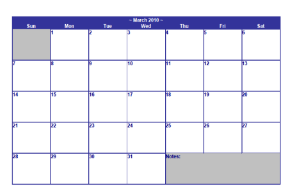
Taxable/BABs: $5.35B

Total: $12.58B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters.

ECONOMIC CALENDAR



MARKET UPDATE (CONT'D)

("BAB") issuance helped municipal market volume gush to $41.7 billion in November. Issuers are scrambling to use the BAB program and its 35% subsidy before its December 31, 2010 expiration. The program's future remains uncertain, although federal lawmakers have discussed the possibility of extending the program another year at a lower subsidy level. BAB issuance totaled $14.2 billion in November according to data from Thomson Reuters. That amount represents the largest monthly BAB issuance since the program's inception in April 2009.

Retail and conduit retail were relatively active in the intermediate to longer end of the curve as investors, back from the holiday-shortened week, were enticed by the increase in yields given the adjustment from the November low yields. Additionally, funds available from December 1, 2010 coupon payments and maturing bonds are being re-invested across the curve before year-end.

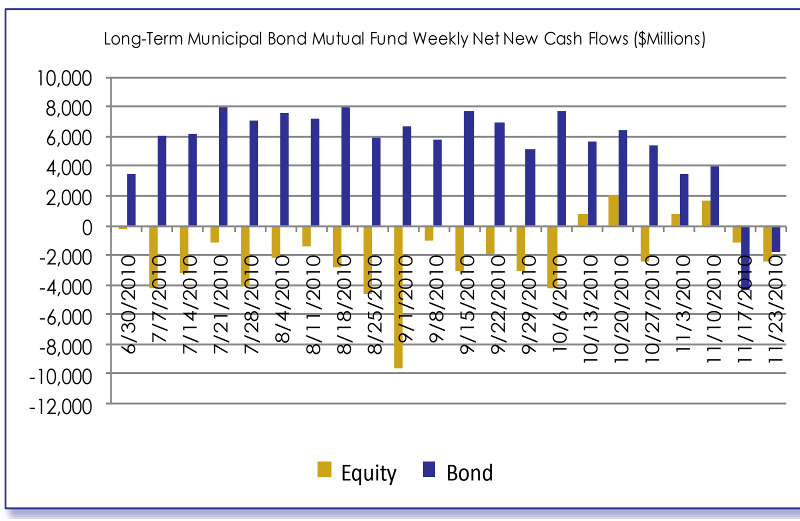
Rockfleet participated in last week's $367,295mm Empire State Development Corporation State Personal Income Tax Revenue Bonds Series 2010A transaction. Utilizing "The Navigator," Rockfleet's secondary trading analytical tool, the sales and trading desk was able to provide several buy-side accounts portfolio management trade ideas which led to orders, placed with the manager. ♣

MUTUAL FUNDS AND MONEY MARKETS

Long-Term Mutual Fund Flows

Total estimated inflows to long-term mutual funds were $2.94 billion for the six day period ended Tuesday, November 23, the Investment Company Institute reported.

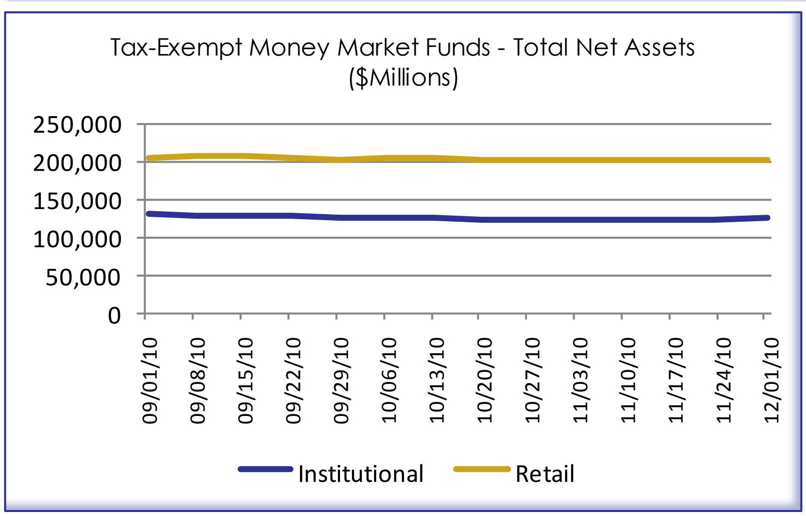
Municipal bond funds had estimated outflows of $3.07 billion.



