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## **In Post-Detroit Bankruptcy Era, California Protects Investors Before Pensioners.**

Before Detroit, many thought general obligation bonds were ironclad. Now they know better.

Starting next year, anyone who buys a general obligation bond from a California locality will stand first in line as a creditor should anything ever happen to cause that locality to restructure its debt. If the law seems redundant to a few people, that's because general obligation debt is supposed to be backed by the full faith and taxing power of the government selling them. In other words, many thought that meant such bonds were unbreakable. So why does California feel the need to clarify that?

The reason goes back to 2013 when Detroit filed for bankruptcy. The city proposed — and eventually pushed through — a restructuring plan that placed general obligation (GO) bondholders behind the city's pensioners when it came to who would recover the most of what they were owed. While pensioners averaged a roughly 90 percent recovery rate, GO bondholders recovered about 80 cents on the dollar. "Everything is different after Detroit," said Robert Christmas, a financial restructuring expert at Nixon Peabody. "There were challenges to things that I think people believed were sacrosanct or hadn't thought about."

California, which has had three cities enter Chapter 9 bankruptcy in the last seven years (San Bernardino is the only one still litigating its case), wants to be clear that its local GO bondholders won't be treated the same way. The new law, Senate Bill 222, places a lien on future property taxes to ensure investors will be repaid. By clarifying that the lien created with each GO bond issuance is a statutory one, it "should reduce the ultimate bankruptcy risk of nonrecovery on local GO bonds, and thus potentially improve ratings, interest rates and bond costs," Christmas said.

These liens don't provide total immunity to bondholders. A statutory lien, noted Matt Fabian in an analysis for Municipal Market Analytics, does not preclude a disruption in payment or ensure that the collateral, in this case tax revenue, will be sufficient for full payment. Still, with California accounting for about 20 percent of all bankruptcies since 2000 and almost 30 percent of all city or county bankruptcies since 2007, Fabian predicts "even small reductions in future California bankruptcies can have a market-wide benefit."

Indeed, Moody's Investor's Service has called the new law a credit positive for California localities. Fitch Ratings, however, has said statutory lien laws have no effect on its credit ratings. California isn't the first state to pass a statutory lien for GO debt, although it is the first to do so in the post-Detroit bankruptcy era. Louisiana and Rhode Island already have laws on the books. Nebraska has been considering one.

Rhode Island provides a good, if somewhat sobering, example of how a statutory lien can play out in a bankruptcy case. When Central Falls filed for bankruptcy in 2011, the state enacted an emergency statute that placed a lien on property taxes and pledged them to GO bondholders. There were lots of positives from Wall Street's perspective. During the bankruptcy no creditor challenged the lien, and

GO bondholders received full and uninterrupted payment of debt service. The judge in that case highlighted the tactic as one he hoped other cities would follow. Central Falls was in and out of bankruptcy in just 13 months, and so its credit rating also began to recover almost immediately. Its rating was moved out of junk status within a month of exiting bankruptcy.

Still, someone has to take a cut. If not GO bondholders, then who? In Central Falls case, it was retirees who settled for roughly half the pensions they were promised. Labor advocates say the move placed a back-breaking burden on retirees who are now living paycheck to paycheck. In California's bankruptcies, GO bondholders and pensioners have been treated fairly equally. But if ever a locality is forced to choose, the new law makes it clear where the favor now lies.

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