

# **Bond Case Briefs**

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## **Custodial Receipts: A Useful Tool for Restructuring Insured Municipal Bonds.**

Municipal restructurings pose many challenges distinct from those encountered in a typical corporate bankruptcy. One challenge frequently encountered in the context of a municipal restructuring is how to restructure municipal bonds insured by a monoline insurance company. Custodial receipts, which have long been used to facilitate secondary market insurance for muni bonds, can be a useful tool that allows a policy on a legacy bond to be mated with a new muni security being issued in a restructuring.<sup>1</sup>

### **Municipal Bond Insurance in a Nutshell**

Under a classic municipal bond insurance policy, a bond insurer will agree to essentially guarantee payment of principal and interest when due on the insured bonds, in accordance with the original payment schedule. If the issuer of the insured bonds defaults, in the payment of interest or principal, the insurer makes the payment to bondholders and will be subrogated to the bondholders' right to the missed payment. Typically, as a condition of, and in exchange for, the insurer covering the missed payment, bondholders will be required to assign their rights to the missed payment to the insurer, and the insurer will be fully subrogated to the bondholders' rights to the missed payment. Usually, so long as a bond insurer has not defaulted on its policy, the bond insurer will control the exercise of most remedies in respect of the insured bonds.

### **Challenges in Restructuring Insured Municipal Bonds**

This works well enough so long as the original bonds remain outstanding. However, often in bankruptcy, an issuer's bonds are canceled, and new restructured bonds are issued in their stead. The economic terms of the restructured bonds may diverge from those of the original legacy bonds in certain key ways, including reduced principal amount and interest rate and an extended amortization schedule. The cancellation of insured bonds in exchange for new restructured bonds gives rise to various questions and uncertainties, including:

- Are payments made by the issuer under the restructured bonds credited against payments owed by the bond insurer on its insurance policy for the legacy (i.e., now canceled) bonds?
- How does the right to payments under the bond insurance policy trade following the restructuring, after the insured bonds are no longer outstanding? Should it trade separately from or together with the restructured bonds?
- How do the insurer's subrogation and assignment rights apply where bonds it is insuring no longer exist, and does the insurer retain subrogation/assignment rights in respect of the new restructured bonds?
- Who has voting rights with respect to the restructured bonds issued in exchange for the legacy insured bonds?

The challenges posed in restructuring insured bonds were highlighted by a New York case in which a monoline insurer argued that it was no longer obligated to make payments on its policy since the

insured bonds were canceled as part of the plan of reorganization.<sup>2</sup> While the trial and appellate courts both rejected this argument, the case demonstrated the importance of considering issues relating to bond insurance policies when preparing a plan of reorganization.

## **Custodial Receipts and Secondary Market Insurance**

One tool that may be useful to address the challenges of restructuring an insured muni bond is custodial receipts — an instrument borrowed from the secondary insurance market.

Unlike the primary insurance market, where policies are purchased by a bond issuer contemporaneously with the original issuance of the insured bonds, secondary market insurance is purchased by holders of uninsured bonds at some point after the original issuance of the bonds. Bondholders wishing to acquire the insurance deposit their bonds with a custodian and receive a custodial receipt, often referred to as a “certificate of bond insurance” or “CBI,” representing the right to receive scheduled principal and interest payments from the custodian.

Ordinarily, payments from the custodian would simply be principal and interest payments on the bonds held in custody, which the custodian receives from the issuer. Should there be a default on the bonds, the custodian will fund the payments through a draw on the secondary market insurance policy issued by the insurer.

The terms of the custody agreement are set forth in a custody agreement between the insurer and custodian, with the holders of the CBIs being identified as third-party beneficiaries of the custody agreement.

The SEC staff has granted no-action relief for secondary market issuance of custody receipts without registration under the Securities Act of 1933 and without the custodian having to register as an investment company under the Investment Company Act of 1940. See *Fin. Sec. Assurance, Inc.*, SEC No-Action Letter, 1988 WL 234169 (Mar. 30, 1988). This no-action relief has been premised on various representations, including that the custodian would play a purely ministerial role.