Money Market Mutual Fund Assets

Total money market mutual fund assets decreased by $3.23 billion to $2.810 trillion for the week ended Wednesday, December 1, the Investment Company Institute reported.

Tax-exempt funds increased by $730 million. Assets of retail money tax-exempt market funds decreased by $1.79 billion to $200.89 billion. Institutional tax-exempt fund assets increased by $2.52 billion to $124.65 billion.♣



Source: Investment Company Institute.

IS MUNICIPAL BANKRUPTCY AN OPTION? (CONT'D)

ruptcy Act in 1937 (Public Law No. 302, 50 Stat 653). It has since been amended several times. It is limited to jurisdictions of a state, so states themselves are ineligible to file.

Title 11 of the United States Code ("Bankruptcy Code") defines a municipality as a "political subdivision, agency or instrumentality of a State." This definition is so generous it can be extended beyond villages, towns, cities, school districts, and counties to include fee based service districts such as public power, bridge authorities, highways, universities, and other special districts or created entities, such as housing authorities, health care facilities, special districts or industrial development agencies. Municipality will be used, therefore, as a general term for an entity permitted to issue bonds in the municipal market.

Unlike Chapter 7 of the Bankruptcy Code, which permits corporations to liquidate holdings to satisfy debts, and Chapter 11, which permits protection during reorganization, Chapter 9 only allows for debt adjustment. The courts are not permitted to dissolve a municipality and sell its assets. The municipality maintains full control over its operations, but may have a receiver appointed.

The process is complicated because, although a bankruptcy petition is governed by state law, the proceedings fall under federal courts. Since these proceedings are not part of the Constitution, federal courts cannot enforce actions on a municipality. The municipality must prepare a plan of adjustment. The court's actions are limited to approval of a petition, confirmation of a plan of debt adjustment and implementation. In a study called Chapter 9 by John H. Knox and Marc A. Levinson of the law firm Orrick, Herrington and Sutcliffe, a bankruptcy judge serves under Article I of the Constitution. A municipality can request a move to or appeal a decision to a District Court that serves under Article III. That court decides whether to take the case. As the authors of the study state, dismissal of a bankruptcy petition is a "nightmare" because it leaves the municipality without protection from its creditors. This raises the issue of preference, where one creditor attempts to supersede others in payment order.

Eligibility requirements are on a state by state basis, but in general require a municipality to secure permission from its state in order to proceed with filing a bankruptcy petition. This permission varies from state to state. Approximately half the states require legislative action to allow a municipal bankruptcy petition to proceed. Georgia and Iowa are among the twenty six states that prohibit municipal bankruptcy. New York and Pennsylvania put local units under a financial control board. Connecticut fought to deny Bridgeport's petition to file bankruptcy, but the court ruled that Home Rule gave implied permission to that city. The situation was different for Waterbury, where Connecticut enacted legislation to restore stability through the issuance of debt financing bonds. In the case of Central Falls, Rhode Island approved new legislation to set up a three step process which increased state intervention in local affairs and stripped municipalities of bankruptcy protection.

