Understanding the Claims Process When an Insured Municipal Bond Defaults[1]

Municipal bonds have historically been among the safest investments available, with default rates among rated issuers running at a fraction of those associated with corporate debt. But as the financial difficulties of several high profile issuers have recently underscored, munis do default from time to time, occasionally impacting a large amount of principal and interest payments due to bondholders. The protection provided by a bond insurer's unconditional and irrevocable guarantee of the payment of principal and interest when due is easily appreciated in such circumstances. Less appreciated and often misunderstood is the bond insurer's ability to work with the bond Trustee or Paying Agent to ensure the proper application of available cash in accordance with bond indenture terms and to quickly determine the amount of a claim when there is a shortfall so that it can be paid in a timely manner.

The Policy Guarantee

Before getting into the mechanics of the claims process, it is important to understand the nature of the guarantee that a municipal bond insurance policy provides. Put simply, with respect to an insured bond, the bond insurer unconditionally and irrevocably guarantees to the bondholder the full and complete principal and interest payment required to be made by the issuer as such payments become due but are not paid. Under the terms of the insurance policy, in the event that the due date of a principal payment is accelerated, unless otherwise elected by the bond insurer, policy payments equal to the unpaid principal and interest due will be made by the bond insurer in the amounts and at the times set forth in the original maturity schedule for the bonds as if there had not been any acceleration. Not all transactions have identical guarantee provisions so it is important to carefully review the policy in order to understand the coverage for a particular bond issue.

How the Bond Payment Process Typically Works

The payment process for a bond issue is defined in the indenture (or other authorizing document) governing the issue. Not all transactions have identical payment provisions so it is important to carefully review the indenture in order to understand the process for a particular bond issue. Typically, the indenture will specify that the issuer send the funds required for a debt service payment to the trustee or paying agent (which may be the same entity) within a specific number of days in advance of the actual

[1] This memo is intended to provide a summary description of the typical claims process when a payment default occurs on an insured municipal bond, for general informational purposes only. The specific terms, requirements and conditions of each insurer's policy, the related bond documents, and any related court orders shall govern such insurer's obligations in respect of any particular claim, rather than this summary description.

payment date. If the trustee/paying agent has sufficient funds on deposit from the issuer to meet debt service requirements on the payment date, then the funds are disbursed to the bondholders in accordance with the terms of the indenture.

However, if the trustee/paying agent does not have sufficient funds on deposit from the issuer to meet debt service requirements on the payment date, one of the following events is likely to occur:

1. If the transaction has a reserve fund, the trustee/paying agent should draw available funds from the reserve fund to cover the shortfall and make the debt service payment.
2. If the transaction does not have a reserve fund or if the amount on deposit in the reserve fund is insufficient to cover the entire amount due, and the bond is insured, the trustee/paying agent should draw whatever funds are in the reserve fund, if any, and notify the bond insurer of the amount necessary to pay the remaining debt service payment shortfall. A claim on the policy can be submitted, by the appropriate party, pursuant to the terms of the insurance policy and the bond documents. After completion of the claims process, payments under the policy will cover the shortfall so that bondholders receive the full amount owed.
3. If the transaction does not have a reserve fund or if the amount on deposit in the reserve fund is insufficient to cover the shortfall, and the bond is not insured, the trustee/paying agent may use all available funds to make partial payments to bondholders in accordance with the priorities set forth in the indenture. However, a payment default will occur, which will likely trigger an event of default.

Payments Under the Insurance Policy

There are two types of financial guaranty insurance policies issued by bond insurers covering the payment of principal and interest when due for the benefit of bondholders:

- “Primary” policies are issued in conjunction with the original issuance of the bonds. Upon a failure of the issuer to provide sufficient funds to the trustee/paying agent to make the then-due debt service payment and notice from the trustee/paying agent, a claim can be submitted by the party identified in the policy for the missed payment on the bonds.
- “Secondary” policies are issued after the initial issuance of the bonds and are purchased by the investor holding all or a portion of such bonds. The bondholder deposits their bond with the bond insurer’s custodian (“Custodian”). The bond insurer issues a secondary market insurance policy covering the payment of principal and interest of such bond deposited with the Custodian, and the investor receives an insured bond certificate evidencing the right to receive the full payment of principal and interest when due from the Custodian either from payments received from the issuer on the bonds or from the proceeds of a draw on the secondary market insurance policy.

