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California Guards Muni Buyers From Bankruptcy With Dibs on Taxes.

San Diego Unified School District didn't think it was fair that rating companies cut its bond grades amid California's fiscal woes four years ago.

So school officials cultivated support among other California districts for legislation boosting protection for investors. Their efforts bore fruit last month, when Governor Jerry Brown signed into law a measure clarifying that tax revenue backs the general obligations of schools, cities and other local issuers. San Diego's system, the state's second-largest after Los Angeles, wants the step to boost its credit rank and lower debt costs.

While rating companies haven't acted on the law, investors have taken notice. The extra yield that buyers demand on some San Diego school debt has shrunk to the lowest in more than three months. Bonds of the Los Angeles Unified School District have also gained. Even though the issuers are solidly investment grade, bondholders welcome the added security after Detroit's record bankruptcy and as Puerto Rico moves toward a historic restructuring.

"It eliminates a lot of uncertainty in the market," said Frances Lewis, director of research in Princeton, New Jersey, at MacKay Municipal Managers, which oversees $13 billion.

Lien In

The law, which takes effect in January, specifies that voter-approved general obligations of school districts and municipalities are backed by a lien on property-tax revenue. While California statutes could be read as having that protection, it wasn't explicitly stated. This would "solidify" prioritizing holders of the bonds, Michael Zezas, chief municipal strategist at Morgan Stanley in New York, said in a July 27 research note.

General obligations from California issuers excluding the state total around $131 billion, according to data compiled by Bloomberg that includes the full value of zero-coupon bonds at maturity.

The San Diego district has about $2.3 billion of general obligations, according to bond documents. In 2011, amid talk of state funding cuts, Moody's and Standard & Poor's lowered the district one step. It's now graded Aa3 and AA-, fourth-highest, respectively.

The downgrade "wasn't warranted" since property-tax revenue goes directly to debt payments, said Jenny Salkeld, chief financial officer for the system, which educates about 132,000 students.

Holy Upheaval

School officials began a push to clarify protections for investors, which gained importance after Detroit's 2013 bankruptcy upended a pledge once held sacrosanct: that communities would make good on debt backed by their full faith and credit.

Amid Detroit's debt negotiations, investors demanded higher yields on some securities from Michigan. Even in California, some districts saw annual interest rates rise as much as a percentage point, said James Spiotto, managing director in Chicago at Chapman Strategic Advisors LLC, which advises on financial restructuring.

For Mark Wuensch at Principal Global Investors, the new law provides limited comfort: It may not matter how secure investors' standing is when a community is struggling. Cash-strapped Puerto Rico temporarily halted monthly transfers into a fund that pays down $13 billion of general-obligation debt, it said in a regulatory filing late Monday.

"The ability to pay is a lot more important than what the law is," said Wuensch, senior fixed-income analyst in New York at Principal, which manages $4.8 billion in munis. "You can only tax people so much."

Ratings Shrug

Credit raters say they don't expect the law to result in many upgrades. It won't guarantee timely debt payments or prevent defaults for issuers in economic distress, the companies said.

The district's advisers said the companies have been too hasty. Mary Collins, a partner at Orrick, Herrington & Sutcliffe LLP, said she plans to explain the law's significance to analysts and that they should give it a "lot more credence."

For San Diego's schools, an upgrade to the top rank could save 0.20 percentage point, or as much as $30 million for the $525 million borrowings planned next year, said Mark Young, managing director at KNN Public Finance, which advises the district.

Bond Bounty

San Diego school obligations due in July 2029 traded July 27 at an average yield of about 3.2 percent, or 0.41 percentage point above benchmark munis, data compiled by Bloomberg show. That's the narrowest spread since their sale in April.

Los Angeles Unified general obligations due in July 2026 traded Tuesday with an average yield spread of 0.24 percentage point, below the 0.37 percentage point average since February. Moody's grades the district Aa2, third-highest.

A clear definition of investor protections has also benefited Detroit. The city garnered an investment grade from S&P for a bond sale planned for this month, its first since exiting court protection in December, partly because of a specified first-lien pledge on income-tax collections.

Michigan and Nebraska are also working on laws establishing a statutory lien on general obligations, Spiotto said.

"The municipal market has needed more clarification on this since previously there hadn't been that many bankruptcies," said Lewis at MacKay. "It became much more important to look at what the definitions are."

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