National Federation of Municipal Analysts

White Paper on General Obligation Bond Payments: Statutory Liens and Related Disclosures

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EXECUTIVE SUMMARY

The National Federation of Municipal Analysts (NFMA) is publishing this White Paper to call attention to the lack of uniform, transparent and clear disclosure of the payment sources and security protections afforded to General Obligation (GO) bondholders. Our concern has to do with whether GO bond documents have complete and appropriate disclosure relating to the presence of a state statutory lien, revenue pledge or other “security arrangement” that entitles GO bondholders to priority repayment or recovery. Such disclosure is deemed particularly important in the event that the government borrower is able to file a petition for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code (U.S. Bankruptcy Code or Bankruptcy Code). While it is recognized that all states do not explicitly allow for a voluntary Chapter 9 filing for local governmental entities, knowledge of the existence of a state statutory lien or other security arrangement serves a useful forward-looking purpose in the event a state alters its laws to permit bankruptcy filings. In addition, as not all state statutory liens qualify for the special protections afforded “statutory liens” under Section 545 of the Bankruptcy Code, the GO bond offering statement should disclose the exact wording of the state statutory lien language so that municipal investors can determine if these special bankruptcy protections are available.

INTRODUCTION

Since its inception in 1983, the National Federation of Municipal Analysts (NFMA) has been at the forefront of efforts to improve the disclosure of credit and market risks facing analysts and investors in the taxable and tax-exempt municipal bond markets. The NFMA is an organization of over 1,300 members, primarily research analysts who evaluate credit and other risks of municipal securities. These individuals represent mutual funds, insurance companies, broker/dealers, financial advisors, bond insurers, and rating agencies, among other stakeholders.

One of the NFMA’s principal goals is the promotion of timely and materially complete and accurate disclosure of information needed to assess municipal securities risks. The organization’s disclosure efforts have addressed broad areas of concern, ranging from industrywide topics to detailed work on specific credit sectors. Some of this work has been communicated to members of Congress and federal regulatory agencies. The NFMA's work has been recognized as authoritative market guidance by other industry associations and various regulatory bodies. For further information on continuing efforts to improve disclosure, see the Disclosure Guidelines and Position Statements in the Publications section of the NFMA's website (www.nfma.org).

In order to develop its white papers, seasoned NFMA analysts representing different types of companies work together to develop information and best practice suggestions on a particular topic. The NFMA provides the municipal securities industry with an opportunity to comment on proposed white papers. These papers provide other industry participants with specific information needed both to help analysts do their jobs better and to allow investors to make better-informed investment decisions. The NFMA believes that the best practice in disclosure will always be the one that provides a steady flow of timely material information from issuers, borrowers, and obligors to the entire market.

This *White Paper on General Obligation Bond Payments* applies to securities in the GO bond market. It is not intended to supplant Securities and Exchange Commission (SEC) Rule 15c2-12 or Rule 2a-7, and should be used in conjunction with guidance provided in those rules. In addition, this white paper is not intended as a summary or discussion of the legal standards or laws/regulations governing conflicts or ethics in municipal finance transactions. It is important to note that the NFMA's disclosure efforts are a continuing process. The NFMA's white papers are not static documents; they will be revisited and changed as market conditions warrant. The NFMA encourages interested parties to submit comments at any time to lgood@nfma.org so that they can be considered in the development of future versions of this white paper.

Please note that this white paper does not constitute legal advice to any participant in the municipal bond market, including, among others, bond issuers, obligors, broker-dealers, and/or law firms. The white paper represents the NFMA's recommended primary market disclosure, based on the experience of its members, and informational needs of investors, as municipal credit analysts and market participants, of information that is important for assessing the credit features and security provisions of municipal bonds.

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OVERVIEW: GOALS OF THIS WHITE PAPER

In this paper, the NFMA intends to comment on the following issues relating to statutory liens:

- Circumstances in the municipal market have changed in a way that has elevated the significance of statutory liens benefitting debt obligations as a security feature of GO bonds.
- GO issuers should adopt best practice disclosure that clearly details the existence (or non-existence), terms and significance of statutory liens in all offering documents going forward.
- The application of statutory liens varies on a state-by-state basis and is still evolving. However, recent legal challenges to the payment of GO bonds in Chapter 9 have reinforced the legal importance and applicability of this type of lien and disclosure of its provisions especially if the statutory lien will be recognized in bankruptcy.
- The widespread differences in disclosure relating to security provisions for GO bonds limits market appreciation for the various treatments of these bonds in Chapter 9 and state court receiverships. Existing disclosure is frequently inadequate. We believe security provision disclosures should include a discussion on the presence (or lack thereof) of a statutory lien on pledged revenues, if any.
- While this paper focuses on statutory liens, there are many other issues that affect the treatment of bondholders in a municipal bankruptcy, such as whether the revenues pledged to pay the bonds constitute "special revenues" under the U.S. Bankruptcy Code, or are subject to mandatory set asides, priorities, or appropriation under state statutory or constitutional provisions. As a disclosure matter, these types of details deserve the same attention from market participants as statutory liens, and this paper is meant in no way to diminish their importance to investors.

The goal of this paper is to provide guidance and recommendations about the best practices for the disclosure of statutory liens in GO bond issues. After a discussion of why the disclosure of statutory liens has become critical, we take stock of the information that is currently being delivered to municipal market participants about the presence of statutory liens through a survey of recent offering documents, rating agency commentary and legal opinions. Finding a muddled message, we build the case for improved disclosure and point out specific disclosure issues that need to be addressed. The NFMA hopes this paper will draw the attention of regulators and industry groups to the importance of disclosing detailed security provisions as a standard practice.

