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7 Things You Must Do If Your Municipal Bond Defaults.

For all the dramatic headlines of financial disaster facing municipal bond issuers due to the coronavirus, when a bondholder gets a notice of default, it is general a pretty dull affair. The wording, usually a series of paragraph-long sentences dense in legalese, states something along the lines of "Notice of Nonpayment of Principal" or similar such language. The actual word "default" may not even appear anywhere in the document.

But in fact, that is what it is. When you, the investor, purchased the bond, you were extending a loan. The borrower covenanted to repay you with interest and return your principal at maturity. Now they are not. That is a default.

Advice For Investors

With hands on experience across several municipal sectors and project financings on all facets of defaults, workouts and restructurings—from testifying in U.S. Bankruptcy Court to serving on Creditor's Committees—let me offer some general advice.

Individual Investors: Find a financial advisor that is expert in municipal bonds. Thinking you can manage your way through a municipal bond default on your own is akin to thinking you can be your own lawyer. Either way, you have a fool for a client.

Financial Advisors: For financial advisors who have never had the pleasure of working through a municipal bond default, be prepared for the inevitable client questions. And those questions are going to come when statements go out showing that month's interest checks are a little light.

Institutional Investors: As an institutional investor in an analyst or portfolio manager role, if this is your first time at the municipal bond default rodeo, rope in a colleague who has been through one or many of these. Having a knowledgeable guide will save a lot of time and possibly your career. If you have been through one, grab a colleague who hasn't so they can learn the ropes. More of these are coming, they are very time consuming, and you'll need all the help you can get.

Now What? Next Steps

1. Be Proactive and Practical

Regardless of who and where you are in the capital stack, the most important thing is to be proactive and practical, notes Rick Frimmer, counsel at the law firm of Schiff Hardin. An acknowledged expert in this complex field, he has represented and advised to numerous clients, both lenders and borrowers, going through financial distress of nearly all degrees. "Get out ahead of it and don't wait until the last minute to act," he states. That goes for borrowers as well as bond holders.

2. See Which Way You Lien

Go to EMMA and download the final Official Statement. (Hosted by the Municipal Securities

Rulemaking Boards, EMMA, short for Electronic Municipal Market Access, is the central repository for information on nearly every municipal bond issued.) Start carefully reading all those sections you might have only skimmed initially about bondholder approval, additional debt, covenants, debt service reserve fund, and in particular, the security provisions.

Suddenly all that "boiler plate"' wording is going to get a lot more interesting. Perhaps it is only a covenant violation. The issuer could not cover debt service by the amount set in the bond agreement. This may require a simple waiver or forbearance agreement.

But on true cash defaults, when debt service wasn't paid, that gets serious fast. You want to find out what your security is to protect your investment and enforce your rights. You'll quickly learn there is a big legal difference between a first mortgage lien and a pledge to pay debt service. A first mortgage lien gets you a seat at the adult table. An unsecured lien gets you a seat at the kids table. Maybe. Pledge? Pledge is brand of furniture polish, not a lien.

3. Be Nice to the Bond Trustee

Prior to a default, most investors don't even know who the trustee is much less what they do. Ginny Housum, a senior vice president and bond trustee at UMB Bank, understands. The usual role of the trustee is to receive and distribute funds in the payment of debt service.

But post-default, the world changes immediately. The bond trustee becomes a fiduciary of the bond trust, charged with acting under the "prudent person" rule. In this role, responsibilities now might involve identifying bondholders, keeping the marketplace informed by posting notices on EMMA and Bloomberg, soliciting direction from investors on selection of counsel and financial advisor, and act on direction of the investors, among other things as might arise.

The role can become complex. Housum notes solutions are not so simple. For example, when there are solely retail bondholders, identifying them and getting majority approvals can be challenging. When bondholders disagree on direction can also present issues. Often disagreement can arise when money must be dispersed from the trust to preserve bondholder assets but not be paid to the bondholders, such as for taxes.

4. A Declaration of Independence

Quickly assembling a good, independent legal and advisory team can expedite a solution preserving cash and assets as well as getting the business back on sound footing. Frimmer adds another important aspect. An independent team brings an unbiased viewpoint on finances, operations and legal matters. He takes care to point out, "like mediation—all parties get a fresh perspective on the possible outcomes."

Another benefit, often unspoken but equally important, is that an independent third party can offer cover to deliver bad news. Stakeholders might otherwise be unable or unwilling to broach a less than optimal result to their respective chains of command. The same news, coming from independent experts, transfers ownership and offers objectivity.

5. Take Up (Financial) Modeling

Any number of events can cause a bond to default. However, the financial outcome is pretty much the same: not enough money in the bank to pay all the bills. Or, as one wag put it, "too much year at the end of the cash flow."

The best thing you or your financial advisor can do is create a cash flow model detailing all the

components and the assumptions behind them. This model will frame the analysis for and drive the decision making of every workout solution proposed. It will rapidly become a beacon of truth. No matter how vociferously a stakeholder may advocate for their particular solution, if it cannot demonstrate sufficient cash flow to pay all expenses, it is dead on arrival.

6. Beware the Conservative Projection

Niels Bohr, Nobel-prize winning physicist, is credited with the saying “Predictions are very difficult, particularly about the future.” During a workout, inevitably you are going to hear someone declare that their projections “are very conservative.”

There is one sure-fire test that measures conservative. Cut every assumption behind those projections in half, then double the time to reach them. Now see how that works in your cash flow model. What you want is not a conservative projection, but a realistic projection. Keep in mind the original financing was based on “conservative projections.” How well did that work out?

7. De-Stress the Distressed

Workouts are stressful. No one wants to be involved in one. It’s a lousy situation. Most often, everyone takes a hit. People are not at their best. There are countless conference calls, proposals and counter-proposals, extension deadline filings. Emotions run high. Deal fatigue sets in. Simple matters can get contentious and stakeholders adversarial in the heat of the moment.

For the best outcome with the least stress, stay focused on finding the best solutions, be realistic as to time frame and expectations, don’t take things personally, and be flexible when considering options.

The Last Step

Through all this, remember why you made this investment in the first place. You likely wanted a steady stream of tax-exempt income and to preserve principal. As you evaluate different solutions, stay focused on those most likely to continue to generate that tax-exempt income and return of principal. It might not be at the 100% you initially expected. But better to come out partially whole than either a rushed solution that leaves you back where you started in a few months or a scorched-earth solution leaving you with nothing at all.

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