

# Bond Case Briefs

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## First Circuit Finds Chapter 9 Special Revenue Provisions Permit Voluntary Payment, But Do Not Require Them: King & Spalding

On March 26, 2019, the First Circuit Court of Appeals, affirming a decision by the District Court emanating out of the Puerto Rico Title III bankruptcy cases, found that Sections 928(a) and 922(d) of the Bankruptcy Code “**permit, but do not require**, continued payment during the pendency of the bankruptcy proceedings.”[i] The First Circuit found that these provisions provide that (i) liens granted prior to bankruptcy that are secured by special revenues will survive while the municipal debtor is in bankruptcy, (ii) the debtor may elect, on a **voluntary basis**, to continue making payments on these debts during the bankruptcy case, but that (iii) the debtor is **not required** to make such payments during the pendency of the case.[ii] While the Opinion was issued in the Puerto Rico Title III case, the Opinion will have implications in municipal bankruptcy cases generally.[iii] And, this Opinion has important implications for holders of bonds secured by special revenues, as it may conflict with a prior decision suggesting that municipal debtors must continue to remit those pledged special revenues during the pendency of a Chapter 9 bankruptcy case.

### **Background**

This dispute concerned bonds issued by the Puerto Rico Highway and Transportation Authority (“Authority”) that were secured by toll revenues (“Tolls”) and excise taxes (“Taxes,” and collectively with the Tolls, collectively, the “Revenues”). According to the Appellants (who are the insurers of the secured bonds), the Puerto Rico Secretary of Treasury is required by statute to transfer, monthly, the Taxes to the Authority for the benefit of bondholders. Appellants also argued that the Revenues were their property and must be transferred to the fiscal agent to replenish funds (“Reserve Accounts”) held in trust by the trustee (“Trustee”) for the benefit of bondholders.

In March 2017, after the enactment of the Puerto Rico bankruptcy law and the appointment of the Financial Oversight and Management Board (“Board”), the Board established a financial plan whereby the Tolls and Taxes would be transferred into Puerto Rico’s general revenues and not transferred to the Reserve Accounts benefitting the bondholders. In May 2017, after the Authority commenced its bankruptcy case, the Trustee was instructed to cease making monthly payments from the Reserve Accounts because “making such payments would constitute an act ‘to exercise control’ over [the Authority’s] property in violation of the automatic stay” provisions of the Bankruptcy Code.[iv] Thereafter, the Authority defaulted on scheduled bond payments. Appellants then commenced an adversary proceeding asserting, among other things, that the transfer of the Tolls and Taxes was exempt from the automatic stay, that failure to remit them was a violation of Sections 922(d) and 928 the Bankruptcy Code, and that the funds held in the Reserve Accounts were the property of the bondholders.[v] The debtors moved to dismiss the complaint, arguing that the Authority was not required to remit payment during the pendency of the bankruptcy case.[vi] The District Court agreed with the debtors and dismissed the case.

### **First Circuit’s Decision**

The First Circuit noted that the Bankruptcy Code establishes generally that property acquired by the debtor after the commencement of the case is not subject to any security agreement entered into by the debtor before the commencement of the case.[vii] However, Section 928 of the Bankruptcy Code exempts liens on “special revenues” from application of that general rule. The First Circuit found that while those liens on special revenues will remain in place during the bankruptcy case, the statute does not mandate any action on the part of the debtor.[viii] Accordingly, the First Circuit held that the Bankruptcy Code does not mandate the ongoing transfer of the Tolls and Taxes to the Trustee, nor does it mandate payment on the Authority’s Bonds, during the pendency of the bankruptcy case.[ix]

Appellant bond insurers also argued that Section 922(d) of the Bankruptcy Code requires the continued transfer of Tolls and Taxes that secure the bonds and exempts bondholder enforcement actions from the Bankruptcy Code’s automatic stay provisions. The First Circuit ruled that the automatic stay provisions do not prohibit the application of pledged special revenues to payment of debt secured by such revenues.[x] Nonetheless, while agreeing that the Bankruptcy Code **permits** a debtor to pay creditors **voluntarily** during the pendency of the bankruptcy case, and allows a secured party to apply special revenues in its possession to bond payments without violating the automatic stays, the First Circuit found that “[n]othing in the statute’s plain language . . . addresses actions to enforce liens on special revenues . . . or allows for the compelling of debtors . . . to apply special revenues to outstanding obligations.”[xi]

## Conclusion

The First Circuit Opinion may be at odds with a decision issued in the chapter 9 bankruptcy case of Jefferson County, Alabama.[xii] That case presented a similar dispute—whether bondholders could compel the transfer of pledged revenues from accounts held by the municipal debtor to accounts held by the bond trustee. There, the court found that the Bankruptcy Code required payment of the special revenues held by the County as of the petition date to the bond trustee, even if the payment occurs after the bankruptcy filing.[xiii] The First Circuit (and the lower court) tried to distinguish Jefferson County on the ground that it did not specifically address whether those payments by the municipal debtor were voluntary or mandatory.[xiv] Clearly, the First Circuit ruling has now created uncertainty as to what legal principles would apply in cases outside of the First Circuit. If the First Circuit holding becomes the commonly-accepted view of the law, that result could impact the pricing and ratings for bonds secured by special revenues, and the willingness of bond insurers to stand behind special revenue bonds in the future.

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[i] *In re Financial Oversight and Management Board of Puerto Rico*, Nos. 18-1165, 18-1166, 2019 WL 1349223, at \*7 (1st Cir. March 26, 2019) (emphasis added). Section 928 of the Bankruptcy Code provides: “Notwithstanding section 552(a) of this title and subject to subsection (b) of this section, 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.” Section 922(d) of the Bankruptcy Code provides: “Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.”

[ii] *Financial Oversight and Management Board of Puerto Rico*, 2019 WL 1349223, at \*7.

[iii] While the Opinion concerns Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”), “PROMESA is largely modeled on municipal debt reorganization

principles set forth in Chapter 9 of the Bankruptcy Code.” *Financial Oversight and Management Board of Puerto Rico*, 2019 WL 1349223, at \*1. Accordingly, as noted, the First Circuit’s rulings will have application in municipal debtor bankruptcy cases commenced under Chapter 9 of the Bankruptcy Code.

[iv] *Financial Oversight and Management Board of Puerto Rico*, 2019 WL 1349223, at \*1-\*2.

[v] *Id.* at \*2.

[vi] The District Court also found that the bondholders did not have a property interest in the funds being held in the Reserve Accounts. The First Circuit noted that it need not address this issue as Appellants failed to develop any argument on appeal going to the “property right” issue. *Id.* at \*3 n.5.

[vii] *Id.* (quoting 11 U.S.C. § 552(a)).

[viii] *Id.*

[ix] *Id.* While the Appellants sought to rely on legislative history, because the First Circuit found that the statute was unambiguous, it was unnecessary to review the legislative history. *Id.* at \*5.

[x] *Id.* at \*5.

[xi] *Id.* at \*6.

[xii] See *In re Jefferson County, Alabama*, 474 B.R. 228 (Bankr. N.D. Ala. 2012).

[xiii] *Id.* at 271. The bankruptcy court in *Jefferson County* also stated that Section 928’s inclusion in the Bankruptcy Code “demonstrates that Congress wanted to ensure no delay occurred in payment to creditors secured by special revenues received by a municipal debtor post petition.” *Id.* at 269.

[xiv] *Financial Oversight and Management Board of Puerto Rico*, 2019 WL 1349223, at \*7.

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