We recommend this white paper be supplemented by the NFMA's June 2014 "White Paper on Best Municipal Bond Issuance and Disclosure Practices" for a thorough discussion of best practices related to the issuance of municipal bonds. This white paper expands on Section IV of the 2014 white paper. We also recommend reviewing the NFMA's 2015 "Recommended Best Practices in Disclosure for State Government General Obligation and Appropriation Debt" for a comprehensive overview of disclosure for state GO bonds.

SECTION 1: WHAT IS A STATUTORY LIEN UNDER STATE LAW AND THE US BANKRUPTCY CODE?

- A statutory lien is created by state law found in a state statute.
- The clarity of the language in statutes is inconsistent, and often it is difficult to tell if a statutory lien exists.
- Issuers should work with counsel to determine if their bonds are subject to a statutory lien and then disclose it.

A statutory lien is different from a Uniform Commercial Code ("UCC") security interest which arises solely out of a contractual arrangement between the issuer and the debt holder, such as a consensual lien created by a bond indenture, bond resolution or ordinance. The difference between statutory liens and consensual liens is critical because a statutory lien could attach to revenues received by the municipality after it files for bankruptcy, while the latter does not. Under Section 552 of the Bankruptcy Code, a perfected security interest in property can terminate upon the filing of a Chapter 9 (except in certain circumstances).

The Bankruptcy Code provides a more restrictive definition of statutory lien calling it "a lien arising solely by force of a statute on specified circumstances or conditions…."[1] The hallmark of a bankruptcy statutory lien is that the lien must arise automatically with no need for perfection, notice of other conditions—it arises purely by operation of law. The importance of a statutory lien on revenues under the Bankruptcy Code is that the statutory lien continues on revenues post-petition (a similar treatment is given to "special revenues"). Hence the secured status of a GO bond would include revenues (e.g., property taxes) to be collected in the future and not just assessed and collected prior to the bankruptcy petition. Although the general definition of a statutory lien may be straightforward, it is not always easy to tell if the statute itself creates a lien on specific revenues. In fact, the difficulty of identifying the existence of a statutory lien may be one of the reasons that the quality of disclosure in this area is so lacking as it may require advice or opinion of legal counsel. The state statute does not need to specifically say that a "statutory lien" is present, but the force and effect of the language of the statute must create the charge against or interest in the specific asset of the debtor.[2] Since the average municipal bond analyst is not also an attorney, it is important that bond counsel or disclosure counsel clearly state whether a statutory lien exists.

Some state statutes are very clear by their language and may even use the words "statutory lien". Others may state that the taxes, revenues and other income pledged by the municipality are immediately subject to the lien of such pledge from the time the pledge is made (i.e., from the time the bonds are issued). In either case, if the law establishes a lien or pledge and therefore a statutory lien is present, this should be disclosed. Sometimes these statutes underscore the point by including language that mandates the priority of the lien on pledged revenues over other claims and liens, or that the pledged revenues can only be used to pay the debt obligation.

[1] See 11 U.S.C. § 101(53).
[2] See 11 U.S.C. § 101(37).

Alternatively, some statutes provide for an intercept of the tax revenue pledge so that taxes are paid directly to a special account or bond trustee for the benefit of bondholders. However, an "earmarking", or restricted use or direct intercept of certain revenues does not in itself create a statutory lien. As previously defined, Bankruptcy Code Section 101(53) has a very specific definition of statutory lien as follows: "lien arising solely by force of a statute on specified circumstances or conditions…but does not include security interest or judicial lien…."

Laws that create statutory liens can be confused with other statutes that relate to revenues pledged by a municipality, which further demonstrates the need for clear disclosure. For example, there are statutes that deal with the perfection of a security interest in pledged municipal revenues, the purpose of which is to establish the secured status of a creditor without the need of any further filing with the Secretary of the State or with any other governmental entity, as might otherwise be required by the UCC Article 9. (e.g., See UCC 9-109(c)(2)). In effect, these types of state laws assume the pre-existence of a valid lien, pledge or security; but they do not create the lien itself. Laws that create statutory liens often include this type of "perfection" provision, but a statutory lien and perfected lien should not be construed as one and the same thing. Their purposes are entirely different. One creates the lien, while the other makes clear that there is no need for any further act in order to perfect the lien. Under the Bankruptcy Code, a statutory lien must arise by operation of law with no steps needed for perfection.

Ultimately the analysis of whether a particular statute creates a statutory lien is a legal one. We do not undertake in this paper to offer definitive conclusions on whether a statutory lien on GO bonds exists under the laws of any given state. Each issuer, with the assistance of counsel, should conduct its own analysis of the applicable state law to determine if its bonds have the benefit of a statutory lien. Instead, our goal is to impress upon issuers, counsel, and all other parties involved in the preparation of offering documents, the importance of examining this issue and making their findings known.

SECTION 2: WHY NOW?

- Until the Great Recession, statutory liens were not an active part of the conventional analytical dialogue related to GO bonds.
- Statutory liens give bondholders a secured claim on pledged revenues, and thus are important to determining risk.
- Whether a bondholder is treated as a secured or unsecured creditor has been one of the key factors in determining bondholder recoveries in bankruptcy.

