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Traditional Municipal Bond Concepts and New ESG Concepts Collide in a Village Outside of Chicago: McNeese

The world of municipal bonds tends to be conservative in nature and slow to change. The ESG movement (environmental, social, governance) presents a new way of looking at things that can cause confusion and even shock when it bumps up against traditional concepts. This was the case in the municipality of Bolingbrook, an Illinois village 36 miles southwest of Chicago.

A municipality's ability to incur debt generally is governed by state law. The security pledged by the municipality in support of the debt will vary, but commonly will fit within one of the following categories:

General Obligation Bonds. Often issued to finance general capital projects such as roads, bridges and public buildings, general obligation bonds are backed by a pledge by the municipality of its "full faith and credit" and a pledge of its taxing power. In an event of default, bondholders may ask a court to force the municipality to use its general funds, or to raise its real estate taxes, in an amount sufficient to pay the bonds.

Limited Tax or Revenue Bonds. Often issued to finance specific commercial or industrial development, such as a shopping mall or public utility infrastructure, limited tax or revenue bonds are secured by a pledge of only the revenues derived from a specific tax or revenue source. In an event of default, bondholders are limited to seeking repayment from the tax or revenue stream that was pledged by the municipality.

As an outgrowth over concerns about climate change and the general environmental health of the planet, the securities business, which is always concerned with risk, wants environmental risks to be analyzed and disclosed in connection with the sale of securities. Many investors are concerned not only with these risks but also with whether the issuer of securities is using the proceeds of the securities to undertake environmentally beneficial projects. For other investors, socially responsible investing has become a key component of their portfolios. These concerns have resulted in the development, first in Europe and now in the United States, of "ESG" concepts – investing with an eye toward environmental, social and governance impacts.

A full discussion and analysis of ESG is beyond the scope of this article. But, a few key points to keep in mind: first, ESG is not specifically defined – efforts to do so are ongoing, including by securities regulators. In the meantime, many concepts, some sound and some less so, have found their way under the ESG umbrella. Second, ESG has become a political football. From the right are claims that ESG is just an excuse for advancing progressive goals and will result in lower returns for investors. From the left are claims that the right is smearing ESG as a means to avoid favored industries being held to account for the environmental impacts of their businesses. Third, as amorphous as the environmental concepts are, the social and governance concepts are even more so.

With the understanding that ESG remains in flux, let's look at what happened to Bolingbrook. In 2005, the Village issued it $47,715,937.70 Sales Tax Revenue Bonds, Series 2005 (the "2005

Bonds"). The 2005 Bonds were issued to finance a commercial and retail development featuring well-known retail and commercial stores. While the Village has issued general obligation bonds over the years, and carried a very high "AA" credit rating from S&P on those bonds, the Village issued the 2005 Bonds as limited tax revenue bonds, secured solely by the sales tax revenues generated by the stores located in the development. The 2005 Bonds were not backed by the Village's full faith and credit, and did not carry a rating from S&P or any other rating agency.

The 2005 Bonds were clearly marketed and sold as limited obligations with a higher degree of investment risk. The Limited Offering Memorandum dated December 14, 2005, pursuant to which the 2005 Bonds were sold, states in several places that the 2005 Bonds are limited obligations of the Village payable only from the specific home rule sales tax revenues pledged to secure the 2005 Bonds, and that neither the full faith and credit nor the general taxing power of the Village is pledged for the payment of the 2005 Bonds. It goes on to state that the 2005 Bondholders do not have the right to compel the exercise of any taxing power of the Village, other than the pledge of the home rule sales tax.

The project did not generate the anticipated level of sales tax revenues to pay debt service on the 2005 Bonds. As a result, the Village defaulted on the payment of the 2005 Bonds. The Village did not default on its general obligation bonds, which continued to be paid as and when due.

On January 26, 2023, S&P, in response to the 2005 Bonds default, downgraded the Village's rating on its general obligation bonds by seven notches, from "AA" to "BBB-". Why would S&P dramatically downgrade the Village's general obligation bonds, when the Village had not defaulted on their payment and had no legal obligation make up the difference on the amounts owed on the 2005 Bonds?

From the viewpoint of traditional municipal bond concepts, however, this downgrade doesn't make sense. The 2005 Bonds were sold with a structure under which the debt was payable solely from one source – the sales tax revenue. The risk was obvious and well-disclosed to potential purchasers that that if the sales tax revenues were insufficient, the debt service would not be paid. The Village has no legal obligation to use other revenues to pay this debt. S&P does not claim that the Village has a legal obligation to do so.

S&P's justification for the downgrade lies in its ESG approach, specifically, the governance component. S&P noted in its report accompanying the downgrade that "the lack of action from the village to address the default … is a risk management, culture, and oversight weakness under governance risk in our environmental, social, and governance framework." S&P further stated in the case of such a determination, it will cap the issuer's rating at BBB-.

S&P also emphasized in its report that the Village's "financial profile remains very strong, supported by strong annual operating surpluses backed by a very strong fund balance and liquidity position. Additionally, the village has an overall growing tax base that is benefiting from its location in the Chicagoland metropolitan statistical area (MSA)." In other words, the Village is a rich municipality which can afford to make the payment from non-sales tax revenues, therefore it should make it even though it is not legally required to do so. S&P also criticized the Village for "taking on a financing that it would not support in the event of a default."

S&P's downgrade determination raises many questions and concerns for other municipalities that have issued limited tax revenue bonds in addition to their general obligation bonds. Are additional disclosures now required when such municipalities issue general obligation bonds? And, for that matter, what would such a disclosure look like?

We may soon see offering documents that contain a statement similar to the following: “In addition to its general obligation debt, the issuer from time to time issues limited obligation debt. It is possible that, at some point in the future, the issuer’s general obligation bonds may be downgraded because of a payment problem with the limited obligation debt. This may be particularly true if the issuer holds a substantial rainy day fund and is otherwise doing well financially.” As nonsensical as this may sound, recall that the Village’s rosy financial picture was cited as a contributing factor for the downgrade.

Finally, from a very basic viewpoint, it is worth questioning what really is “good management” by a municipality. For Bolingbrook, “good management” (at least in S&P’s view) meant paying debts that the Village was not legally obligated to pay. However, is it reasonable for a governing body elected by (and accountable to) the citizenry to use those citizens’ tax dollars to pay limited obligation debt intended to benefit retail and commercial stores? And, for that matter, is it reasonable to expect an employee to recommend that such a non-required payment be made?

If “good management” is instead defined to mean proper stewardship of the public coffers, we think many municipalities would choose to follow Bolingbrook’s approach.

by Timothy J. Horstmann and David Unkovic

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