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Yes, Special Revenue Bonds Remain Special: Mintz Levin

Judge Swain's decision in the PROMESA Title III bankruptcy proceeding of the Puerto Rico Highways and Transportation Authority ("PRHTA") that a federal bankruptcy court cannot compel a municipal debtor to apply special revenues to post-petition debt service payments on special revenue bonds has generated controversy and caused some market participants to question whether, if the decision is upheld by the First Circuit on appeal, the perception that special revenue bonds have special rights in bankruptcy remains justified.

The short answer is that, whatever the First Circuit does with the Swain ruling, bonds secured by special revenues should continue to emerge from bankruptcy proceedings more unscathed by the issuer's bankruptcy than bonds that are not special revenue bonds or secured by statutory liens.

Judge Swain's order dismissed a complaint by PRHTA's bond insurers for declaratory and injunctive relief requiring PRHTA to remit special revenues received by PRHTA to its bond trustee for payment of bond debt service, and for a declaration that PRHTA lacked a property interest in the trustee-held debt service reserve fund (which would have permitted the trustee to apply the debt service reserve fund to bond debt service payments without further legal analysis.)

It is important to focus on what Judge Swain did and did not hold:

- The most controversial portion of Judge Swain's opinion addressed the meaning of Section 922(d) of the Bankruptcy Code, which exempts from the bankruptcy stay "the application of pledged special revenues." Judge Swain stated that Section 922(d) "makes clear that the automatic stay is not an impediment to continued payment, whether by the debtor or another party in possession of pledged special revenues, of indebtedness secured by such revenues…." She held, however, that the quoted exception from the stay did not extend to lifting the stay in order to permit a creditor to seek a court order compelling the debtor to turn over special revenues to a bond trustee.
- Even under Judge Swain's narrow reading of Section 922(d), a bond trustee in possession of special revenues need not seek or obtain relief from stay to apply special revenues to debt service payments. Special revenue bonds structured with a "true" lockbox, in which revenues flow directly to the bond trustee or an agent for the trustee, should not be impacted by Swain's decision, even if upheld. In contrast, under Judge Swain's reading of Section 922(d), special revenue bonds in which revenues flow to the issuer and the issuer covenants to turn the revenues over to the bond trustee upon receipt may, at a minimum, suffer delay in the payment of scheduled debt service.
- Judge Swain's rulings on the debt service reserve fund consisted of rejection of the proposition that the debtor lacked a property interest in the reserve, and an assertion that the court lacked authority to compel the application of the reserve fund to debt service. Even under Judge Swain's narrow reading of Section 922(d), a trustee-held reserve fund containing special revenues may be applied by the bond trustee to debt service on the bonds without relief from stay. It is unclear whether the bond trustee in the PRHTA case lacked confidence that the funds in the reserve fund qualified as special revenues; if they so qualified, there was no apparent need to seek any court ruling prior to applying such funds, nor is there anything in the court's ruling precluding such application of special revenues.

On appeal, the bond insurers will seek to persuade the First Circuit that Judge Swain's reading of Section 922(d) is overly literal, that legislative history suggests Congressional intent that special revenue bonds not be "impaired" in a bankruptcy, and that failure to receive scheduled post-petition payments when due constitutes the type of impairment Congress intended to preclude by enacting Section 922(d).

However the First Circuit reads Section 922(d), good reasons remain for an issuer to turn over net special revenues, as debtors in Chapter 9 proceedings have historically done. Section 928 of the Bankruptcy Code provides that a "lien on special revenues … derived from a project or system shall be subject to the necessary operating expenses of such project or system." In the PRHTA proceeding, the "special revenues" included, in addition to toll revenues, some Commonwealth-imposed excise taxes that may not qualify for this operating expense carveout because they are not "derived from a project or system." But most special revenue bond issuers are protected by Section 928 from being left without a source of payment for necessary operating expenses even if they turn over net special revenues. Moreover, even under a narrow reading of the special revenue protections, to the extent an issuer seeks to apply net special revenues for purposes other than debt service, it is dissipating cash collateral and the creditors should be entitled to relief from stay in the absence of "adequate protection". What may or may not be "adequate protection" for an issuer's expenditure of cash collateral is a separate topic that Judge Swain has addressed tangentially in other opinions, but in most instances special revenue bond issuers should have little incentive to hang on to net special revenues versus turning them over – they may lose adequate protection litigation, and even if they do not, special revenue bond issuers are often standalone authorities precluded by state law (and in the case of PROMESA, federal law) from applying their revenues for purposes other than their own operating expenses, debt service and, although there is yet another litigable issue over whether funding capital expenditures at the expense of paying current debt service is permissible (and if so, under what circumstances) under the Chapter 9 special revenue provisions, capital expenditures on the system that generates the special revenues.

In any event, however broadly or narrowly the courts ultimately construe the Section 922(d) exception to the stay for application of special revenues, the primary reason that special revenue bond status is important and beneficial resides in Section 928(a) of the Bankruptcy Code, which provides that, unlike most revenue pledges that are cut off upon the filing of a bankruptcy petition, "special revenues acquired by the debtor after the commencement of the case shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." This is the main source of protection for special revenue bonds – the fact that the bankruptcy process does not permit the debtor to free itself from the lien on its post-petition special revenues. Because pledged special revenues can stretch into perpetuity until the special revenue bonds are fully paid, there is generally little advantage to issuers in not keeping current on post-petition debt service.

The fact that special revenue bondholders have a permanent lien on special revenues generated by the debtor does not, of course, guarantee full payment of special revenue bonds in instances where structural issues prevent an issuer from fully servicing its debt – i.e the special revenues being generated are simply insufficient to service the debt . But it does mean that special revenue bonds should do better in bankruptcy than comparable bonds that are unsecured or secured only by pre-petition revenues.

Where a special revenue bond issuer claims that it will not be able to repay special revenue bonds in full, the case for relief from stay to preclude the issuer from dissipating cash collateral in excess of any applicable operating expense carveout is compelling. The most disturbing element in Judge Swain's opinions to date are statements, mostly in dicta, that come close to the line, or cross the

line, of suggesting that PROMESA Section 305, which states that a bankruptcy court "may not, by any stay, order, or decree, in the case or otherwise, interfere with … any of the property or revenues of the debtor", precludes a bankruptcy court from granting any relief from stay when a creditor seeks to prevent detrimental application of cash collateral. Section 305 cannot be read to override other provisions of PROMESA, such as provisions authorizing relief from stay for lack of adequate protection, nor is the lifting of a stay to permit a creditor to pursue state court remedies against a municipal debtor the equivalent of a bankruptcy court's "interfering" with the debtor's revenues. Accordingly, Judge Swain's overbroad pronouncements on Section 305 are likely to be cut back by the First Circuit.

With all of that said, it is understandable that special revenue bondholders would prefer a reading of Section 922(d) that permits creditors to seek to compel a municipal debtor to turn over special revenues during the pendency of a bankruptcy proceeding in those instances where there is not a "true" lockbox and the debtor fails to do so voluntarily. But whether the First Circuit reads 922(d) narrowly or more broadly than Judge Swain, special revenue bonds will remain justifiably "special."

by Leonard Weiser-Varon

USA February 26 2018

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