The harsh effects of the Great Recession on the finances of state and local governments are well known. Large job losses, precipitous declines in property values, and generally reduced economic activity led to sharp drops in tax revenue and, at the same time, new demands were being placed on government resources. The credit quality of many municipalities suffered as a result. In certain cases, the economic strain came suddenly, while in others the Great Recession exacerbated problems that were years in the making. The downturn even led some local governments, most notably the City of Detroit, to file for bankruptcy.

The recent spate of municipal bankruptcies has challenged certain assumptions about the promises made by cities and towns to repay bonded debt from any and all available taxes. Once thought to be the ultimate form of security, the sanctity of this "general obligation" pledge has been questioned and to a large extent, undermined, by the claims of other bankruptcy creditors. Holders of GO bonds have received lower recoveries than pensioners and even other classes of municipal bondholders in several court-approved settlements, including the Detroit case. Discovering that the rights to repayment of a GO bondholder can be inferior to those of other creditors has challenged the past beliefs of the investor community related to security.

In the wake of these recent cases, the market has focused on trying to determine where GO bondholders fit in the hierarchy of creditor claims. One of the key factors in this assessment has been whether GO bondholders are treated as secured or unsecured creditors. A secured creditor is one that has a specific charge against or interest in property, including revenue, for the payment of debt, whereas an unsecured creditor does not. In the context of GO bonds, this enhanced right to repayment, if it exists, typically comes in the form of a statutory lien and/or in some cases, special revenues. Having a statutory lien is therefore significant because it can ensure the priority of bondholder claims over those of other creditors.

Security liens, or statutory or constitutional mandated payments, have not been a part of the conventional analytical dialogue related to GO bonds. They received scant attention prior to the Great Recession, in large part due to the extremely low default and bankruptcy rates of municipalities. On the relatively rare occasions in which local government bankruptcies did occur, such as in the case of San Jose Unified School District in 1983, investors expected to receive, and normally did receive, full recovery of what was owed to them on GO bonds.[3] Moreover, the market relied heavily on the strength and history of one of the most common types of GO security pledges used by local governments, which entitles bondholders to receive the benefit of a specific unlimited tax levy to repay bonds, often approved by voters under a statutory provision of state law.

The protections afforded GO Unlimited Tax Bonds (ULTGOs) were directly challenged in the City of Detroit's bankruptcy filing by the Emergency Manager (EM), who proposed that the City's ULTGOs be treated as unsecured debt due to the absence of explicit language that the EM believed would be sufficient to support a post-petition statutory lien determination. While a legal settlement rather than a judgment by the U.S. Bankruptcy Court was used to determine the recovery value on Detroit's ULTGOs, the legal challenge on the grounds that the GOs were not secured debt was clearly enough to spark a legitimate call by investors for more clear and detailed disclosure on the GO bond's secured status both outside and inside a Chapter 9 bankruptcy.

As Detroit and other recent Chapter 9 cases have demonstrated, the protections afforded by the Bankruptcy Code to different types of municipal bonds have entered the mix of information that must form the basis of a sound investment decision. In particular, the presence or absence of a statutory lien can have a major impact on whether and to what extent GO bondholders have a secured claim and get paid once a municipality files for bankruptcy.

[3] The San Jose Unified School District filed for Chapter 9 municipal bankruptcy on July 1, 1983 and continued to make scheduled debt service payment on its unlimited tax general obligation bond when due.

In general, adequate disclosure of the secured status of bonds has thus assumed increased importance. In order to have a full understanding of what they are buying, investors of GO bonds should be aware of their rights under state law and under Chapter 9 bankruptcy, and know if their GO holdings are protected from impairment. Even outside of the bankruptcy context, understanding exactly what a bondholder's security is, is critical. Such security features might also affect the price an investor might be willing to buy a particular GO bond. It is therefore incumbent on those who sell such bonds to provide investors that information.

Section 2A: The Presence of Statutory Liens Affects Many Market Participants

Many factors influence ratings, the decision to buy or sell, insurability, and pricing in the primary and secondary markets. The presence of a statutory lien influences the decisions of the various market participants, and is particularly important in the case of obligors with weaker credit profiles or an increased risk of defaulting or entering into bankruptcy. The presence or absence of a statutory lien may inform market participants' opinions of potential recovery rates and the fair value of the bond, demonstrating the importance of this information to the proper functioning of the municipal market. Because of the importance of statutory liens to so many market participants, clear disclosure is necessary.

Section 2B: History and Potential Impact on Recovery in the Event of a Bankruptcy

While Chapter 9 filings remain rare, statutory liens become particularly meaningful in the event of a municipal bankruptcy filing. The lien on a contractual pledge of an entity's taxes or revenues may terminate as part of the bankruptcy proceedings unless there is a statutory lien or pledge of special revenues. However, statutory liens have repeatedly been ruled not to be invalidated as part of a Chapter 9 filing, allowing applicable bonds to be classified as secured debt during the Chapter 9 process. Generally, the U.S. Bankruptcy Code currently dictates that secured debt receives priority of payment—up to the value of the collateral—including in a Chapter 9 proceeding.[4] However, determining the value of the secured GO bondholders' claim in bankruptcy has not been litigated, and many uncertainties exist as to secured claim valuation of GO bondholder claims.