Typically, the municipality must demonstrate that it is insolvent, have a plan to adjust its debt obligations, and often is required to obtain the agreement of its creditors to such action. Then there is the issue of preference. Since many local obligations are under service contracts, where do bond holders rank in payment? Since 1934, only 616 municipalities have declared bankruptcy,

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UPCOMING EVENTS

Investment Management Network's 15th Annual Super Bowl of Indexing | December 5 – 8, 2010 | Phoenix, AZ

MSRB Municipal Securities Outreach Seminar | December 6, 2010 | Chicago, IL

Advanced Learning Institute: Social Media for Government | December 6 – 9, 2010 | Las Vegas, NV

Smith's Research & Gradings All-Star Municipal Analysts Program | December 8, 2010 | New York, NY

Standard & Poor's 2010 Leveraged Credit and Recovery Hot Topics Conference | December 9, 2010 | New York, NY

The Bond Buyer's 9th Annual Deal of the Year Awards | December 9, 2010 | New York, NY

Housing Trust Fund Corporation (NY) Board Meeting | December 9, 2010 | Webcast

Savader Asset Advisors' An Introduction to Municipal Securities and the Municipal Marketplace | December 16, 2010 | Webinar

More events...

IS MUNICIPAL BANKRUPTCY AN OPTION? (CONT'D)

Section 109(c) of the Bankruptcy Codes sets forth eligibility requirements for chapter 9. The entity —

(1) is a municipality;

(2) is specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;

(3) is insolvent, i.e., generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute or is unable to pay its debts as they become due;

(4) desires to effect a plan to adjust such debts; and,

(5) (A) has obtained the agreement of creditors holding at least a majority of the claims in each class that such entity intends to impair under a plan in a case under such chapter;

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

(C) is unable to negotiate with creditors because such negotiation is impracticable; or,

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of the Bankruptcy Code.

according to the Bond Buyer. Given variations in each state, there is not a large enough sample of petitions to generalize outcomes. The most significant cases may be informative. According to Chapman and Cutler LLP, there have been 245 municipal bankruptcy filings since 1980, but only 45 filed by actual municipal units; the others were special districts or health care facilities.

A significant distinction in a bankruptcy is in which state a municipality lies. In the case of Orange County, it was shown that California did not closely monitor its local units. Proposition 13 had recently passed, and this restricted the ability of local government to raise tax revenue, resulting in extreme fiscal pressure. There is now a similar movement nation-wide to reduce taxes and limit spending with austerity measures.

Indeed, the use of bankruptcy has now shifted to a possible tool used against union pension plans. In 2008, the City of Vallejo, CA filed for bankruptcy due to falling tax revenues and rising expenses. U.S. bankruptcy judge Michael McManus apparently determined that Vallejo has the authority to void existing contracts with its unions as part of its reorganization effort, according to The National Law review. However, there is disagreement over the ruling. The city's actual plan did not address pensions. In the opinion of attorneys involved in the case, it is legally possible for the city to reduce pension benefits if the current plan fails to restore solvency. Even if Vallejo does not attack union pensions, a path is open for other cities in California to do so. The municipal world may well see a number of bankruptcies, or the threat of bankruptcy, to renegotiate union contracts.

In contrast to California, the State of Michigan forbade the City of Hamtramck to declare bankruptcy. The state offered three alternatives: a low interest loan from the state, issuance of TANs or a fiscal stabilization bond. Hamtramck is out about $3 million, which it claims is owed to it by Detroit through a revenue sharing program. Detroit denies this, and the cities are in litigation.

Default

An event of default may be technical — an affirmative or a negative covenant is violated, or a debt services default — a late or missed interest payment. The municipal market has expanded into new sectors which do not carry a general obligation pledge of full faith and credit for those bonds. When derivatives were used in portfolios to secure some of these bonds, they were further estranged from municipality's general revenues.

