Bond Case Briefs

Municipal Finance Law Since 1971

Public Service Over Debt Service: The Implicit Lien Senior To Municipal Bondholder Rights.

The primary role of municipalities is to provide essential public services; this responsibility does not change, even in the advent of a bankruptcy. Recent bankruptcy court rulings in Detroit, Stockton and now Puerto Rico have made municipality priorities clear: when governments are in distress, bondholders can hope for post-default recoveries pennies and cents on the dollar that was originally promised. Bondholders must be reminded that the core of successful municipal bond investing is thorough, deep and objective credit research. Covenants and legal provisions only offer credit protection if the borrower is economically and financially solvent; in the advent of a bankruptcy, public services will always come before debt service obligations.

Investors in Detroit, Stockton, and now Puerto Rico looking to the legal covenants as their ultimate safety net are missing two critical points: First, fundamental economics and good governance are primary credit drivers; covenants and security provisions are not. Second, municipalities will always need to provide essential public services over anything else.

These three bankruptcies are prime examples of where economics and governance failed, ultimately diminishing bondholders' secured rights. In each place, weakness in these credit drivers foreshadowed problems years in advance.

Take Detroit. Poor governance practices (just one example: envelopes with tax payments were found in a closet—in a fire station), the realignment in the auto industry resulted in manufacturing job losses and a massive population exodus. Evidence of the city's demise were visible well before the situation became dire, but we continued to lend.

Stockton's reliance on overly optimistic projections of tax revenues based on ever-rising home values—leading to overspending and over-borrowing—also foreshadowed the final result. And we continued to lend.

Puerto Rico's loss of manufacturing jobs, rising deficits papered over by borrowing and opaque financial reporting all started a full decade before the 2008 Recession finally stripped away all pretense of a functioning economy or government. And we lent a total of $75 billion to the island's government and its public corporations.

In each case—Stockton, Detroit and Puerto Rico—there were perceived-and-assumed-strong legal provisions to preserve and protect bondholders. In each case, the bondholders fought vociferously but to no avail. They received significantly lower recoveries than the strongly worded documents suggested.

Covenants and legal provisions only offer credit protection if the borrower is economically and financially solvent. This is why the core of municipal bond investing has been and remains thorough, deep, and objective credit research with a laser focus on the key drivers of financial performance. Despite investor optimism, none of these borrowers passed key credit screens.

Not that the bondholders didn’t try mightily to persuade the Court to enforce those covenants and legal provisions. After all, bankruptcy is about contract impairment and lien prioritization. The Court is legally bound to draw conclusions from the facts and apply appropriate legal criterion in its judgment. But there is another, higher criterion that it also weighs.

When a municipality files for bankruptcy, it doesn’t just roll up the streets and shut down town hall. Before, during, and after bankruptcy, a municipality has to keep providing public services. The trash is picked up, police and firemen still respond to emergencies, street lights stay on, commuters travel to work and children go to school.

Paying bondholders doesn’t do any of those things. In a municipal bankruptcy, the final feasibility test for the Court’s approval is: Can the municipality provide these critical public services once the plan is approved? Therein lies the implicit lien senior to all other liens and claims.

When it comes down to public service versus debt service, public service will prevail.

Barnet Sherman is the Director of Municipal Impact Credit Research at Neighborly Investments, a first-of-its-kind Impact Asset Manager.

Posted 06/13/2018 by Barnet Sherman

Neighborly Insights

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com