In the following table, we present five case studies of recent Chapter 9 proceedings. While not all of these Chapter 9 proceedings involved ULTGO bonds, and many recoveries were

[4] A statutory lien should remain unaltered in a Chapter 9 proceeding, and there is a continuing right to be timely paid after the filing of a Chapter 9. Such unimpairment was recognized in the Chapter 9 proceedings of Orange County, California in 1994 (delay in payment due to appeal and reversal of Bankruptcy Court as to effect of a statutory lien) and the Sierra Kings Health Care District Chapter 9 in 2009 (relating to the General Obligation Bonds).

negotiated as opposed to court ordered, this summary underscores the importance of understanding whether you have a statutory lien or not going into a Chapter 9 proceeding.[5]

Historical Chapter 9 Recovery Rates

Debtor	Year Filed	Type of Debt	Plan Recovery
Orange County, CA	1994	TRANs	100%
Sierra Kings Healthcare District, CA	2009	ULTGO Bonds	100%
Central Falls, RI	2011	ULTGO Bonds	100%
Jefferson County, AL	2011	Sewer Warrants	60%-80%
		LTGO Warrants	88%-95%
		Lease Revenue Warrants	100%
		LO School Warrants	100%
Detroit, MI	2013	ULTGO Bonds (Insured)	74%[6]

Key:
TRANs=tax and revenue anticipation notes
ULTGO=unlimited tax general obligation
LTGO=limited tax general obligation
LO=limited obligation

Orange County, California: During Orange County's 1994-1995 bankruptcy proceedings, there was considerable debate as to whether the county's tax and revenue anticipation notes (TRANs) were subject to a statutory lien. The accompanying state statute, California Government Code section 53856, stated that "the note or notes and the interest thereon shall be a first lien and charge against, and shall be payable from the first moneys received" by the entity.

Under the note resolution, the county was obligated to set aside pledged revenues on a monthly basis and make up any deficiency from generally available funds. Following the county's filing for Chapter 9 protection in December 1994, the county ceased making set aside payments citing they were no longer required, pursuant to 11 U.S.C. Section 552(a).[7] Noteholders sought relief in bankruptcy court, calling for the county to make set aside payments. The court found noteholders had a security interest as opposed to a statutory lien, with the security interest no longer valid due to the county's Chapter 9 filing. Upon appeal, the U.S. District Court reversed the lower court's decision, finding the county's approximately $60 million of TRANs were subject to a statutory lien, which survived the Chapter 9 filing.[8] The matter was remanded back to the bankruptcy court with instructions to provide appellants protection of their interests.

[5] Spiotto, Reducing Risk of State and Local Government Debt Obligation, Statutory Liens from Rhode Island to California SB222, http://muninetguide.com/reducing-risk-to-payment-of-state-and-local-government-debt-obligations-statutory-liens-from-rhode-island-to-california-sb222/.

[6] ULTGO bonds had a recovery rate of 74%. Because the bonds were insured, bondholders experienced no principal reduction, but insurers had to make up for the difference between the 74% recovery and par value, or 26%.

[7] U.S. District Court for the Central District of California. 189 B.R. 499. July 12, 1995.

[8] Ibid.

The applicable debt was eventually refinanced and paid in full as part of the county's debt adjustment.

Sierra Kings Healthcare District, California: Sierra Kings Healthcare District provides a useful example of a special district ULTGO subject to a statutory lien, which was upheld in bankruptcy proceedings. The district filed for Chapter 9 protection in October 2009. Included in the district's debt at the time was $5.7 million of ULTGO bonds paid from a property tax levy within the district, as well as $7.1 million of revenue bonds.

As part of the bankruptcy proceedings, U.S. Bankruptcy Court, Eastern District of California (Case 2009 19728) confirmed the district pledge of ad valorem taxes as both a special revenue pledge and a statutory lien. The court further ruled that the Chapter 9 proceedings and any resulting debt adjustment plan could not interfere with bonds, notes or municipal obligations that were special revenue pledges or subject to a statutory lien.[9] The district's revenue bonds were not provided similar protections.

Central Falls, Rhode Island: Central Falls provides one of the strongest supports for the value of statutory liens during bankruptcy. Prior to the city's filing for Chapter 9 in 2011, the Rhode Island State Legislature instituted a statutory lien on local GO debt which applied to previously issued debt as well as future issuance. Section 45-12-1 of the Rhode Island State Statutes now states:

> "…the pledge of ad valorem taxes and general fund revenues is subject to the lien of the pledge without delivery or segregation, and the first lien on ad valorem taxes and general fund revenues is valid and binding against all parties having claims of contract or tort or otherwise against the city or town, whether or not the parties have notice thereof. The pledge shall be a statutory lien effective by operation of law and shall apply to all general obligation bonds and notes and other financing obligations of cities, towns and districts heretofore or hereafter issued and shall not require a security agreement to be effective."

The city continued to make full and timely debt service payments on its unlimited tax GO bonds throughout bankruptcy proceedings, while GO bondholders realized a 100% recovery rate from the city's bankruptcy plan.[10] Lease holders, pension beneficiaries and vendors all were subject to varying levels of reductions.

Jefferson County, Alabama: Jefferson County filed a Chapter 9 petition for relief in November 2011. Sewer warrants represented the vast majority of outstanding debt at the time of the filing,

[9] US Bankruptcy Court, Eastern District of CA. Sierra Kings Health Care District, Case 2009-19728. September 13, 2010.
[10] U.S. Bankruptcy Court, District of Rhode Island Case 11-13105.

while limited tax GO warrants, limited obligation school warrants and lease revenue warrants were also outstanding. At the time of the proceedings, there was no statutory lien for GO debt in the state of Alabama.

