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Recent Ruling Against Puerto Rico Revenue Bondholders Causes Waves in U.S.: Holland & Knight

HIGHLIGHTS:

- The U.S. Court of Appeals for the First Circuit has upheld a controversial ruling by a U.S. District Court in a case involving special revenue bonds issued by the Puerto Rico Highway Transportation Authority (PRHTA).
- The District Court ruled in January 2018 that the Authority was *permitted, but not required*, by the U.S. Bankruptcy Code to apply special revenues to pay the bonds during adjustment proceedings under the Puerto Rico Oversight, Management and Economic Stability Act of 2016 (PROMESA).
- The District Court's ruling contradicted long-held conventional wisdom regarding a municipal debtor's obligation to apply special revenues after commencing a bankruptcy proceeding.

The First Circuit's affirmation may have widespread impact on the municipal revenue bond market. The U.S. Court of Appeals for the First Circuit has affirmed a controversial ruling regarding the treatment of municipal revenue debt, leaving investors with lingering questions about the value and significance of a revenue pledge in a municipal bankruptcy.

The original U.S. District Court decision roiled the municipal markets in January 2018, when Judge Laura Taylor Swain, the judge overseeing Puerto Rico's debt restructuring, ruled that municipal debtors were permitted, but not required, to apply special revenues to pay related bonds. Judge Swain's ruling reversed long-held conventional wisdom regarding the mandatory application of special revenues following municipal bankruptcy.

Background and District Court Decision

The case involved several series of bonds (the Bonds) issued by the Puerto Rico Highway and Transportation Authority (PRHTA), a public corporation of the Commonwealth of Puerto Rico. By statute, the Bonds were secured by a gross lien on revenues derived from certain highway tolls and excise taxes (collectively, the Pledged Special Revenues). The Bonds were also insured by a number of financial insurers (the Insurers), who were subrogated to the bondholders' rights upon payment of a covered default of the Bonds.

In March and April 2017, each of the Commonwealth and PRHTA adopted fiscal plans purporting to modify the application of the Pledged Special Revenues. Under the Commonwealth's fiscal plan, certain of the Pledged Special Revenues would be diverted to the Commonwealth for its general revenue purposes, and under the PRHTA fiscal plan, PRHTA would be authorized to apply Pledged Special Revenues to pay operating expenses ahead of debt payments, in contravention of the gross lien granted to holders of the Bonds.

On May 21, 2017, the Financial Oversight and Management Board for Puerto Rico (the Board) commenced debt adjustment proceedings for the PRHTA under Title III of the Puerto Rico Oversight, Management and Economic Stability Act of 2016 (PROMESA), which under Section 301 thereof incorporates and makes applicable to it portions of the U.S. Bankruptcy Code. Shortly thereafter, the

trustee for the Bonds was instructed by the Puerto Rico Fiscal Agency and Financial Advisory Authority, on behalf of PRHTA, to cease making scheduled payments, based on the rationale that such payments violated the automatic stay under Section 362(a) of the U.S. Bankruptcy Code (as incorporated into PROMESA by Section 301 thereof). On July 3, 2017, PRHTA defaulted on a scheduled payment of \$219 million.

The Insurers filed suit against the Commonwealth, the PRHTA, the Board and various other entities and individuals, seeking declaratory and injunctive relief. The Insurers asked the court to declare, among other things, that the Bonds were secured by special revenues exempt from the automatic stay and to grant an injunction requiring PRHTA to resume remittance of the Pledged Special Revenues. The Insurers' arguments hinged on the interpretation of Sections 922(d)1 and 9282 of Chapter 9 of the U.S. Bankruptcy Code (each incorporated into PROMESA by Section 301 thereof), which address the treatment of special revenues in municipal bankruptcy.

Judge Swain granted the defendants' motion to dismiss the Insurers' claims, holding, in effect, that while Section 928 extended the Bonds' statutory lien to cover post-filing special revenues and Section 922(d) indeed *permitted* the municipality to apply those special revenues to make the secured payments, *neither Bankruptcy Code section affirmatively required such payments*.

