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SB 344 (Machado); 2008 STAT. Ch. 3.

I. INTRODUCTION

The story of Chapter 3 is a cautionary tale of how failures in one corner of the securities market can have far-ranging consequences.[1] In the era of subprime and variable-rate mortgages, investment banks and financiers started slicing and dicing debt and offering it in increasingly complex forms, leading many to borrow without an accurate understanding of the risks involved.[2] Governments, and the myriad of agencies that comprise governments, could not escape the lure of innovative and non-traditional methods of debt financing that promised cheap and easy money.[3] Seeking ever-decreasing interest rates on their debt, governments and agencies issued new and increasingly complex types of bonds, and for a period, realized the low interest rates they were seeking.[4] But nothing lasts forever.

As the subprime mortgage crisis threw financial markets into turmoil, municipalities and public agencies across California and the nation faced difficult decisions.[5] In the boardroom of the Bay Area Toll Authority (BATA), the reality

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1. *See* Julie Creswell & Vikas Bajaj, *Municipalities Feel Pinch as Another Debt Market Falters*, N.Y. TIMES, Feb. 15, 2008, at C1 ("The failed auctions are tied to and exacerbating the larger problems in the financial markets.").

2. *See generally* Vikas Bajaj & Louise Story, *U.S. Mortgage Crisis Spreads Past Subprime Loans*, INT'L HERALD TRIB., Feb. 12, 2008, *available at* http://www.iht.com/articles/2008/02/12/business/12credit.php?page=1 (on file with the *McGeorge Law Review*) (noting that many people are defaulting on complex loans that were once thought to be a safe investment).

3. *See* Michael B. Marois, *Alabama, California Failures Expose Muni 'Dark Side'*, BLOOMBERG, Mar. 19, 2008, http://www.bloomberg.com/apps/news?pid=20601109&sid=a_uMoiFGIT5o&refer=home (on file with the *McGeorge Law Review*) (affirming the "expensive lesson" local governments are learning).

4. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008).

5. *See generally* Letter from David J. Slawson, President, E. Mun. Water Dist. & Anthony J. Pack, Gen. Manager, E. Mun. Water. Dist., to Mike Machado, Senator, Cal. State Senate (Mar. 3, 2008) [hereinafter EMWD Letter] (on file with the *McGeorge Law Review*) (arguing that bond costs must be reduced to assure EMWD can maintain vital services without raising rates); Rich Saskal, *California Issuers Eye New ARS Strategies*, BOND BUYER, Mar. 7, 2008, http://www.bondbuyer.com/printthis.html?id=2008030695FQWXVY (on file with the *McGeorge Law Review*) (explaining that agencies are under pressure to cope with rising interest rates).

of a financial "tsunami" finally confronted the board.[6] Interest rates on the bonds they issued skyrocketed, stressing the ability of the BATA and similar agencies to continue servicing their debt without raising fees or cutting services.[7] BATA officials concluded that they would need to refinance their debt to take $720 million of auction rate bonds off the market until the situation stabilized.[8] BATA executive director Steve Heminger described the market as "structurally broken with little chance of correction."[9] Municipalities and agencies sought to temporarily repurchase their bonds, but wanted to ensure the bonds would still represent outstanding debt that could be restructured and resold when the market improved.[10] Senator Machado introduced Chapter 3 to assure governments and agencies that they retained the flexibility to buy back or restructure their bonds without extinguishing the debt.[11]

II. BACKGROUND

A. *Financial Background*

State and local governments, as well as agencies, commonly offer bonds as a way of raising capital that can be paid off over an extended period. For a long period of time, governments only issued fixed-rate bonds.[12] A fixed-rate bond's interest rate is set when the bond is issued and remains the same for the life of the bond, which usually lasts thirty years or more.[13] However, in the last two decades, municipalities and public agencies began issuing variable-rate bonds.[14] Unlike fixed-rate bonds, the interest rate on variable-rate bonds can float up or down in accordance with the market and the terms of the contract for the issuance of the bonds.[15]

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6. Saskal, *supra* note 5; Michael McDonald, *Auction Supply 'Tsunami' Portends Municipal Losses*, BLOOMBERG, Mar. 3, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=atxaBnNonAqI (on file with the *McGeorge Law Review*) (describing the auction failures as a "tsunami").