Default can be cured without resulting in the insolvency of a municipality. Often, as in the case of Nassau County or more recently Erie County in New York State, the state

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IS MUNICIPAL BANKRUPTCY AN OPTION? (CONT'D)

can assert control over local finances to prevent defaults and avoid bankruptcy. Sometimes the state will create a special oversight authority, such as the Municipal Assistance Corporation ("MAC") for New York City, to manage the situation until fiscal health is restored. There was also the Moratorium Act, which for three years protected the city from litigation regarding its default on short term obligations. The recovery period for New York City was six years before it could issue bonds on its own, compared to eighteen months for Orange County, CA. to recover from bankruptcy and three years to regain an investment grade rating from Moody's in 1997.

A recent study by Moody's Investors Service, Inc. indicates that from 1970 to 2000, not one of 14,775 municipal issuers defaulted on general obligation bonds. Issuers with credit enhancement (insurance or a letter of credit) were excluded from the study. Likewise, there were no defaults from 1,894 water and sewer revenue issuers. For the 1,381 not-for-profit health care issuers there were ten defaults. Fitch, in its November 2010 publication, reports that over the past ten years the cumulative default rate for state and local government bonds ranged from 0.04% to 0.29%, including below investment grade rated bonds, for the three major rating agencies. According to a February 2010 report by Standard and Poors Corporation, of housing market bonds issued between 2005 and 2007, $2.23 trillion, or 68%, of original $3.39 trillion issuance, were downgraded. Defaults account for 9.6% and only 14%, or $451 billion, have been paid in full.

Enhancement

The bankruptcy of Orange County, CA in 1994 was a godsend for the bond insurance industry, which officially began with the issuance in 1971 of Greater Juneau bonds, but in reality in 1979 when both the Municipal Bond Insurance Agency (MBIA) and American Municipal Bond Assurance Corporation (AMBAC) were rated AAA (both now have speculative ratings). Orange County's action created panic in the market because it was a conservative suburb with a good economic base, not a small or speculative entity. It was also the first instance of the impact of

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Bond Insurer	Moody's	S&P	Fitch
ACA Financial Guaranty Corp.	Rating Withdrawn	Rating Withdrawn	Rating Withdrawn
AGMC (FSA)	Aa3 Negative	AAA Negative	Rating Withdrawn
Ambac Assurance Corp.	Caa2 Positive	R	Rating Withdrawn
Assured Guaranty Corp.	Aa3 Negative	AA+ Stable	Rating Withdrawn
Assured Guaranty Muni Corp.	Aa3 Negative	AA+ Stable	Rating Withdrawn
Berkshire Hathaway Assurance	Aa1 Stable	AA+ Stable	Not Rated
CIFG Assurance North America	Rating Withdrawn	Rating Withdrawn	Rating Withdrawn
Financial Guaranty Insurance Co.	Rating Withdrawn	Rating Withdrawn	Rating Withdrawn
MBIA Insurance Corp.	B3 Negative	BB+ Negative	Not Rated
Nat'l Public Finance Guarantee	Baa1 Developing	A Developing	Rating Withdrawn
Radian Asset Assurance Inc.	Ba1 Stable	BB- Negative	Rating Withdrawn
Syncora Guarantee Inc. (XLCA)	Ca Developing	R	Rating Withdrawn

UPCOMING EVENTS

New York State Thruway Authority/Canal Corporation Board Meeting | January 19, 2011 – 11:00 a.m. EST | Webcast

Smith's Research and Gradings State & Local Government Finance Conference | January 19 – 20, 2011 | Chicago, IL

Texas Municipal Utilities Association Annual Conference | January 20 – 21, 2011 | Fort Worth, TX

MSRB Municipal Securities Outreach Seminar | January 25, 2011 | Los Angeles, CA

Texas City Management Association William "King" Cole Session I | January 27 – 28, 2011 | Austin , TX

National Federation of Municipal Analysts (NFMA) Advanced Seminar on Utilities | February 3 – 4, 2011 | LaJolla, CA

Texas Municipal League Elected Officials' Conference | February 11 – 13, 2011 | Austin, TX

Texas Municipal League Legislative Briefing | February 14, 2011 | Austin, TX

The Bond Buyer's 15th Annual Texas Public Finance Conference | February 14 – 15, 2011 | Austin, TX

More events...

