Gurtin Municipal Bond Management

Municipal Credit Research Report

FAQ: Rhode Island's Near Repudiation of 38 Studio Bonds

March 2015

Rhode Island recently considered repudiating their 38 Studios appropriation debt. Gurtin Municipal Bond Management has no exposure to that series of debt; however, we have followed the situation closely given that there is no modern precedent for a State to default on a direct debt obligation since Arkansas during the Great Depression.

During the two most recent budget cycles, the State of Rhode Island considered not appropriating the funds to pay debt service on a series of bonds backed by its moral obligation pledge. The highly public nature of the project, which financed a video game development company founded by former baseball player Curt Schilling, the company's bankruptcy, and the State's reluctance to fulfill its pledge to bondholders have generated widespread headlines. Gurtin Municipal Bond Management has never held any exposure to the bonds in question.

The case of Rhode Island is noteworthy since the repayment of a state obligation, regardless of security, had rarely been so tenuous. It is without precedent for a state government in the modern municipal bond era to force bondholders to wait until the final hour to find out if they will be paid. Since the decision to appropriate funds to pay these bonds will likely be an annual issue for the State, we wanted to publish the following Frequently Asked Questions to highlight both the facts surrounding the 38 Studios case and why Gurtin Municipal Bond Management avoided exposure to this debt given a number of analytic red flags we uncovered well before the situation began to unravel.

What Did Rhode Island Vote On?

As part of its Fiscal 2014 and Fiscal 2015 budgets, the Rhode Island Legislature provided for the payment of the Rhode Island Economic Development Corporation's (RIEDC) Job Creation Guaranty Program Taxable Revenue Bonds (38 Studios, LLC Project), Series 2010. The most recent budget allocated $12.5 million – an amount equal to the debt service on the bonds for 2015.

What Was The Purpose Of The Bonds?

In 2010, the State created a $125 million loan program for the Economic Development Corporation to encourage high wage job growth in the sciences, technology, digital media, and other innovative technologies. During the summer of 2010, the Corporation issued $75 million of bonds against the $125 million total authorization, to loan to 38 Studios LLC (a startup video game manufacturer) to relocate their operations from Maynard, MA to Rhode Island.

What is the Security of the Bonds?

The Series 2010 bonds were expected to be repaid by 38 Studios in monthly installments, but in the event of an insufficiency, the RIEDC was directed by statute to request that the State legislature appropriate the amount required to fully repay bondholders. Such an arrangement did not constitute a general obligation of the State, nor was it a lease. There was no legal commitment whatsoever on the part of the state to cure any deficiency.

While not a legally binding pledge, the enabling statutes make clear that the State's intent was to use its resources "to induce lending to companies growing their employment in Rhode Island", acknowledging, "that companies in growth phases are limited in their ability to obtain reasonable credit without access to credit enhancement". The resultant pledge by the State is what is known in the municipal market as a moral obligation – a pledge by a guarantor (Rhode Island in this case) to stand behind the bonds to increase their marketability. Though there is no legal requirement for the State to make payment, and no sanction can be imposed in the event they fail to honor their commitment, the market views such a pledge as an implicit obligation of the State.

Why Was There Such a Close Call?

After relocating to Rhode Island, 38 Studios released only a single product to mixed reviews, and by June 2012, had laid-off its staff, and filed for Chapter 7 bankruptcy protection. That the company failed was not in of itself an unusual occurrence, and would have been a footnote in the annals of failed economic redevelopment efforts absent the State's recent debates but for Rhode Island's moral obligation pledge.

What makes this occurrence unusual is that the enormous resistance to honor the moral obligation rose well above the traditional political banter typically surrounding economic development projects.

Since the failure of 38 Studios, pressure increased dramatically on lawmakers to disavow the debt, and allow for it to default. That the company was founded by a famous and outspoken athlete, Curt Shilling, only added to its visibility, and heightened public awareness and media coverage.

The debate turned fractious with different State officials openly clashing: The Governor and then-Treasurer (now the current Governor) both advocated for repayment (though each had opposed making the loan in 2010), arguing failure to pay would do irreparable harm to the State's credit and reputation. Various elements of the legislature who felt the project had questionable value and supporting payment would encourage future dubious projects opposed honoring the State's moral obligation. The vocal opposition suggested that promises were made by policy makers without the legal authority to do so, and argued that funds earmarked for debt service would be better spent elsewhere.