While the county's GO debt was not subject to a statutory lien, GO warrant holders' recovery rates ranged from 88% to 95%.[11] Lease revenue warrants, which were secured by lease rental payments made by the county to the Jefferson County Public Building Authority, and the limited obligation school warrants, secured by a pledge of 1% of gross Education Sales Tax revenues, were not impaired by the county's debt adjustment plan.[12]

Sewer warrant holders' recovery was as low as a 40% loss for those who did not consent to the settlement with the bond insurers contained in the plan of adjustment, but most bondholders consented to the settlement and were paid approximately 80% of principal. The lower recovery rate for sewer warrant holders was mainly driven by the lack of pledged revenues to meet debt service due to a failure of the county to comply with the original projected rate schedule and rate covenant. While special revenue pledges are treated as secured debt under Chapter 9, debt service on such bonds are subject to available pledged revenues less necessary operating expenses of the system.[13]

Detroit, Michigan: After filing for Chapter 9 bankruptcy in 2013, the City of Detroit defaulted on many aspects of its debt, including its ULTGO bonds. As part of the ensuing proceedings, the city's EM argued that its ULTGO and Limited Tax GO (LTGO) bonds not additionally secured by distributable state aid should be treated as unsecured debts by the court.[14] There was question as to whether there was sufficiently explicit language granting the bonds a statutory lien in Michigan prior to or during the city's Chapter 9 proceedings. Article IX Section 25 of the Michigan Constitution provided: "The repayment of voter approval bonded indebted is guaranteed" and the ULTGO were voted approved with the collected tax revenues intended to be paid to voter approved debt.[15]

In accordance with a settlement between the city and its ULTGO bondholders, ULTGO bonds had a recovery rate of 74% to insurers and 100% to bondholders with the balance (26%),

[11] Moody's Investor's Service. Jefferson County's Lower GO Leverage Fuels Higher Recovery than Sewer. March 18, 2014.

[12] U.S. Bankruptcy Court, Northern District of Alabama. Jefferson County, Alabama, Case 11-05736. December 2, 2013.

[13] 11 U.S. Code Subchapter 928; U.S. Bankruptcy Court, Northern District of Alabama. Jefferson County, Alabama, Case 11-05736. January 12, 2012.

[14] City of Detroit, Michigan. Proposal for Creditors. June 14, 2013.

[15] Legislation was introduced in Michigan legislature in 2014 to clarify and confirm that the ULTGO statutory pledge of the revenues to the Bondholders was intended to be a statutory lien (H.B. 4495). This legislation has passed the Michigan House and is awaiting passage by the Michigan Senate at the time of this writing. Passage of the bill could help mitigate the stigma and cloud raised by the Detroit bankruptcy, improve market acceptance of Michigan ULTGOs for schools and cities and lower the borrowing costs. Failure to enact the law could confirm fears that the concerns raised by Detroit that increase borrowing costs for schools and municipalities issuing ULTGOs by about 100 basis points was correct and the additional cost will likely become a permanent burden.

coming 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.[16] Unsecured LTGO bondholders received a 41% recovery rate.

SECTION 3: CURRENT PRACTICES RELATED TO DISCLOSURE OF STATUTORY LIENS

Issuers typically describe the security for their bonds in a brief section of the official statement. For bonds backed by a GO pledge, this description often specifies the limited or unlimited nature of the ad valorem taxing authority for the payment of debt service, and may also include a pledge of the full faith and credit of the issuer. Given increased investor focus on the importance of statutory liens, however, recent challenges to the payment of GO bondholder claims as fully secured claims, historic offering statement disclosure regarding GO bond security disclosure is no longer adequate.

This section looks at how the disclosure of statutory liens has been handled in specific cases. Certain cases provide helpful models, but they are the exception. For the most part, the GO security disclosure is hard to understand, incomplete, or non-existent.

Section 3A: Disclosure in States that Provide for a Statutory Lien

Statutes conferring a lien on tax revenues pledged for debt service currently exist in various states (e.g., California, Colorado, Idaho, and Rhode Island).[17] In addition, Florida provides for a lien on the escrow for refunded bonds, and New Jersey recently enacted legislation creating a statutory lien on state aid for bonds additionally secured under the state's Municipal Qualified Bond Act.

Issuers in Colorado, Louisiana, and Rhode Island have made specific reference to statutory liens or to the statute creating the lien in their offering documents. In the official statement for its Series 2015 issue, Poudre School District R-1 in Colorado described the security as follows (emphasis added):

> "The Bonds are general obligations of the District payable from ad valorem taxes which may be levied against all taxable property within the District without limitation of rate and in an amount sufficient to pay the principal of and interest on the Bonds when due….The Bonds are not secured by land within the District, but rather by the District's obligation to certify to the Board of County Commissioners of the County a rate of levy sufficient, together with other legally available revenues, to meet the debt service

[16] Oral Opinion on the Record. U.S. Bankruptcy Court for the Eastern District of Michigan. Case 13-53846. November 7, 2014.

[17] See, e.g., statutes in California (Section 15251 of CA Education Code and Section 53515 CA Gov. Code), Rhode Island (R.I. Gen. Laws Chapter 45-12), Colorado (Colorado Revised Statute 11-57-208), Idaho (*Id.* Code Title 57, Chapter 2, Section 234). Compare: e.g., Louisiana (LA Rev. Stat. 39:14301), Oregon (OR Rev. Stat. 287A.310), Texas (TX Govt. Code Title 9, Subtitle A, Sec. 1202.006 and 1208.002) and Utah (UT Code. 11-14-501).