IS MUNICIPAL BANKRUPTCY AN OPTION? (CONT'D)

derivatives.

Credit enhancement has fallen on hard times, with financial distress experienced by MBIA and Ambac's parent company, Ambac Assurance Corp. The financial weakness of the insurers raises the question of the merit of their product, but also the high cost for such protection. New firms face high entry barriers in this field, since fee revenue is derived over the term of the insured bonds; therefore, there is little competition.

Risk

Risk can be categorized as credit, market or liquidity, among others.

Credit risk for general obligation bonds has historically been low. When municipal bonds were initially issued it was typically as a general obligation of the community, paid from a full faith and credit pledge of their total general tax income resources. Enterprise bonds had specific revenue pledges from the operation of a facility, such as a water or sewer plant, or parking authority. John Mitchell (who became Richard Nixon's attorney general) created the "moral obligation" bond which had no tied revenue stream to support it but merely the good name of the municipality. More recently new sectors have opened under tax exempt status, with housing and health care facilities the largest component.

Market risk can be influenced by economic data, bad news about a particular issuer or sometimes the category (such as the collapse of the mortgage market and falling housing prices). It can also be a result of interest rate changes or supply. Market risk may not be related to credit risk or reflect credit quality.

Liquidity for general market names is generally high, since they are widely traded, but small and local

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EMMA AS A DUE DILIGENCE RESOURCE

Effective Wednesday, December 1, the MSRB amended its continuing disclosure service, EMMA, to reflect amendments to SEC Rule 15c2-12. The Rule now requires the following enhanced reporting:

- Inclusion of variable rate demand and other demand securities;
- Submission of notices of certain events within ten business days;
- Eliminates the general materiality condition for certain of the Rule event notices;
- Expands tax event notices:
  - ⇒ Adverse tax opinions;
  - ⇒ The issuance by the IRS of proposed or final determinations of taxability;
  - ⇒ Notices of Proposed Issue (IRS Form 5701-TEB), or other material notices, determinations or material events with respect to the tax status of the security;
- Conversion of formerly voluntary event-based disclosures to mandatory event notices:
  - ⇒ Tender offers;
  - ⇒ Bankruptcy, insolvency, receivership, or similar event of the issuer or obligated person;
  - ⇒ The consummation of a merger, consolidation or acquisition involving an obligated person or the sale of all or substantially all of the assets of the obligated person, other than in the ordinary course of business;
  - ⇒ The entry into a definitive agreement to undertake such actions, other than pursuant to its terms, if material; and,
  - ⇒ The appointment of a successor or additional trustee, or the change of name of a trustee, if material.

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IS MUNICIPAL BANKRUPTCY AN OPTION? (CONT'D)

issuers may face obstacles when issuing and are thinly traded if at all. Bond holders may have no choice but to hold these investments to maturity. Outside events can also influence liquidity, and combine with market risk to depress the value of a bond, because perception is critical to valuation. Tenuous connections, such linkage of U.S. municipal bonds with European sovereign bonds, can create a liquidity risk.

Conclusion

Municipal defaults may occur as a result of the Great Recession, but will most likely be in housing and health care or other sectors which are dependent upon specified revenues or fees. It is less likely that there will be an abundance of municipal bankruptcies. Those that do occur will either be in the above sectors or municipal entities that experience severe economic or political stress.

Combined with a poor economy, the impact of exotic securities on portfolios and rising pension fund costs may combine to be a "perfect storm" for municipal bonds. The possibility of politically motivated actions to reduce tax revenue or to review municipal pension plans or contracts as part of a purported fiscal responsibility plan will raise concern in those states, such as California, that have a loose relationship to their local units. ♣

Louise Gantress is a contributor to Muni Market Update. The opinions expressed are her own.

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