7. *See* Saskal, *supra* note 5 (claiming that debt restructuring is needed to avoid raising toll fees to maintain current level of services).

8. *See id.* (discussing BATA's role in refinancing the debt).

9. *Id.*

10. Letter from Bill Lockyer, Treasurer, Cal. State, to Arnold Schwarzenegger, Governor, Cal. State (Mar. 24, 2008) [hereinafter Lockyer Letter] (on file with the *McGeorge Law Review*).

11. *See id.* (urging the Governor to sign the bill to ensure bond issuers have the ability to repurchase bonds); Letter from Michael Machado, Senator, Cal. State Senate, to Hector De La Torre, Assembly Member, Cal. State Assembly (Mar. 3, 2008) [hereinafter De La Torre Letter] (on file with the *McGeorge Law Review*) (requesting to add the urgency clause to the bill).

12. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 5, 2008).

13. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008).

14. *Id.*

15. *See* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 2-3 (Mar. 5, 2008) (noting that interest rates fluctuate with the market and are often capped by contract).

Until recently, variable-rate bonds seemed mutually advantageous for both investors and issuers.[16] Money market funds and large investors sought out municipal bonds because they presented a safe, liquid, and tax-exempt investment.[17] Bond issuers took advantage of the high demand by paying reduced interest rates and thus reducing their borrowing cost.[18] However, the credit crisis, created by problems in the mortgage market, spilled over and affected two types of variable-rate bonds issued by municipalities and public agencies: variable-rate demand bonds and auction-rate securities.[19]

Variable-rate demand bonds (VRDBs) have variable interest rates which are reset at regular intervals by an investment bank (often called a remarketing agent) to ensure sufficient demand to purchase the supply of bonds on the market.[20] The remarketing agent's goal is to set the interest rate low enough to reduce the costs of the issuers, but high enough to assure a return to investors sufficient to create demand for all the outstanding bonds.[21] If there is insufficient demand to purchase all the bonds, the remarketing agent can either purchase the bonds itself or sell them to a bank paid to "backstop" the bonds.[22] The bond's terms usually specify that if a bond is sold to a backstop bank, the interest rate automatically increases as a payment for backstopping the bond.[23] As of March 2008, there were approximately forty billion dollars in outstanding VRDBs in California.[24]

Auction-rate securities (ARS) differ from VRDBs in that a remarketing agent does not independently set the interest rate.[25] Instead, auctions are held at fixed intervals and the interest rate is determined by the outcome of these auctions.[26] As a general rule, the higher the demand for ARS, the lower the interest rate drops, as buyers compete to offer the issuer the best deal.[27] Correspondingly, the lower the demand, the higher the interest rate rises to entice buyers to purchase the outstanding bonds, and also the higher the chances of a failed auction if

16. *See* Marois, *supra* note 3 (stating that cities were led to believe that low interest rates were available with little risk through variable-rate bonds); SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008) ("Marketplace demand for variable rate bonds has traditionally been very high . . . .").

17. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008).

18. Letter from Jim Wiltshire, Deputy Dir., Cal. Ass'n of Counties, to Arnold Schwarzenegger, Governor, Cal. State (Mar. 25, 2008) [hereinafter Wiltshire Letter] (on file with the *McGeorge Law Review*) ("[T]he variable-rate bond market . . . has been a reliable source of low-interest borrowing for local governments for many years . . . .").

19. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008).

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. Lockyer Letter, *supra* note 10.

25. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 4 (Mar. 19, 2008) (noting that the interest rate for ARS is set at auction).