> requirements on the Bonds. *Such annual levy for debt service creates a statutory tax lien.*"[18]

Similarly, Rhode Island issuers have explicitly stated that bondholders enjoy a statutory lien on tax revenues pledged for debt service. In the offering documents for its series 2014 A and B issue, Providence, Rhode Island additionally provides a summary of the statute creating the lien (emphasis added):

> "In July of 2011, *the General Assembly enacted amendments to Section 45-12-1 of the Rhode Island General Laws to provide for a statutory lien on ad valorem taxes and general fund revenues for the benefit of general obligation debt of cities and towns such that the statutory lien has a priority in a bankruptcy*. The amendments provide, in part, as follows…"[19]

Although Louisiana issuers have generally not used the phrase "statutory lien" in describing the security in their official statements, they have noted that pledged tax revenues are subject to the lien of the pledge, and have cited the statute that creates the lien. In its Series 2015 issue, Bossier Parishwide School District stated the following (emphasis added):

> "The Issuer pledges the revenues of the special, unlimited ad valorem tax referenced above as security for the Bonds….Pursuant to the Louisiana Constitution, the proceeds of such tax may only be used to pay debt service on the Bonds, and pursuant to Section 39:1430.1 of the Louisiana Revised Statutes of 1950, as amended, *the tax collections so pledged and then or thereafter received by the Issuer or paying agent shall be subject to the lien of such pledge."*[20]

California recently enacted legislation (SB 222) that clarified the statutory lien security for GO bonds. Subsequently, San Diego Unified School District became one of the first examples of disclosure on the new law, having issued GO bonds in November 2015.[21] The official statement for that offering provided the following language, which describes the specific instance and broader application of the new law (emphasis added):

> "California Senate Bill 222 (2015) ("SB 222), which becomes effective January 1, 2016, provides *that general obligation bonds issued by California local agencies, like the District, are secured by a statutory lien on the ad valorem taxes levied and collected to pay principal and interest on the bonds*, regardless of whether the bond issuer or bondholders take any steps to pledge, record, or take possession of the taxes."

While SB 222 provides for a statutory lien, bond counsel reportedly also provided a special opinion stating the ad valorem property taxes securing the bonds would be considered special revenues in the event of Chapter 9 proceeding and would be exempt from automatic stay

[18] Official statement dated Aug. 26, 2015, available at http://emma.msrb.org/EP1075214.pdf.
[19] Official statement dated Jun.19, 2014, available at http://emma.msrb.org/EA875025.pdf.
[20] Official statement dated Apr. 9, 2015, available at http://emma.msrb.org/EA955060.pdf.
[21] Official statement dated Dec. 2, 2015, available at http://emma.msrb.org/EP896628-ER727980-ER1129473.pdf.

provisions.[22] In order to make timely debt service payment, the Board of Supervisors of San Diego County is obligated to levy ad valorem taxes, without limitation as to rate or amount. Collected ad valorem revenues are required to be deposited in the district's Interest and Sinking Fund, which is required by law to be used solely to make payments on the district's GO debt.[23]

If counsel provides an opinion or analysis on statutory liens, special revenues or security provisions in general that is used to support statements in the preliminary offering statement (POS) or other sales materials, the NFMA asserts that those opinions should be made public in the offering documents and available to all potential investors since they clearly are material information intended to influence an investment decision. If these opinions or analyses are provided to the rating agencies to influence the rating of the bonds, NFMA argues for their disclosure in the POS for the same reasons. It is NFMA's belief that all of these legal opinions or analyses contain material assumptions and exceptions that must be disclosed so that investors can assess the reasonableness of the opinions. The NFMA has consistently taken the position that disclosure of material information to only one market participant, such as a rating agency, should not occur, and any material information used to rate or price bonds should be available to all investors and disclosed in the POS. If counsel's opinion or analysis is confidential or not subject to public disclosure, that fact needs to be stated and appropriate risk disclosures put in the POS regarding reliance on "confidential" legal opinions. In any case, the full text of the relevant statutes should be included in the POS so that investors may derive their own conclusions with advice of counsel, and any relevant state higher state court decisions on the statute should be cited.

Section 3B: Disclosure in States that Do Not Provide for a Statutory Lien

Among issuers in states that either do not provide for a statutory lien or where the language is unclear as to its status, only those in Connecticut seem to regularly disclose this fact. The following excerpt from North Haven, CT's official statement for its 2015 issue is typical of disclosure from Connecticut issuers:[24]

> "There are no statutory provisions for priorities in the payment of general obligations of the town. There are no statutory provisions for a lien on any portion of the tax levy or other revenues or property to secure the bonds, or judgments thereon, in priority to other claims."

Aside from Connecticut, we have been unable to find examples of disclosure on statutory liens in states where they do not exist.

[22] Special Revenues' Opinion Boosts San Diego School Bonds. The Bond Buyer. Dec. 1, 2015.
[23] Official statement dated Oct. 8, 2015. Available at http://emma.msrb.org/IssueView/IssueDetails.aspx?id=ES358868.
[24] Official statement dated Sept. 22, 2015, available at http://emma.msrb.org/ES968334.pdf.

SECTION 4: WHAT IS NEEDED FOR MORE DETAILED GO PAYMENT PROTECTION DISCLOSURE?

