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Legislation Opens a New Chapter for Municipal GO Bondholders in California

In a move intended to fortify the rights of holders of California municipal general obligation debt as well as lower borrowing costs for California municipalities, earlier this month, California Governor Jerry Brown signed into law SB 222. This provision, which creates a first lien priority for general obligation debt issued by California's municipalities, was designed to create additional protections for holders of municipal general obligation debt in the event of a municipal bankruptcy under the U.S. Bankruptcy Code (the "Bankruptcy Code").[1] The anticipated result of this new law is a greater likelihood that California municipal general obligation bondholders are paid in full even if the issuing municipality files for bankruptcy protection.

Under prior law, general obligation bonds issued by California municipalities — those bonds secured by the taxing power of a municipality — were generally treated as unsecured debt. This was because the pledge securing these types of bonds was created through a contract, and pursuant to § 552 of the Bankruptcy Code, that lien terminated upon a bankruptcy filing. Section 552, however, does not apply where a lien is statutory in nature, meaning that if the underlying statute authorizing an issuance of debt also includes language establishing a "statutory lien," that lien will survive the bankruptcy filing. SB 222 provides for such a lien. California municipalities will now have the ability to issue debt with a statutory lien, thus providing the additional protections after a bankruptcy filing.

Similar types of statutory liens were put to the test in the 2011 bankruptcy filing of the City of Central Falls, Rhode Island. In that instance, less than a month before the City of Central Falls filed a municipal bankruptcy petition, Rhode Island enacted legislation, similar to SB 222, establishing a statutory lien for all general obligation bond debt issued by Rhode Island municipalities. In line with the new provision, and despite its bankruptcy filing, Central Falls honored its general obligation bonds throughout the bankruptcy proceeding, and its bonds were unimpaired by the city's bankruptcy plan.

This treatment contrasts with that afforded to bondholders in the recent Detroit municipal bankruptcy proceeding. In that instance, Detroit had previously issued certain (i) limited tax general obligation bonds (the *"LTGO Bonds"*) and (ii) unlimited tax general obligation bonds (*"ULTGO Bonds"*). Michigan does not have any type of statutory lien provision similar to SB 222, and the City's emergency manager was therefore able to argue that these two bond issuances constituted unsecured debt. Ultimately, after a settlement of these issues, holders of the LTGO Bonds and ULTGO Bond received less than full payment on their bonds from the bankruptcy estate, and even less than other creditors (such as pension claimants) who were similarly situated.

While this new statutory lien should help to protect holders of California municipal general obligation debt, it is important to note that although a bankruptcy filing will not extinguish this statutory lien, the Bankruptcy Code does not require timely payment on debt secured by a statutory lien during the entity's bankruptcy proceeding. As a result, payments to holders may be delayed during the pendency of the municipality's bankruptcy.

Furthermore, the treatment of a statutory lien in bankruptcy stands in contrast to the treatment of municipal obligations secured by a pledge of "special revenues." With respect to municipal obligations secured by special revenues, § 922(d) of the Bankruptcy Code specifically requires the continued regularly scheduled payment of principal and interest notwithstanding a bankruptcy proceeding, subject only to the net operating expenses of the underlying project for which such special revenue obligations have been issued. Therefore, while holders of special revenue debt may continue to receive timely payments during bankruptcy in accordance with the governing requirements of the underlying debt, even with SB 222, payments to California municipal general obligation bondholders may or may not be delayed in bankruptcy.

As enacted, the new California provision should therefore ensure greater bankruptcy protection for general obligation bondholders. Another potential benefit of SB 222 would be to reduce or even eliminate political influences to permit discrimination against bondholders, who are often viewed less sympathetically than other claimants such as employees, retirees and small business trade creditors.

Given the reduced risk profile, this protection should have the added benefit of giving California municipalities greater access to credit markets, while possibly lower borrowing costs.

1 Specifically, SB 222 applies to those general obligation bonds payable from ad valorem taxes levied pursuant to Article XIIIA, Section 1(b)(2) & (3) of the California Constitution and issued by California's cities, counties, cities and counties, school districts, community college districts, authorities and special districts.

For More Information

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