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Why Statutory Liens Matter in a Chapter 9 World.

CHICAGO – Municipal industry experts on Thursday urged analysts to continue focusing on how the presence of statutory liens can change the treatment of debt in bankruptcy proceedings and ratings analyses.

The experts discussed liens during a panel at the National Federation of Municipal Analysts' annual meeting here.

A statutory lien is a provision of a law that gives certain bonds held by investors a higher ranking in a bankruptcy recovery hierarchy than others without such liens. Some states, like California and Rhode Island, have passed laws that explicitly create liens, while the presence of liens for credits in certain other states is still debatable. The possible confusion is compounded even more because the characteristics of statutory liens may differ from state to state.

There is also a question of how special revenue and other pledges compare to statutory liens in terms of protecting bondholders.

The Detroit bankruptcy is one of the more recent events that led observers to question how liens may affect the assessment of debts in bankruptcy proceedings. However, Michigan statutes did not explicitly extend any liens to the debt considered in the Detroit bankruptcy proceedings.

Amanda Van Dusen, a principal with the law firm Miller Canfield, Paddock and Stone in Michigan, said that she didn't appreciate the significance of the word "lien" in a statute until she talked with bankruptcy lawyers.

"I thought, as most bond lawyers did, that a pledge means a promise," she said. "The first lesson that the bankruptcy lawyers pounded into me [was] … that a pledge is a promise and in bankruptcy, promises are broken."

Richard Ciccarone, president and chief executive officer of Merritt Research Service, said that when he was given general obligation bonds that said they were payable from an unlimited tax, he viewed that as a pledge similar to a statutory lien.

"In a way, the pledge that was implied here was something we always believed was really like a common law marriage, you didn't really say yes to the vow, but you were married," Ciccarone said. "You may not necessarily find the words 'statutory lien,' but you believed it was a statutory lien."

Judge Frank Bailey, a U.S. bankruptcy judge for the District of Massachusetts, said Ciccarone was partially right because the bankruptcy code's definition of a statutory lien does not specify that the statute must use the words "statutory" or "lien" in creating one, only that the language match up to the definition outlined in the code.

The panelists also agreed that the lack of bankruptcy court decisions on statutory liens leaves observers with a lack of precedent. Most resolutions where statutory liens are involved come through negotiated settlements. The murky territory that liens currently occupy means industry

participants need to talk more about what provisions borrowers may have, Ciccarone said.

“For the analyst still left in a world where [the consideration of statutory liens] is evolving, your responsibilities are going to be more burdensome,” he said. “If [issuers] think they have a statutory lien, we want that to be clear. If they don’t know, we want them to say they don’t know.”

Jane Ridley, a senior director and analytical leader with Standard & Poor’s, both moderated the panel and played a key role in a report released on Wednesday regarding the role of statutory liens in ratings.

The report acknowledged a recent trend, exhibited by Detroit, Puerto Rico, and earlier by Central Falls, R.I. in its bankruptcy proceedings, of legal provisions like pledges becoming less binding after earlier being widely considered unalterable. But it said ratings analysts should continue to rely more on an issuer’s fundamental areas of credit health than the presence of a statutory lien.

For example, the report wrote that if a rating agency was comparing two school districts, one with strong credit fundamentals but no statutory lien and one with weak credit fundamentals but with a statutory lien, “it is difficult for us to imagine a scenario where the latter would carry a higher issue credit rating.”

However, the report said that “the existence of legal protections can inform our opinion of the issuer’s incentive and ability to pay its various obligations.”

“Legal protections, whether in bond documents or by operation of law, can strengthen a bondholder’s recovery prospects,” the report said. “However, we’ve observed that when an issuer’s creditworthiness deteriorates to the point where bondholders’ main comfort is to rely on the legal provisions for payment, the situation isn’t nearly as straightforward as it may have appeared when the bonds were issued.”

The report also was in line with the panelists’ assessments of the lack of legal precedent, arguing that applying legal concepts outlined in negotiated settlements and incomplete case law to all of their ratings is “without analytical merit.”

The Bond Buyer

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