The situation became so discordant that a Finance Committee hearing was held to discuss the deleterious effects of not honoring the Moral Obligation – something extraordinarily rare and unsettling for a state to even have to discuss. The inclusion of debt service did pass through the Finance Committee and ultimately the full legislature, but throughout the entire process, there was never a forceful, unified, and unambiguous message on the part of the State that they recognized the commitment.

Isn't disagreement about budgetary priorities normal?

Yes. However, debt repayment is not viewed as optional. While other items compete for a government's resources, debt service, regardless of legal pledge, is not expected to be up for debate at the state level.

Additionally, the intensity of the deliberations evoked a significant amount of confusion. Some contended that since voters were not asked, and did not approve the bonds, it was an unenforceable obligation. Such a claim displays a total misunderstanding of the nature and market interpretation of a moral obligation. Those advocating repayment never asserted that it was a binding commitment, but given the nature of the pledge, the State implied it would backstop the bonds if it had the means to do so.

Were there red flags?

Yes. Notwithstanding the unprecedented nature of events, there are several elements which Gurtin Municipal Bond Management identified as analytic red flags that led to our avoidance of the bonds in question. Our Credit Research philosophy requires a thorough analysis of not just the obligor issuing the debt, but also of the security that is being utilized. Gurtin Municipal Bond Management maintains that a granular understanding of each security is imperative to understanding credit risk regardless of the name or pledge of the issuer or obligor. To truly understand the risks carried by a particular security, it is imperative to understand the mechanics of the security, the obligor's comfort with that security, the project being financed, and even the political environment surrounding the financing. Below is a list of the numerous red-flags that our Credit Research team noted early and used to avoid exposure to the bonds:

- The moral obligation pledge of Rhode Island wrapped a speculative corporate obligation – therefore, we were uncomfortable with the underlying security that provided bondholders with a primary repayment source and believed it had an elevated likelihood of failure.
- The purpose of the borrowing was relatively far from a state's core function.
- Though the bonds received broad approval by the legislature, the project itself was controversial from the beginning, with many questioning the wisdom of placing the State's appropriation pledge on $125 million for a single company.
- As the deal was being finalized, the state treasurer attempted to block it by asking Moody's and S&P not to review the bonds.

What would the consequences of a default have been?

If the State had chosen to default it would have been an unprecedented event. There has not been a state default on any obligation since the Great Depression. Even more extraordinary would have been the fact that, unlike the last state default (Arkansas in 1933 due to overleveraging), this would have been an outright repudiation of the debt. Consider:

- Maximum annual debt service on the bonds is $12.5 million per year, relative to a $5.3 billion General Fund budget. The State clearly had the financial means to fulfill its obligation
- The authorizing language of the loan program used very specific and telling language. The statute created a program directing the RIEDC (itself a creation of the legislature) to make loans for economic development purposes, and if needed, come back and petition them (the legislature) if funds were required to meet the obligations of RIEDC. Such a promise was described by the State as an "enhancement", the absence of which, would not likely allow for capital market access for loan recipients. Thus the State deliberately made representations it would stand behind the debt to help facilitate the bonds' marketability.
- The exact language typically seen for a moral obligation can vary, and there is a wide spectrum of strength. (See our report "Gurtin Municipal Bond Management's Approach to Moral Obligation Pledges" for further discussion of how such bonds are treated analytically. Regardless of the language, no state in the modern era has defaulted on their appropriation debt.

Though the State commitment is not legally binding, its intentions were quite clear, so for a lawmaker to be quoted saying "I can't believe anyone bought this stuff,"[1] shows a willful repudiation. Had a default occurred, since there is no precedent, it is unclear if the market reaction would have been muted or significantly damaging, or how the rating agencies would have reacted.

- **Bondholders:** Strictly from a monetary point of view, we believe the impact of a default on bondholders probably be minor because the Bonds are wrapped by insurance. Therefore, assuming the insurer remained solvent at the time of the default, the end bondholder would probably have been made whole, with the insurer left to pursue the State using whatever limited remedies were available. Additionally, the total amount of debt in question ($96 million including interest payments)

[1] "Rhode Island House GOP Leader: Don't Pay 38 Studios Bonds," The Bond Buyer (June 20, 2013)

pales in comparison to the multi-trillion municipal market as a whole.

