

Bond Case Briefs

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Fitch: Puerto Rico Ruling Could Have Wide-Ranging Impact on Municipal Debt.

Fitch Ratings-New York-06 February 2018: A ruling last week by district court judge Laura Taylor Swain that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt 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. Credit ratings that could be negatively affected if the ruling is upheld on appeal include bonds secured by utility, transportation and tax revenues that are currently rated above the municipality's Issuer Default Rating (IDR).

Through a series of provisions, Chapter 9 protections have resulted in special revenue obligations receiving current payments from available net pledged revenues during the pendency of every municipal bankruptcy since enacted in 1988. These provisions protect special revenue obligations by continuing the lien on post-petition revenues (outlined in section 928(a)) and relieving bondholders from the constraints of the automatic stay provisions of the code (section 922(d)). This allows enforcement of the lien for the purpose of applying net pledged revenues to payment of the special obligation debt payment due.

Section 928(b) specifies that "necessary operating expenses" will be paid prior to debt service where special revenues are derived from a project or system. This alleviates the concern that bondholder payments might be placed above the health and safety of the municipality and its residents when resources are scarce.

The court's opinion appears to introduce a new gloss on the purpose and application of section 922(d). It states that 922(d) was included in the code only as permission for a municipality to continue paying special revenue obligations if it chooses to do so during bankruptcy. This is inconsistent with Fitch's prior understanding of the purpose of 922(d) for two reasons. First, the municipality already has the right to pay obligations of its choice during the proceeding as a general principle. This right is embedded in section 904, which places the municipal debtor in command of its assets and liabilities throughout the process without court intervention. A specific provision authorizing payment of special revenue-backed debt is unnecessary, redundant and not in keeping with Congressional intent. Examples of payments to unsecured creditors during the pendency of a bankruptcy include Central Falls' opting to continue debt service payments on its GO debt and the continuation of required pension contributions by Detroit and Stockton.

The second reason we were surprised by the court's interpretation of 922(d) is that the automatic stay provisions in section 362 act as a constraint on actions by creditors — not debtors — to enforce liens following the filing of a bankruptcy proceeding. The provisions of 922(d) are an explicit exception to this constraint which was clearly intended to allow creditors with a special revenue obligation lien to enforce any currently due debt service payments while the bankruptcy case proceeds. It is correct that the provisions of 922(d) do not create an automatic obligation of the debtor to make the payment — that obligation exists in the underlying bond documentation. 922(d) simply removes a constraint on enforcement by bondholders of rights to receive payments of debt

service due.

One of the plaintiffs in the case has already appealed the court's decision, and it will be reviewed by the first circuit court of appeals. Pending the outcome of that appeal Fitch will continue to treat special revenue obligations as separated from the related IDR.

A final court ruling that payment of special revenue obligations during a bankruptcy is optional would create uncertainty about full and timely payment of special revenue obligations, potentially removing the basis for rating special revenue obligations above a municipality's IDR. For example, airport revenue bonds and water and sewer bonds issued by the city of Chicago might be capped at the city's 'BBB-/Stable IDR. Chicago's sales tax securitization corporation's 'AAA' revenue bond rating would not be affected, as the corporation is a separate entity that would not be affected by a bankruptcy of the city.

We do not believe notching above the IDR to reflect perceived recovery prospects of special revenue debt would be warranted given that there would be new uncertainty around the level of recovery in a future bankruptcy. Existing Fitch criteria allow us to reflect potential recovery in post-bankruptcy security ratings to the extent prospects for recovery become apparent.

Contact:

Amy Laskey
Managing Director
+1-212-908-0568
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Thomas McCormick
Managing Director
+1-212-908-0385

Media Relations: Sandro Scenga, New York, Tel: +1 212-908-0278, Email:
sandro.scenga@fitchratings.com

Additional information is available on www.fitchratings.com

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