26. *Id.*

27. *Id.*

ultimately all the bonds cannot be sold.[28] When an auction fails to sell all the bonds, not only are holders stuck with bonds they cannot sell, but the bonds' interest rate rises pursuant to the bonds' terms.[29] As of March 2008, there were approximately twenty-eight billion dollars in outstanding ARS in California.[30]

The trouble for variable-rate markets began when bond insurers became caught up in the mortgage meltdown.[31] Variable-rate bonds are insured against default and depend heavily on their insurer's good rating to maintain high demand.[32] Under Rule 2a-7 of the Securities and Exchange Commission (SEC), money market funds, which had commonly held up to seventy percent of their value in municipal variable-rate bonds, can only hold bonds rated AA or higher on a scale of AAA (the highest) to D (the lowest).[33] As the mortgage crisis slammed companies insuring mortgage-based securities, their ratings were reduced, chilling demand and making investors hesitant to purchase variable-rate bonds.[34]

As the decline in demand worsened, ARS auctions began to fail and remarketing agents began to exercise their contractual rights to force backstop banks to purchase unsold VRDBs.[35] Failures in the variable-rate bond market called into question the previously unquestioned liquidity of variable-rate bonds.[36] Many purchasers invested in variable-rate bonds specifically because they considered them safe and liquid.[37] Therefore, as investors lost confidence in the liquidity of variable-rate bonds, money market funds and corporations that

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28. *Id.*

29. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 4 (Mar. 5, 2008).

30. Lockyer Letter, *supra* note 10.

31. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 5, 2008).

32. *Id.* (stating that a bond's rating typically comes from the rating of the bond insurer, which is rated based on its fiscal stability).

33. 17 C.F.R. § 270.2a-7 (2008). Under the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.* (2006), the Department of the Treasury has the authority to promulgate regulations of money market funds such as the one at issue. Bonds and bond insurance is rated by several high profile firms including Standard and Poor's and Moody's. For a basic introduction to bond ratings, the ratings scale, and how ratings are assigned, see STANDARD & POOR'S, GUIDE TO CREDIT RATING ESSENTIALS (2009), http://www2.standardandpoors.com/spf/pdf/fixedincome/SP_CreditRatingsGuide.pdf. *See also* Liz Rappaport, *New Monkey, Same Backs: Another Debt Market for Government Loses Buyers, and Rates Rise*, WALL ST. J., Feb. 28, 2008, at C1 ("Many such funds have 70% or more of their assets invested in [variable-rate demand notes].").

34. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 5, 2008).

35. Michael McDonald, *Auction Bond Failures Near 70%; No Sign of Abating*, BLOOMBERG, Mar. 5, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aamTy2dyu.U8 (on file with the *McGeorge Law Review*) (there were thirteen auction failures between 1984 and 2006, and 536 in a single day in early March); Rappaport, *supra* note 33 (remarketing agents began putting bonds to backstop banks in February 2008).

36. *See generally* Gretchen Morgensen, *As Good as Cash, Until It's Not*, N.Y. TIMES, Mar. 9, 2008 (stating that investors found variable-rate bonds less liquid as they previously thought).

37. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008).

relied on the liquidity of the bonds to maintain the availability of cash fled the market.[38] Exemplifying the scope of the meltdown, less than fifty ARS auctions failed between 1984 and 2007, while 536 failed on a single day in March, 2008, and nearly 1000 failed in a three-day period in February 2008.[39]

The ripple effect of the mortgage crisis first killed the ratings and then the demand for variable-rate bonds, forcing a dramatic spike in interest rates.[40] Interest rates on ARS that reset weekly increased 6.41 percent in March 2008 from the prior year's average of 3.89 percent.[41] ARS bonds issued by the Sacramento County sewer system increased from a low of 1.35 to 12 percent in March 2008.[42] The increases placed enormous pressure on the governments and agencies required to pay these interest rates.[43] Issuers sought a way to take their bonds off the market until the situation calmed.[44]

B. Legal Background

Municipalities and public agencies that wish to pull their bonds off the market must comply with both federal securities regulations and state laws governing public bonds.[45] When bond issuers began attempting to repurchase their bonds, attorneys advised them that SEC regulations might not permit their repurchase.[46] This was largely due to concern following a prior thirteen million dollar fine levied against banks for unauthorized bidding on ARS.[47] Numerous

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38. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 5, 2008).

