[Bond Case Briefs]

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[S&P: Stockton Judge's Pension Comment to Have Modest Influence on U.S. Municipal Bankruptcy Filings.]

SAN FRANCISCO (Standard & Poor's) Oct. 2, 2014–U.S. Bankruptcy Judge Christopher Klein's statement on Oct. 1 that a final plan of adjustment for Stockton, Calif. to exit bankruptcy protection can include reduced payments to the California Public Employees Retirement System (CalPERS) could increase the appeal of bankruptcy for some distressed municipalities, but Standard & Poor's Ratings Services expects overall municipal bankruptcy filings to remain rare.

More pertinently, will the theoretical ability to reduce pension costs (with many legal uncertainties to be navigated and litigated) induce a significantly larger number of local governments to enter bankruptcy? In short, we believe the answer is no. However, the statement by Judge Klein, of U.S. Bankruptcy Court for the Eastern District of California, could prove meaningful for a very small portion of distressed municipalities nationwide as they contemplate potential avenues to address mounting budget and liquidity pressures with little room to navigate.

Judge Klein's decision also highlights the uncertainties that municipalities and their stakeholders face in the interaction between state and federal laws in bankruptcy. Our observation is that many Chapter 9 municipal bankruptcy cases are settled without creating legal precedent. Judge Klein has not ruled yet on Stockton's proposed plan of adjustment. However, we believe that he signaled that the city could propose (although to date, it has not) as part of its future exit from bankruptcy cuts to pension contributions with unclear effects on what benefits retirees would receive. This could prove meaningful for some municipalities considering bankruptcy. The implicit outcome, however uncertain it may be, could help frame their negotiations with employees on potential changes to retirement benefits as partial solution to mounting budgetary pressures.

In practice, however, we believe any material benefits to a municipality's credit quality from Judge Klein's statement are likely to be quite muted. There are several reasons for this.

First a bankruptcy filing is necessary but not sufficient for a municipality to abrogate its employee contracts under the judge's statement. Second, we believe the bankruptcy process is the start of a negative campaign that once underway puts the municipality in question immediately and substantially in a distant place from its peers in regard to popular perception, market access, and viability of long-term provision of services.

In our view, municipal bankruptcy continues to carry a substantial stigma because it signals that management has abdicated its role as a steward of a community's financial resources and sets in motion what is often a long and costly process. Moreover, the likely negative effects of bankruptcy on a community's long-term economic growth prospects can further impair the municipality's ability to recover financially. Standard & Poor's laid out these negative effects in more detail in the article, "Detroit's Bankruptcy Filing Is Becoming A Long And Costly Row To Hoe," published Dec. 3, 2013. We continue to believe that very few obligors would seriously consider bankruptcy as an option in a large and broad municipal market.

Although we have witnessed three California cities, including Stockton, file for bankruptcy protection in the past five years, we believe that credit quality in the state is stable overall, with most California cities having shown the ability to make difficult budget adjustments during the Great Recession to bring expenditures in line with revenues.

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