## **Custodial Receipts as a Tool for Restructuring Insured Municipal Bonds**

While originally developed in the secondary insurance market, custodial receipts can be used to facilitate a restructuring of insured bonds. And unlike secondary insurance market arrangements where the custodial agreement is grafted onto the existing debt documentation, in the restructuring context, the indenture and other bond documents can be designed to work in tandem with the custody agreement.

Of course, the utility and feasibility of custodial arrangements will depend on the particulars of the terms of the restructuring. However, where the replacement debt securities are designed to track certain basic features of the legacy insured bonds, such as their payment schedule, a suitable custody arrangement can be engineered.

### *CBIs as a Replacement for Legacy Insured Bonds*

The terms of a custodial arrangement may in these circumstances include features and provisions such as the following:

- On the effective date of the plan of reorganization, the insured legacy bonds are canceled, and the former holders of the insured legacy bonds receive custody receipts, or “CBIs,” representing a participation in the custody arrangement established under the plan.
- The CBIs are issued under their own CUSIP in “street name” through DTC, which facilitates the

trading of beneficial interests in the CBIs.

- Also on the effective date, the restructured bonds issued in respect of the insured legacy bonds are deposited with an independent custodian. Consistent with the no-action letters for secondary market insurance, the role of the custodian is purely ministerial.
- The insurance policy for the insured legacy bonds is also deposited with the custodian.
- The custodian holds the restructured bonds and the insurance policy in custody on behalf of, and for the exclusive benefit of, the holders of the CBIs, pursuant to the terms of a custody agreement, to which the custodian and the insurer are parties.
- The CBIs represent the right to receive the payments that would have been due on the legacy uninsured bonds (had they not been canceled) in such amounts and at such times as they would have been due in accordance with the original unaccelerated payment schedule of the insured legacy bonds.
- The custodian uses debt service on restructured bonds held in custody to fund a portion of these payments.  
To the extent debt service on the restructured bonds is insufficient, the custodian makes a draw on the insurance policy to fund the shortfall.
- As part of the custody arrangement, the insurer agrees to remain bound by its original insurance policy, notwithstanding the cancellation of the original insured bonds.
- So long as the restructured bonds remain in custody and the insurer continues to perform under its policy, the insurer retains its rights of consent and control over exercise of remedies in respect of the restructured bonds to the same extent as it had such rights and control in respect of the legacy insured bonds under the legacy indenture.
- After all amounts are paid to the holders of the CBIs in accordance with the original payment schedule of the legacy insured bonds, the custodial relationship is dissolved and the restructured bonds held in custody are transferred to the insurer.

### *Issues to Be Considered*

The parties, particularly representatives of the legacy bondholders, will need to consider and address a variety of issues in structuring a custodial arrangement under a muni bond plan of reorganization. These may include:

- How and by whom the custodian is compensated.
- The means for removing and replacing the custodian.
- Availability of information concerning the CBIs and the custodial arrangements, through postings on EMMA or otherwise.
- Availability of information concerning payments of principal and interest on the restructured bonds, and draws on the insurance policy, which may be required by bondholders for tax and accounting purposes.
- How and under what circumstances the custody agreement may be amended.
- The rights and remedies available to holders of the restructured bonds in the event of an insurer default, including the role, if any, of the indenture trustee in these circumstances.

### **Custodial Receipts as One Tool Among Many**

Custodial arrangements will not be suitable for all situations. For example, these arrangements are unlikely to be attractive where long dated insured capital appreciation bonds are to be replaced with current pay restructured bonds. Also, the parties will need to be cognizant of the tax and securities law and other regulatory considerations relevant to CBIs. Where custodial arrangements are unsuitable, parties and their counsel will need to consider alternative means of preserving the benefits of the insurance policy for the legacy bondholders and their successors. Nonetheless, the custodial model should be on the radar of parties engaged in the restructuring of insured municipal

bonds. In the appropriate circumstances, it can be a linchpin of a successful restructuring that effectively preserves the economic expectations of insured bondholders.

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1 Kramer Levin recently served as counsel to holders of insured municipal bonds in a restructuring that employed custodial arrangements of the kind described in this article.

2 See *Oppenheimer AMT-Free Municipals v. ACA Fin. Guar. Corp.*, 959 N.Y.S.2d 90 (Table), 36 Misc.3d 1229(A) (Sup. Ct. 2012), *aff'd as modified*, 971 N.Y.S.2d 95 (App. Div. 2013).

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