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Why Issuers Must Increase Statutory Lien Disclosure.

WASHINGTON – The National Federation of Municipal Analysts wants issuers to improve their disclosures about statutory liens and how they could affect general obligation bonds following a slew of recent municipal bankruptcies where this was a key issue.

The group made the recommendation in its draft "White Paper on General Obligation Bond Payments: Statutory Liens and Related Disclosures," which it released on Wednesday. Members of the municipal securities industry will have an opportunity to comment on the paper through Oct. 15. NFMA is also sharing the paper with municipal regulators and other market groups.

While the paper is focused on statutory liens, the group notes that other issues that affect the treatment of bondholders, like whether pledged revenues constitute "special revenues" under the bankruptcy code, also deserve attention when thinking about disclosure.

"The NFMA has always believed that good disclosure benefits all market participants, not just the analyst community," said Jennifer Johnston, chair of NFMA's industry practices and procedures committee. "We think if there is uniform, transparent, and clear disclosure of the presence of a statutory lien, it really is a best practice."

Johnston, a vice president and research analyst with Franklin Templeton's municipal bond department, said the paper is the result of NFMA members expressing frustration about unclear statutory lien disclosure.

A statutory lien, according to the federal bankruptcy code, can only be created under a state statute that specifies the circumstances and conditions of the lien. Such liens are important, according to NFMA, because they allow lien revenues to continue to be collected even after the filing of a bankruptcy petition under Chapter 9.

NFMA said one potential barrier to better disclosure is determining whether a statutory lien is actually in place under state law. Not all states have laws establishing statutory liens and some have laws that do so without actually using the words "statutory lien." Some states have laws that are written in a way that makes it difficult to tell if such liens exist.

For that reason, the NFMA paper instructs issuers to talk with their bond counsel to make a determination about the presence of such a lien. Issuers should disclose the information they have gathered whether it shows there is a statutory lien, it is unclear, or one does not exist.

The paper also asks that issuers include in bond documents: where the lien authorization comes from; the full text of the statutory lien; any opinions or analysis from the bond counsel; whether pledged revenues are commingled with non-pledged revenues; and whether the state is considering legislation that may institute or alter a statutory lien. Issuers in the same state could standardize statutory lien disclosure, the NFMA said.

Gathering lien information is important for all issuers, even though some states do not allow

municipal bankruptcies, NFMA added.

“It may be tempting to point out that not all states allow municipalities to file for bankruptcy, and in those non-bankruptcy states, the issue of a statutory lien is moot,” the paper says. “But as with the financial condition of a city, laws can change.”

NFMA also uses its paper to walk through several examples of municipal bankruptcies from 1994 to 2013 where GO bond assumptions were challenged and statutory liens played a role. Many of the recoveries were negotiated instead of court ordered, NFMA noted.

In Orange County, Calif.’s 1994 bankruptcy, the U.S. district court found that the county’s approximately $60 million of tax and revenue anticipation notes were subject to a statutory lien. That debt was eventually refinanced and paid in full as part of the county’s debt adjustment. Similarly, in the bankruptcy proceedings involving Central Falls, R.I., in 2011 the state legislature instituted a statutory lien on local GO debt that allowed GO bondholders to realize a 100% recovery rate from the city’s bankruptcy plan while leaseholders, pension beneficiaries, and vendors were all subject to varying levels of reductions.

The paper juxtaposes those results with the ones from Detroit’s bankruptcy in 2013 where the city’s emergency manager, Kevyn Orr, argued that the city’s unlimited tax GO bonds (ULTGOs) were not secured by a statutory lien. Michigan’s legislature later made the statutory lien explicit, but in the settlement between the city and its ULTGO bondholders, ULTGO bonds had a recovery rate of 74% to insurers and 100% to bondholders with the 26% balance made up from the bond insurers under their insurance policy.

“This was the highest recovery rate among the city’s debts, yet below that experienced by many statutory lien ULTGOs in other Chapter 9 proceedings,” the NFMA wrote in the paper.

The white paper further gives examples of good disclosure from issuers in states like Colorado, Louisiana, and Rhode Island where they made explicit references to statutory liens. But the group said it could only find Connecticut as an example of a state where issuers disclosed that a statutory lien either does not exist or may exist.

The Bond Buyer

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