Section 4A: What Should Disclosure Look Like?

- The disclosure should discuss whether a state statutory lien exists, where that authorization comes from, and include the full text of the statutory lien. If there is a lack of clarity on the existence of a statutory lien, the uncertainty should be clearly stated. Whether a state statutory lien can be avoided under Section 545 of the Bankruptcy Code should also be discussed.
- Any opinions or analyses provided by bond counsel and used by any market participant in conjunction with the issuance of the bonds should be disclosed publicly in the offering document.[25]
- Also important to understanding statutory liens is disclosure of whether pledged revenues are commingled with non-pledged revenues.
- The issue of state statutory liens is one that lends itself to standardized disclosure for issuers of GO bonds within the same state.
- If debt is issued under newly passed statutory lien legislation and there was debt outstanding at the time of the legislation, issuers (or their advisors) should disclose whether the statute retroactively applies to previously issued debt.

As discussed in Section 1 of this white paper, the Bankruptcy Code gives special treatment to certain statutory lien bonds through a continuing post-petition claim on identifiable, pledged revenues received by a debtor after the filing of a bankruptcy case. This continuing, post-petition lien in turn helps support the secured status of the GO bondholder claim and increases the difficulty of impairing that secured claim in a Chapter 9 bankruptcy. The cases discussed demonstrate that the primary benefit of this special treatment is the prospect of higher recoveries in bankruptcy. Rating agencies and numerous other commentators have noted the superior recovery prospects of statutory lien bonds as a reason to favor them over other types of bonds.[26] Having a statutory lien also raises the possibility that payments to bondholders will continue uninterrupted through the bankruptcy process. These two advantages – the prospect of higher recoveries and the possibility of uninterrupted payment – prove the importance of a statutory lien to bondholders.

Presented with the choice between owning two bonds at the same price, one with a statutory lien on pledged revenues and one without any lien on those same revenues, investors would reasonably prefer the one with a statutory lien, all other things being equal. Yet in today's

[25] As also stated in the NFMA White Paper on Best Municipal Bond Issuance Practices, Section III-P, we do not think there should be disclosure of any information to only rating agencies or any one market participant. June 25, 2014.

[26] See, e.g., Epstein, Kenneth R. and Lawrence A. Larose. Michigan Statutory Lien Bill – A Clarification of Existing Law. The Bond Buyer. October 26, 2015.

market, most investors are not able to make this distinction because they are not given the relevant information.

As noted earlier in this white paper, the answer as to whether a statutory lien exists may not always be clear. Investors must understand that the kind of certitude they seek may not be possible. But ambiguity or debates as to the law should not excuse issuers and underwriters from their disclosure obligations. Even uncertainty or the desire for further legislative clarification can be clearly stated. Therefore, in cases where it is not readily apparent that a statutory lien exists, it is still reasonable for investors to expect a diligent examination of the law and a summary of the analysis. True clarity of disclosure is to state either a statutory lien exists or does not, or, if it is unclear, to explain the reasons why it is unclear. As with any legal issue pertaining to the issuance of municipal bonds, the conclusions of counsel should be presented to investors following a review of the relevant law. As a best practice, the statutory or constitutional provision that gives rise to the statutory lien should be referenced.

Beyond answering the basic question of whether a statutory lien exists, the discussion of this security provision should help investors understand the significance of such a lien. Such an analysis naturally involves consideration of bankruptcy provisions and the legal standing of a statutory pledge within the framework of Chapter 9. It is thus critical to explain the special status of statutory lien bonds as secured debt and the rights of statutory lien bondholders to post-petition revenues. Whether payment on bonds backed by a statutory lien are subject to the automatic stay is another important disclosure point.

Other points of disclosure depend on the specific state law at hand. The state law may direct the payment of a dedicated revenue stream into a special account that is held by a third party. Alternatively, the law may restrict the permitted uses of the revenues subject to the statutory lien. For example, in California, the recently enacted Senate Bill 222 requires all taxes collected on behalf of school districts to be credited to an interest or sinking fund of the school district held by the governing county and used solely for the payment of debt service. A bankruptcy court cannot impair, limit, stay or interfere with state's power to control by legislation or otherwise a municipality's exercise of its political or governmental powers, including as to expenditures, and therefore, the details of state law are worthy of attention since they could affect the treatment of the pledged revenues in bankruptcy.[27]

A related GO payment concern that must be addressed regarding statutory liens is the commingling of pledged revenues. It is a general principle of UCC Article 9 (security interests) and other state laws, that a lien, pledge or security on revenues can be lost if the pledged

[27]Sections 903 and 904 of the Bankruptcy Code contain the language required by the Ashton and Bekins cases cited below that the Bankruptcy Court must honor and cannot stay or interfere with any state statutory or constitutionally mandated required payment of tax revenues or proceeds of property as collected are to be paid to the debt it is so pledged and dedicated to. The municipality as debtor cannot consent or act contrary to such state statutory or constitutional mandated payments. For a detailed analysis of the legal support for this, see Ashton v. Cameron County Water Improvement District Number 1, 298 U.S. 513 (1936) and In United States v. Bekins, 304 U.S. 27 (1938). For a detailed analysis of the legal support for these provisions, see James E. Spiotto, The Myth and Reality of Statutory Liens and Special Revenue Treatment in Chapter 9, October 7, 2015, http://www.chapmanstrategicadvisors.com/media/event/15_Chapman_Strategic_Advisors_Myth_and_Realities_of_Statutory_Liens_0715.pdf.

revenues are commingled with non-pledged revenues in an account. So despite having a statutory lien on pledged revenues (e.g., property tax collections), if the pledged revenues are deposited in a government account with other revenues, bondholders can lose their lien unless they can identify the pledged revenues in the account—which can be difficult. Therefore, full disclosure of whether pledged revenues are commingled is necessary.