39. *See* Creswell & Bajaj, *supra* note 1 (stating that there were almost 1,000 failures from February 12 through February 15 of 2008); McDonald, *supra* note 35 (stating that 521 failures occurred on March 4); McDonald, *supra* note 6 (stating that less than 50 failures occurred from 1984 to 2007).

40. *See generally* John Hill, *More Local Agencies Caught in Bond Turmoil: Failed Auctions Raise the Cost of Borrowing for SMUD, Placer and El Dorado Services*, SACRAMENTO BEE, Mar. 3, 2008, at A1 (noting that cities and agencies are being squeezed by higher interest rates); Saskal, *supra* note 5 (stating that BATA and similar agencies must cut services or raise fees if they continue paying high interest rates).

41. Marois, *supra* note 3.

42. Hill, *supra* note 40.

43. *See, e.g.*, Letter from Jan Schori, Gen. Manager, Sacramento Mun. Util. Dist., to Mike Machado, Senator, Cal. State Senate (Mar. 4, 2008) [hereinafter Schori Letter] (on file with the *McGeorge Law Review*) (describing the need for SB 344 due to the impact of increased bond interest rates); Wiltshire Letter, *supra* note 18 (same); Letter from Steve Heminger, Executive Dir., Metro. Transp. Comm'n, to Arnold Schwarzenegger, Governor, Cal. State (Mar. 7, 2008) [hereinafter Heminger Letter] (on file with the *McGeorge Law Review*) (same).

44. *See* Wiltshire Letter, *supra* note 18 (stating that municipalities and agencies look for options for obtaining relief from the high interest rates).

45. *See* CAL. GOV'T CODE § 43607-18 (West Supp. 2008) (outlining the requirements for bond authorization); 17 C.F.R. § 270.2a-7 (2008) (providing federal securities regulation of municipal bonds).

46. Lynn Hume, *SEC's ARS Guidance Pending*, BOND BUYER, Mar. 11, 2008, http://www. bondbuyer.com/printthis.html?id=200803109H9UTW58 (on file with the *McGeorge Law Review*).

47. *Id.*

Members of Congress wrote the SEC requesting clarification on the issue.[48] This prompted the SEC to issue a notice explicitly providing that an issuer may legally repurchase its own bonds, provided they comply with disclosure requirements intended to prevent market manipulation.[49]

California law regulates the process by which bonds are authorized and issued by municipalities and public agencies.[50] While California law does not bar a municipality or agency from repurchasing its own bonds, prior to Chapter 3, the law was unclear as to whether the repurchase of the bonds would extinguish the debt.[51]

III. CHAPTER 3

Chapter 3 clarifies that a state or local government may repurchase bonds issued by itself or others on its behalf without automatically canceling or extinguishing the debt.[52] Chapter 3 does not alter the contractual terms for the issuance of the bonds.[53] Therefore, the debt represented by the bond remains valid and outstanding irrespective of the fact that the issuer repurchased it.[54] Consequently, issuers who wish to extinguish bonds in accordance with the terms of the bonds may still do so.[55]

IV. ANALYSIS

After California Treasurer Bill Lockyer sponsored Chapter 3, the Legislature overwhelmingly passed it, giving municipalities and public agencies the flexibility to navigate the breakdown of the variable-rate market.[56] Prior to

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48. *See* Lynn Hume, *Sen. Schumer Joins Chorus for SEC Reform on Auction-Rate Securities*, BOND BUYER, Mar. 5, 2008, http://www.bondbuyer.com/printthis.html?id=20080304KF3BVTGC (on file with the *McGeorge Law Review*) (noting that Senator Schumer and other lawmakers lobbied the SEC for regulatory changes).

49. *See generally* I.R.S. Notice 2008-41, 2008-15 I.R.B. 742 (assuring that repurchase with proper disclosure is permitted).

50. *See generally* CAL. GOV'T CODE § 43607-18 (West Supp. 2008) (covering all aspects of bond authorization).

51. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) ("Existing law is unclear about whether the purchase or other acquisition of bonds by the bond issuer represents an extinguishment of the bond debt.").

52. CAL. GOV'T CODE § 5925 (enacted by Chapter 3).

53. *Id.*

54. *Id.*

55. *Id.*

56. *See* ASSEMBLY FLOOR VOTE, UNOFFICIAL BALLOT (Mar. 10, 2008) (noting that Chapter 3 passed 70-3); SENATE FLOOR VOTE, UNOFFICIAL BALLOT (Mar. 24, 2008) (noting that Chapter 3 passed 33-1); SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) ("Purpose of the Bill: To allow the state and local government bond issuers to repurchase some or all of their outstanding bonds without extinguishing the debt, in order to give these entities the flexibility to reoffer the debt to the bond market on more favorable terms."); *see also* Press Release, Senator Michael Machado, Relief for Municipal Bond Issuers

Chapter 3, however, municipalities and public agencies trapped in the variable-rate bond market had no good options. If they chose to keep their bonds on the market, they faced soaring interest rates.[57] If they pulled their bonds off the market by repurchasing them, they received no guarantee that the repurchase would not extinguish the bonds.[58] Chapter 3, though only a sentence long, gives municipalities the flexibility to pull their bonds off the market, protects repurchased bonds from extinguishment, and respects the terms of the bonds.[59]

Chapter 3's primary supporters were those most directly affected by the variable-rate demand market.[60] The California State Treasurer sponsored Chapter 3, which also received letters of support from municipalities and public agencies in dire need of fiscal relief from soaring interest rates.[61] Chapter 3's supporters achieved near unanimous consensus in the legislature on its passage due to the clear negative consequences of inaction and because the bill was sufficiently narrow to address only this particular issue.[62] However, Chapter 3's narrow focus may be its biggest drawback, since the cause of the breakdown in the variable-rate bond market is due to systemic issues in the credit market and Chapter 3 provides only a single method of coping with a single symptom of systemic problems.[63]

A. *The Potential Harm of Inaction*

When Chapter 3 was introduced, the variable-rate bond market was in disarray, placing cities in dire need of fiscal relief and forcing interest rates to rise to unanticipated highs.[64] The harm in having bonds left on the market is fairly

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Passes Legislature (Mar. 24, 2008) (on file with the *McGeorge Law Review*) (stating that the legislature passed the bill with the specific intent to give bond issuers flexibility to repurchase bonds and reoffer it at a later date).

57. *See generally* McDonald, *supra* note 6 (noting that soaring interest rates are taking a toll on municipalities and public agencies that issued variable-rate bonds).

58. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) ("Existing law is unclear about whether the purchase . . . of bonds by the bond issuer represents an extinguishment of the bond debt.").

59. *See* CAL. GOV'T CODE § 5925 (enacted by Chapter 3) (stating that in a single sentence that repurchasing the bond does not extinguish it, thus opening the way for cities to repurchase bonds without the consequences of cancelation); Heminger Letter, *supra* note 43 (stating that the MTC supported Chapter 3 because it provided options to cities and agencies).

60. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 8 (Mar. 19, 2008) (listing supporters of Chapter 3, such as California Treasure Bill Lockyer, the Sacramento Municipal Utilities District, the Eastern Municipal Water District, and the Center for Responsible Lending).

61. *See id.* (listing supporters of Chapter 3).

62. *See* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 1 (Mar. 5, 2008) (stating that the bill only clarifies extinguishment issues and preserves terms of bonds as they currently exist); Lockyer Letter, *supra* note 10 ("We need to act now to help taxpayers avoid further financial harm.").

63. *See* Creswell & Bajaj, *supra* note 1 ("The failed auctions are tied to and exacerbating the larger problems in the financial markets."). *See generally* Bajaj & Story, *supra* note 2 (describing larger credit crisis as it relates to meltdown in mortgage market).