A bond insurance policy generally provides for the payment by the bond insurer on the later of the scheduled payment date or one business day after receipt by the bond insurer of notice that a required payment has not been or will not be made by the issuer. Each bond insurer has particular claim forms that it uses but all include similar elements, including an assignment to the bond insurer of the bondholders' rights in respect of the insured payment in exchange for the bond insurer making such payment. In some cases, the bond insurer first transfers the necessary funds to its paying agent or insurance trustee, who then disburses claims payments as claims are received; in other cases, the bond insurer may make payment directly to the bondholder or the trustee/paying agent for the benefit of the bondholders.

What Can Delay the Insurance Claim Payment Process

There are a number of factors that can result in a delay in the receipt of an insured bond payment by a bondholder:

1. **Failure to File a Timely Claim** –In the case of a primary insurance policy, a delay on the part of the trustee/paying agent to notify the bond insurer or the bondholders of non-payment by the issuer, or a failure on the part of the party entitled to make a claim on the policy to make that claim on a timely basis, may result in insufficient funds to pay investors on the payment date. Only after such notices are given and valid claims are made will payment under the policy be made in accordance with the timing and other terms of the policy. With respect to a secondary policy, the Custodian for the secondary insurance policy holder may have no prior notice of a payment default on a bond deposited with the Custodian until the payment is actually not received on the payment date of the bonds. As a practical matter, that means the Custodian is unlikely to be in a position to submit a claim to the bond insurer until the day following the missed payment date and then the bond insurer has one business day to make payment on the claim. Consequently, the Custodian may not receive sufficient funds to pay the insured bondholders until two days after the scheduled payment date of the principal and/or interest on the bonds.

2. **Delayed Delivery of Necessary Information to the Bond Insurer** –There are circumstances in which the trustee/paying agent may be unable to submit a timely and complete and accurate notice of the payment default to the bond insurer, which may delay the submission and payment of claims on the policy. These may include bond documents in which debt service funds are not made available to the trustee/paying agent until the scheduled payment date, meaning that the trustee/paying agent may not know whether there will be sufficient funds to make the required debt service payment until the end of the day. Other circumstances which may result in delays include, among other things, the collection of information from beneficial owners when needed and delayed information related to the application of partial or whole payments by the issuer on the payment date.

3. **DTC and/or Brokerage Account Delays** – If the bond insurer makes the claim payment to the trustee/paying agent for the benefit of the bondholders, the trustee/paying agent typically wires the debt service payment, in bulk, to the Depository Trust Company, which then allocates the payment to each bondholder's financial institution of record. Depending on the financial institution where each bondholder's brokerage account resides, it may then take several days for the funds to be properly allocated to each of the bondholder accounts.

Conclusion

This paper is intended to provide a summary of the mechanics involved in the processing of insurance claims on behalf of owners of municipal bonds in the event that the issuer fails to make the required payment or insufficient funds are on deposit with the trustee/paying agent to make such payment. The trustee/paying agent plays a critical role in the payment of principal and interest on all bond issues. As described above, the role of the trustee/paying agent is magnified upon the occurrence of a payment shortfall or disruption in the payment of funds to bondholders. A bond insurance policy provides an unconditional guarantee of the payment of debt service on insured bonds. However, the timely transfer and deposit of such payments to bondholders relies on the prompt and accurate actions of the trustee/paying agents, the Depository Trust Company and the banks or brokers where bondholders maintain their investment accounts. Accordingly, in such circumstances, the bond insurer works diligently to communicate with the trustee/paying agent to coordinate the payment of insured amounts to satisfy the timely payment of debt service to the bondholders.