At the time of this writing, there are a number of states that are actively considering legislation to grant a statutory lien to GO bonds.[28] The goal of such legal changes is to elevate the status of bondholder claims or to confirm existing law, thereby ensuring that municipalities are able to access the market at the lowest possible cost. Given the potential to affect the security and pricing of bonds if such legislation becomes law, it is important for investors to know if legislative efforts are underway in a given state and the relevant details of the legislation.

Since a state legislature could pass law to create a statutory lien at any time, it is important that issuers disclose whether the legislation applies to previously issued debt as well as debt issued in the future. If it is unclear whether the legislation is retroactive to debt outstanding at the time of the legislation, that too should be disclosed.

We note that the disclosure of statutory liens is one that lends itself to standardization. Since the relevant state law applies equally to all GO bonds within a state, the disclosure could be the same. Connecticut and Rhode Island are examples of places where uniform disclosure has taken hold.

For issuers and counsel, standardization may ease the burden of crafting language that accurately reflects state law as a separate exercise for each bond issue while also satisfying their respective disclosure responsibilities. Therefore, we encourage collaboration among bond lawyers to create uniform disclosure for each state.

Section 4B: Disclosure of the Existence or Non-Existence of a Statutory Lien Should Be Made in All Cases.

It may be argued that information related to statutory liens is important only if a bankruptcy filing is imminent. While it is true that the benefits of a statutory lien bear fruit in the context of bankruptcy, this does not mean issuers should wait until they are in financial distress to tell investors whether a statutory lien exists. First, it is impossible to know with certainty at the time of issuance if a municipality will remain financially solvent through the life of the bonds. Any conjecture along these lines involves a level of subjectivity that makes it impossible to develop a common standard of disclosure. Therefore, it is simply not feasible to use the relative credit strength of the issuer as a gauge to measure whether this disclosure is necessary.

Second, there are many situations in which bonds include special security features that only come into play if the issuer runs into financial difficulty. For example, debt service reserve funds provide an extra layer of protection to bondholders if the normal flow of revenues runs dry. Their presence is always disclosed in the offering documents even though at the time of

[28] See, e.g., HB 4495 in Michigan and LB 67 in Nebraska.

issuance no one expects them to be used. The same is true of mortgages and bond insurance. So while the existence of a statutory lien may be especially important to know for issuers near bankruptcy, it always forms part of the overall security package, and therefore should be disclosed in all cases at the time of debt issuance.

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. But as with the financial condition of a city, laws can change. Indeed, states may change their municipal bankruptcy laws precisely when a community is in fiscal distress. Michigan tweaked its emergency manager law as pressure mounted on Detroit, and Rhode Island passed legislation in anticipation of the Central Falls bankruptcy. Since states can alter the bankruptcy authorization at any time, clarification on the lien status is needed regardless of whether bankruptcy is currently available to municipalities within a particular state.

Section 4C: Summary of Disclosure Recommendations

- We believe that statutory lien disclosure can be standardized, particularly within a given state.
- Disclosure should outline whether a statutory lien exists and clearly state if it does not. Legislation creating the statutory lien should be included, excerpted or cited.
- If there is uncertainty as to whether a statutory lien exists, a discussion of the reason for the lack of clarity should also be included.
- Any legislation under consideration that could impact the bond's security should also be disclosed.

SECTION 5: CONCLUDING THOUGHTS

Recent municipal bankruptcy cases have demonstrated the value to bondholders of having a statutory lien and being treated as a secured creditor. Currently, investors have difficulty determining if GO bonds have the benefit of a statutory lien because the offering documents often do not provide this information. The NFMA strongly recommends that issuers, underwriters, and legal counsel improve and update all future GO bond disclosures to clearly state the existence or non-existence of a statutory lien pledge. The offering documents for GO bonds should also explain the basis under existing laws in which the lien has been created and the significance of such a legal security in the context of state laws as well as the Bankruptcy Code.

While this paper has focused on statutory liens, there are many other issues that affect the treatment of bondholders in a municipal bankruptcy, such as whether the revenues pledged to pay the bonds constitute "special revenues" under the Bankruptcy Code, or are subject to mandatory set asides, priorities, or appropriation under state statutory or constitutional provisions. As a disclosure matter, these types of details deserve the same attention from market participants as statutory liens, and this paper is meant in no way to diminish or dispute their importance to investors. Indeed, as discussed herein, state laws can fundamentally link these other issues with the issue of statutory liens.

Better disclosure of statutory liens and other matters affecting bondholder treatment in municipal bankruptcy should not be viewed as a burden, but rather as an opportunity for issuers to improve market credibility and acceptance. More detailed security disclosure should be especially beneficial to municipalities that issue GO bonds with statutory liens. In addition to lowering borrowing costs generally, it can help distressed issuers maintain market access when it is most needed. In all cases, full and accurate disclosure enables informed investment decisions and provides a better understanding of these critical issues. Finally, insofar as it may improve disclosure in the market, we ask for clarity in state laws. The task of figuring out whether a statutory lien exists should not be made unnecessarily difficult.