64. *See generally* McDonald, *supra* note 6 (increasing interest rates resulting for failures in the variable-rate bond market wreaking havoc on bond issuer's budgets).

simple and straightforward. Put plainly, municipalities and public agencies cannot afford to pay the increasing interest rates without increasing fees and taxes or cutting services.[65] Supporters, such as the Sacramento Municipal Utilities District, Metropolitan Transportation Commission, and California Hospital Association, insisted that their debt be restructured to avoid severe financial hardship.[66] There was therefore a broad consensus that a solution such as Chapter 3 would be required to avoid possible disruptions of public services and skyrocketing costs to taxpayers.[67]

If a city repurchased its own bonds, it would face another potential peril to its financial health. Prior to Chapter 3, California law was unclear as to whether a bond issuer would legally extinguish the debt represented by a bond by repurchasing the bond.[68] Avoiding extinguishment is critical for several reasons. Under California law and the terms of variable-rate bonds, extinguishment may impose significant costs on the municipalities and public agencies that issued the bonds.[69] Further, state law requires that public bonds receive proper authorization through approval by the city legislature and then a public vote.[70] If extinguished, the bond might need to be reauthorized for reissuance at a later date, requiring cities to go through the time-consuming and expensive process of bond authorization again.[71] Additionally, extinguishment would terminate the contract for the bond insurance and cause termination penalties on the bond to kick in.[72] As a result, bond issuers would have to bear the cost of the penalties and the new insurance policies before they could reissue the bonds.[73] The difficulty and cost of reauthorizing bonds, purchasing insurance, and paying termination penalties are substantial obstacles to municipalities and public agencies seeking to repurchase their bonds.[74]

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65. *See* Saskal, *supra* note 5 (stating that BATA, which faces the same situation as many other public agencies, would have difficulty maintaining service level without raising fees if something is not done to restructure their bond debt); Wiltshire Letter, *supra* note 18 (describing how local governments are stressed by extraordinary interest rates).

66. *See* Letter from David van der Griff, Legislative Advocate, Cal. Hosp. Ass'n, to Mike Machado, Senator, Cal. State Senate (Mar. 12, 2008) [hereinafter Griff letter] (on file with the *McGeorge Law Review*) (expressing the need to restructure their debt); Heminger Letter, *supra* note 43 (same); Schori Letter, *supra* note 43 (same).

67. *See* ASSEMBLY FLOOR VOTE, UNOFFICIAL BALLOT (Mar. 10, 2008) (showing that Chapter 3 passed 70-3); SENATE FLOOR VOTE, UNOFFICIAL BALLOT (Mar. 24, 2008) (showing that Chapter 3 passed 33-1); SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 8 (Mar. 19, 2008) (listing no opposition to the bill).

68. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) ("Existing law is unclear about whether the purchase . . . of bonds by the bond issuer represents an extinguishment of the bond debt.").

69. Lockyer Letter, *supra* note 10 ("Debt extinguishment has costly and problematic consequences.").

70. *See generally* CAL. GOV'T CODE § 43607-16 (West Supp. 2008) (detailing how bonds are authorized and regulating the elections to authorize them).

71. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 19, 2008); Lockyer Letter, *supra* note 10.

72. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 19, 2008).

73. *Id.*

74. *See* Lockyer Letter, *supra* note 10 ("Debt extinguishment has costly and problematic consequences.").

Extinguishment might also negatively affect the demand for bonds by interfering with the bonds' tax-exempt status.[75] Part of the reason municipal bonds are so attractive to investors is that they are tax-exempt, and so retaining their tax exempt status is important for cities hoping to resell the bonds in the future.[76] Extinguishment might terminate public bonds' tax-exempt status and would thus severely decrease demands for public bonds once they are reissued.[77]

But for Chapter 3, municipalities and public agencies would have to choose between facing soaring interest rates and risking extinguishment.[78] Chapter 3 may result in significant savings because it allows municipalities and public agencies to avoid both scenarios by repurchasing their own bonds with no risk of extinguishment.[79] Chapter 3 received overwhelming bipartisan support, in part because it protects basic public services and result in significant savings to the state.[80]

B. *The Narrow Scope of Chapter 3*

Chapter 3 has a narrow focus because it is intended to provide a specific method of coping with a particular problem.[81] The breakdown in the variable-rate market was caused by a of lack liquidity and not by cities and agencies defaulting on their debts.[82] Thus, Chapter 3 does nothing to upset the terms of bonds or disrupt existing debt by explicitly stating that the terms of the bonds will still govern them.[83] Rather, Chapter 3 provides assurances that the preferred method of coping with the credit crisis—repurchasing existing bonds—will not result in the extinguishment of the debt.[84] Chapter 3 makes only a minor change, one

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75. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 19, 2008).

