
Fitch Disagrees with Moody's Legal Analysis on Chicago Public Schools.

Fitch Ratings-New York-01 February 2017: Moody's Investor Services (Moody's) has issued a report discussing:

–Legal options available to the Chicago Public Schools (CPS) to address its operating deficit, suggesting CPS can divert state aid to support operations to get around a restriction on a certain tax levy; and
–Bondholder protections provided by CPS' dedicated capital improvement tax bonds series 2016 (CIT bonds), minimizing the special revenue status while crediting a 'lock box' device as a real enhancement.

Fitch Ratings disagrees with Moody's on both points.

State Aid Not Available for Budget Relief

Moody's report "Chicago Public Schools, IL Frequently Asked Questions", released on Jan. 12, states "the district could elect to use unrestricted [general state aid] GSA for operations instead of debt service" on alternate bonds issued under the Illinois Local Government Debt Reform Act (the Act). Unless by 'elect' Moody's is referring to a successful ballot referendum, a plain reading of the Act indicates this is not the case. Section 15(e) of the Act clearly indicates that CPS must apply available alternate revenues {state aid} to debt service. As there is no option in the law to apply alternate revenues to operations, Fitch believes any attempt to do it would draw a successful challenge in litigation opposing an attempt to levy taxes while alternate revenues were available for debt service.

The law (Section 15(e)) is pretty clear in our opinion, as it states: "[t]he …revenue source ..shall be in fact pledged to the payment of the alternate bonds; and the governing body shall covenant, to the extent it is empowered to do so, to provide for, collect AND APPLY [emphasis added] such …revenue source …to the payment of the alternate bonds." It further states "The pledge …as provided in this Section for alternate bonds, shall constitute a continuing obligation of the governmental unit … and a continuing appropriation of the amounts received. All covenants relating to alternate bonds and the conditions and obligations imposed by this Section are enforceable by any bondholder of alternate bonds affected, any taxpayer of the governmental unit, and the People of the State of Illinois acting through the Attorney General … The intent is that such revenue source, shall be …applied to the payment of debt service on such alternate bonds so that taxes need not be levied, or if levied need not be extended, for such payment."

Alternate Bonds Not Same as Other ULTGOs

Fitch believes this constraint on extending property taxes absent a referendum is consistent with the Property Tax Extension Limitation Law (PTELL), which limits growth in the property tax extension to the lesser of 5% or CPI in the prior calendar year unless the increase is approved by voters. Debt service is limited to the "debt service extension base", which is based on the 1994 property tax extension for debt service, increased annually at the lesser of 5% or CPI, unless approved by voters.

The Act exempts alternate bonds from this limitation. If an entity could readily opt to extend the property tax instead of paying debt service from the identified revenue source (GSA, in this case) despite the availability of the alternate source, the PTELL's constraint on the rate of property tax growth for debt service would be ineffective. Fitch believes that the only way CPS could extend the ad valorem tax for debt service would be an insufficiency of pledged state aid revenues, which of course would create other serious financial challenges.

Lockbox Does Not Enhance Credit Quality

Unlike Moody's, Fitch does not give rating uplift for the presence of a third-party lockbox structure absent other legal considerations. A lock box is a simple security device that loses its effectiveness upon a bankruptcy filing as a consensual lien on revenues generally does not continue once bankruptcy begins. There are two exceptions: bonds secured by pledged special revenues and bonds secured by a statutory lien. In a Chapter 9 bankruptcy, Fitch does not believe such a structure would insulate ordinary pledged revenues from an automatic stay. Therefore bonds utilizing that structure but not secured by pledged 'special revenues' as defined under section 902(2) of the code or by a statutory lien on pledged revenues could not be rated above the Issuer Default Rating (IDR).

No Statutory Lien Under Bankruptcy Code

Fitch also does not agree that the CIT bonds are secured by a statutory lien, which is defined in Section 101(53) of the Code as a lien arising automatically, by force of statute, on specified circumstances or conditions. This lien is in contrast to a consensual lien (or security interest [defined in Section 101(51) of the Code]), in which a lien is created by agreement, where both parties to a financing agree to a certain security structure and document that agreement in an indenture or loan document. The Debt Reform Act does not provide a statutory lien for bondholders as defined in the bankruptcy code. It gives effect to a consensual lien without any further requirement for filing or notice and is a protection against other lien holders.

Bankruptcy Protection Arises from Special Revenue Designation

Fitch believes that the pledged CIT revenues would be considered 'pledged special revenues' in the event of a CPS bankruptcy. As Moody's points out, one of the differences between the alternate and CIT bond structures is that the former are "ultimately a general obligation of the district, which pledged its full faith and credit to their repayment." The CIT bonds are "payable from the CIT tax levies only." Fitch believes that this distinction is precisely the reason the CIT bonds can be considered to be secured by special revenues under 902(2)(E) of the code. As stated in Fitch's rating action commentary discussing our 'A' rating/Outlook Stable on the bonds: "Fitch sets a high bar for considering local government tax-supported debt to be secured by special revenues, which provide security that survives the filing of a municipal bankruptcy (in preservation of the lien) and benefit from relief from the automatic stay provision of the bankruptcy code. We give credit to special revenue status only if, in our view, the overall legal framework renders remote a successful challenge to the status of the debt as secured by special revenues under Section 902 (2)(E) of the U.S. Bankruptcy Code.

"Fitch has identified a number of elements we consider sufficient to reduce the incentive to challenge the special revenue status given the definitions outlined in the bankruptcy code. These include clear statutory restrictions on the use of pledged revenues to finance identified projects and clear separation from the entity's operations. Fitch has undertaken an extensive review of the statutory provisions that govern the use of the CIT. Those provisions, along with the legal documents governing the bond issuance, and related bankruptcy opinions provide sufficient strength for Fitch to rate the CIT bonds higher than the IDR.

"The bonds are secured by a first priority lien on CIT revenues. The board is authorized under the Illinois School Code to levy the CIT on all taxable property within the district, which is coterminous with the city of Chicago. State statute limits the permitted uses of CIT revenues to include construction, acquisition and equipping of school and administrative buildings, and site improvements. The board has identified specific capital projects in the bond resolution that may be funded either by bond proceeds or by residual CIT revenues. Any amendments to the project list must be passed by board resolution. The revenues legally cannot be used for general operations of the board."

CIT Bonds Not Same as Detroit's DSA Bonds

Revenue ownership is crucial. Moody's likens the CIT bonds to Detroit's distributable state aid (DSA) bonds, as in both cases the trustee receives the pledged revenues directly from a third party. However, Fitch views as a crucial distinction that the DSA revenues were not property of the city of Detroit, thus not included in the city's bankruptcy estate. In the case of CPS, however, the CIT revenues are clearly property of the district. Were they not, Fitch's rating would have been based on the credit quality of Cook County, which collects the revenues and remits them to the trustee. Fitch's IDR on Cook County of 'A'/Stable Outlook, does not cap the CPS rating.

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