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The Appellate Court And Puerto Rico: Lessons For Investors.

Puerto Rico's bankruptcy is a consistent reminder of what really matters when investing in municipal bonds. It's pretty simple: sound economics, responsible financial management, well-articulated public policy, positive social impacts and essential public service projects.

The most recent reminder comes from a new United States Court of Appeals ruling. The ruling appears to strip away the core legal tenet backing the security provisions investors in municipal bonds backed by a pledge of dedicated revenues rely on: a statutory lien on revenues reserved for debt service is not affected by a bankruptcy filing.

By affirming a previous U.S. District Court decision, the Court rejected that. This latest ruling has "raised broad concerns about the protections provided in Chapter 9 of the U.S. bankruptcy code to holders of bonds secured by pledged special revenues," according to Fitch Ratings.

As with any investment, you should be doing your own research and drawing your own conclusions. Read the ruling, then read the actual law 11 U.S. Code Section 922 and Section 928 on the matter. Read the well-written Amicus Curiae brief submitted by the National Federation of Municipal Bond Analysts for a fair summary of the background and the issues. For an independent legal perspective, read the very tightly crafted memorandum on the ruling's implications by Mintz Levin's Public Finance Counsel Leonard Weiser-Varon.

The overall lesson municipal bond investors, both current and prospective, should take from reading these legal proceedings is that all the covenants in an OS, or all laws on the books, will not protect you if any or all of those initial five simple but critical components mentioned in the first paragraph are not present. Of course, covenants and legal protections are factors in the investment decision process: if done properly, they can be structured to create early warnings and some semblance of enforcement capability. But no investor should rely solely on the covenants and enforcement of legal protections to bail them out of trouble. No amount of legalese ever generated a dollar of debt service coverage.

As bondholders in the various debts of Puerto Rico as well as investors in other bankruptcy proceedings have experienced–and having gone through three municipal bond bankruptcies, including testifying in Federal Bankruptcy Court, I have had that experience–there is logic, then there is the law. Or perhaps more to the point, to quote Mr. Bumble, "the law is an ass." No one relies on an ass to protect their financial interests.

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