76. *See* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 5, 2008) (investors seek municipal bonds because they are safe, liquid, and tax-exempt).

77. SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 19, 2008); Lockyer Letter, *supra* note 10.

78. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) (noting that existing law is unclear regarding the extinguishment of the bond debt); McDonald, *supra* note 6 (stating that cities with bonds face extremely high interest rates).

79. ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 1-2 (Mar. 5, 2008) ("[There are u]nknown, potentially major savings . . . to state and local government issuers of variable rate bonds.").

80. *See* EMWD Letter, *supra* note 5 (stating that bond costs must be reduced to assure the maintenance of vital services in a cost effective manner); Press Release, Senator Michael Machado, *supra* note 56 (stating that the Legislature passed Chapter 3 because of the pressing need to reduce the costs of servicing outstanding bonds).

81. *See* Lockyer Letter, *supra* note 10 ("While [Chapter 3] will facilitate the repurchase [of] outstanding bonds, it does not change any covenants of the bonds. All terms and conditions . . . remain in place and cannot be altered.").

82. Creswell & Bajaj, *supra* note 1 ("'This is not a credit event, this is a liquidity event.'" (quoting Jon D. Maier, Merrill Lynch analyst)).

83. *See generally* Lockyer Letter, *supra* note 10 (stating that the purpose of Chapter 3 is to give issuers greater flexibility to repurchase and then reoffer bonds while preserving all the terms and conditions of the bond.).

84. CAL. GOV'T CODE § 5925 (enacted by Chapter 3).

which does not upset existing law, but rather clarifies a previously unclear point regarding extinguishment.[85] As a result, with the exception of this single clarification, Chapter 3 preserves the status quo of California law and public policy.[86]

However, Chapter 3 is a small fix designed to address only one aspect of a wider problem in the credit market.[87] The breakdown of the variable-rate bond market was caused by larger forces emanating from a national credit crisis.[88] A significant part of the national credit crisis was due to issues and policies that extend far beyond California, such as increasingly complex and risky credit schemes that went unregulated and unchecked for years.[89] Because the credit market is more integrated than ever, breakdowns in one area, such as mortgages, can affect other areas of the credit market, such as municipal bonds.[90] Therefore, so long as the base issues plaguing the credit market go unresolved, subsequent problems will continue to arise and more Chapter 3s will be needed to put out fires as they arise.[91] What makes Chapter 3 effective—its focus and bipartisan support—may also demonstrate its limitations: the persistence of the economic and financial issues at the core of the credit crisis. To truly resolve the issues raised by Chapter 3, it is necessary to look beyond bonds, and beyond California, and instead look to the larger issues facing the credit market.[92]

V. CONCLUSION

As the twin evils of soaring interest rates and extinguishment closed in and nearly trapped municipalities and agencies, Chapter 3 was a necessary measure to

85. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 2 (Mar. 19, 2008) ("Existing law is unclear about whether the purchase . . . of bonds by the bond issuer represents an extinguishment of the bond debt.").

86. *See* Lockyer Letter, *supra* note 10 (noting the limited impact of Chapter 3). *See generally* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344 (Mar. 5, 2008) (providing no indication of a change in law and policy beyond resolving the question of extinguishment); SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344 (Mar. 19, 2008) (same).

87. *See* De La Torre Letter, *supra* note 11 (requesting the addition of an urgency clause because of the urgent nature of the bill). *See generally* Bajaj & Story, *supra* note 2 (describing a larger credit crisis as it relates to the meltdown in the mortgage market).