- **Rating Agencies:** Rating agencies have not had to opine on a state default in the modern era (defined as post Great Depression when government bankruptcy first came into existence). There is no historical experience on what type of action would be warranted on the State's general obligation and lease appropriation ratings (which were not threatened to default), and further, no guidance on how the State could repair their credit rating once downgraded. What is clear, however, is the rating agencies would likely have had to take actions on all the various State securities, not just the moral obligation bonds in question.
- **Capital Markets:** How the capital markets would respond is another difficult question. It is almost certain that misunderstanding, misreporting and general confusion would be rampant in the early phases, potentially causing spreads on all state debt to widen. How wide and for how long would depend on how the market generally viewed the default. If it was seen as an isolated incident that was part of a misguided economic development project that went wrong, there would likely only be mild and contained consequences. If however, the market viewed this as a confidence shattering event, the consequences could cascade into a wider and far more damaging experience. In addition to the State's own debt being punished, borrowing penalties for local governments within the State could be imposed in the form of higher interest rates on their bonds. Scrutiny on all moral obligation bonds issued by other governments in other states would also likely be intensified. The ripple effect throughout the market is very difficult to quantify, but we believe it could have been more far-reaching than many may appreciate.

Conclusion

The fact that Rhode Island came close to disavowing its moral obligation is noteworthy given the seventy year absence of a state default, somewhat disconcerting given how late in the process repayment was finally agreed upon, and clearly illustrates how misunderstanding and confusion can erupt, given the rhetoric of both the public and lawmakers.

Gurtin Municipal Bond Management is committed to always achieving a granular understanding of both an obligor's overall health and, just as importantly, the nature and intricacies of the underlying security and nature of any obligation. Without a thorough understanding of the security an obligor is pledging, investors cannot truly understand the risk to which they are exposed. In our opinion, assuming that all securities are created equally and all moral obligations pledges are the same exposes clients to risks such as those recently posed by Rhode Island's alarming debate on whether to pay its debt.

Please feel free to contact us at research@gurtin.com for additional information.

Check out our Twitter @followGurtin and LinkedIn for news, information, and market updates.

Share the report:

Analysts:

John Humphrey
Senior Vice President, Co-Head of Research
jhumphrey@gurtin.com

Michael Johnson
Managing Partner
mjohnson@gurtin.com

Important Disclosures

The contents of the report are for informational and educational purposes only. Each investor should make his or her own investigation and evaluation of the investments including the merits and risks thereof, and this report should not be construed as investment, tax, financial, accounting or legal advice. Gurtin Fixed Income Management, LLC, doing business as Gurtin Municipal Bond Management ("Gurtin") is a registered investment adviser with the U.S. Securities and Exchange Commission (the "SEC").

The analysis contained herein is based on the data available at the time of publication, certain assumptions, that if different could result in different outcomes, and the opinions of Gurtin. The opinions and information stated and relied upon herein may become outdated, change, or otherwise be superseded at any time without notice. Certain information contained in this report is based upon third party sources, which Gurtin believes to be reliable, but are not guaranteed for accuracy or completeness. Neither the SEC nor any other federal or state agency or non-U.S. commission has confirmed the accuracy or determined the adequacy of this document. Any report to the contrary is unlawful.

Each investor should inform himself or herself as to the tax consequences of the investments and services described herein. Clients should have the financial ability and willingness to accept the risks associated with the investments made by Gurtin. Gurtin reserves the right to modify any of the terms described herein.

No assurance can be given that the investment objectives will be achieved or that investors will receive a return of any capital. In considering any prior performance information, historical or hypothetical, contained herein, clients should bear in mind that prior performance does not guarantee nor is it indicative of future results. Performance includes the reinvestment of all income. Therefore, no current or prospective client should assume that the future performance of any specific investment or investment strategy (including those undertaken or recommended by Gurtin) will be profitable or equal to corresponding indicated performance levels.

Each recipient of this report acknowledges and agrees that the contents hereof constitute proprietary information that Gurtin derives independent economic value from. The recipient further agrees that the contents of this report are a trade secret, any reproduction or distribution of this report, in whole or in part, or the disclosure of its contents, without the prior written consent of Gurtin, is prohibited, and the disclosure of this report or its contents is likely to cause substantial and irreparable competitive harm to Gurtin. By accepting this report, each recipient agrees to the foregoing.