88. Creswell & Bajaj, *supra* note 1 (noting that the financial markets are tied to the failed ARS auctions).

89. *See* SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 3 (Mar. 19, 2008) (stating that the bond crisis precipitated from spillover of the mortgage crisis). *See generally* Bajaj & Story, *supra* note 2 (explaining that major cause of mortgage meltdown was the increasingly complex and risky finance and credit devices).

90. *See* Creswell & Bajaj, *supra* note 1 (noting the connection with the financial markets).

91. *See* Dakin Campbell, *Credit Crunch Hits Variable Rate Market*, BOND BUYER, Feb. 29, 2008, http://www.bondbuyer.com/article.html?id=20080228MDVURAHW (on file with the *McGeorge Law Review*) (noting that the bond crisis is a secondary effect of the credit crunch, which is caused by larger problems).

92. *See* Bajaj & Story, *supra* note 2 (stating that the causes behind the credit crunch are large and systemic).

give bond issuers a safe escape path.[93] Because bond issuers are not unwilling or unable to pay their outstanding debts, allowing the extinguishment of bonds would impose significant needless costs on taxpayers through the reauthorization of bonds, termination of insurance, termination penalties, and the re-certification of the reissued bonds as tax exempt.[94] However, prior to Chapter 3, the only alternative to risking the consequences of extinguishment was to pay the extraordinarily high interest rates, which also imposed unnecessary costs on taxpayers and threatened essential public services.[95] Chapter 3 provides a safe escape path by allowing public-bond issuers the ability to avoid unnecessary costs of extinguishment or soaring interest rates, while continuing to hold them to the obligations represented by the bonds.[96] However, the cause of the bond crisis goes beyond what Chapter 3 and California alone can resolve;[97] while Chapter 3 provides an important fix to an urgent problem, it does not resolve the root cause of the problems in the variable-rate bond market.[98]

93. *See* Lockyer Letter, *supra* note 10 (describing the need for Chapter 3).

94. *See* ASSEMBLY COMMITTEE ON APPROPRIATIONS, COMMITTEE ANALYSIS OF SB 344, at 1-2 (Mar. 5, 2008) (describing the fiscal impact as "potentially major savings"); SENATE FLOOR, COMMITTEE ANALYSIS OF SB 344, at 5 (Mar. 19, 2008) (describing the consequences of extinguishment).

95. *See* Wiltshire Letter, *supra* note 18 (stating that Chapter 3 is needed to escape a market plagued by extraordinary interest rates).

96. *See* Lockyer Letter, *supra* note 10 (stating that Chapter 3 gives issuers options but does not alter the terms of the bond).

97. *See* Creswell & Bajaj, *supra* note 1 (stating that the problems in the variable-rate bond market are related to the fallout of the national credit crunch that began in the mortgage market).

98. Since the writing of this article there have been substantial developments in many of the areas discussed in this piece. As this article goes to press, President Obama has been inaugurated and has begun to address the "credit crisis" that precipitated the creation of the Troubled Assets Relief Program (TARP), commonly known as "the bailout." *See* Perry Bacon, Jr., *Obama Lobbies for 2nd Half of Bailout*, WASH. POST, Jan. 12, 2009, at A4 (noting that President Obama encouraged legislators to "back the spending of the funds remaining in the Troubled Asset Relief Program and a separate stimulus package estimated at $800 billion."). This article has pointed to several systemic problems, not addressed by Chapter 3, which posed threats to the stability of the capital markets. *See supra* Parts II.A & IV.B. To some degree, the concerns this article raises about the potential of systemic problems threatening a large scale disruption of the credit market have been borne out by the credit crisis that is sure to occupy a substantial part of President Obama's first term. *See id.* (discussing President Obama's approach to the economic crisis); Louis Uchitelle, *Pain Spreads as Credit Vise Grows Tighter*, N.Y. TIMES, Sept. 18, 2008, at A1 ("The latest outgrowth of the housing crisis . . . threatens to gradually corrode economic activity on Main Street, mainly by disabling the credit on which so many everyday transactions depend . . . .").