Many commentators expressed surprise at Judge Swain's ruling, which upset the widely held view in the municipal market that the protections afforded special revenues in municipal bankruptcy were, in fact, intended to provide bondholders with the certainty of payment during the adjustment proceeding, resulting from not only the continuing lien on special revenues, but a statutory obligation to apply those special revenues to pay the secured debt notwithstanding the automatic stay. Fitch Ratings, in a statement issued following Judge Swain's original ruling, warned that "If the ruling is upheld on appeal, credit ratings that could be negatively affected include utility, transportation and tax revenue bonds rated higher than a municipality's Issuer Default Rating," echoing the sentiment of others in the market.

First Circuit Decision and Potential Effects

The First Circuit heard the Insurers' appeal and, on March 26, 2019, affirmed Judge Swain's ruling, dismissing the Insurers' claims. In its opinion, written by Judge Juan Torruella, the First Circuit found that "In sum, Sections 928(a) and 922(d) permit, but do not require, continued payment during the pendency of the bankruptcy proceedings. The two provisions stand for the premise that any consensual prepetition lien secured by special revenues will survive the period of municipal bankruptcy, and, accordingly, municipalities can elect to voluntary [sic] continue payment on these debts during the course of the bankruptcy proceedings so as to not fall behind and thus be at risk of being unable to secure financing in the future."

Although the First Circuit's ruling covers only Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island, commentators and rating agencies have expressed concern that the ruling will have a broader impact on holders of municipal revenue debt, particularly given the relative scarcity of case law interpreting issues of municipal bankruptcy. The First Circuit's affirmation raises serious concerns about the value of a municipal revenue pledge and creditors' ability to enforce any lien on such revenues post-bankruptcy or to otherwise protect the revenue stream.

As the First Circuit noted, like its analog in Section 904 of the U.S. Bankruptcy Code that applies in Chapter 9 municipal bankruptcies, Section 305 of PROMESA denies the court presiding over the Commonwealth and the PRHTA's debt adjustment proceedings the power and jurisdiction to "interfere with ... any of the property or revenues of the debtor; or ... the use or enjoyment by the debtor of any income-producing property." Thus, in a situation where some portion of the pledged

revenues is being expressly diverted away from the issuer and the remainder of the pledged revenues are being applied, on an ongoing basis, to operating expenses in violation of the applicable bond documents, the courts' dismissal of the Insurers' claims appears to leave bondholders exposed as the stream of revenues continues to be depleted, without any recourse in the adjustment proceeding itself. If this is the case, it appears that the Insurers' only remedy, then, would be to persuade the court to grant relief from the automatic stay imposed by PROMESA on the grounds that the property interest embodied by the lien was not being adequately protected, and seek a remedy from some other competent court of more general jurisdiction to enforce their contractual and statutory rights (although the First Circuit's opinion does not comment on this).

Because the First Circuit's decision rests entirely upon the interpretation of provisions of Chapter 9 that are incorporated into (but not otherwise modified by) PROMESA, the court's ruling could be viewed as equally applicable to all special revenues in municipal bankruptcies. Accordingly, while the First Circuit's decision stands, municipal revenue bond ratings may be negatively impacted by the weakened bondholder protections; Fitch Ratings has already indicated that it will continue to monitor the case to determine whether ratings action is warranted. As a function of perceived credit risk, the price and valuation of new and existing municipal revenue debt may also be impacted, regardless of whether the rating agencies take action. Issuers of revenue bonds may consider taking additional steps to assure the market that they intend to honor their obligations, although the relative value of such an assurance may also be negatively impacted by the First Circuit's decision. In addition, new debt issues may benefit from structures that provide greater protection for pledged revenue streams. Market participants will need to consider whether new disclosure is warranted in light of the ruling's reversal of long-established market views regarding special revenues.

Assured Guaranty, one of the Insurers, has indicated that it is considering its legal options, including an appeal to the U.S. Supreme Court, or a challenge that the effective destruction of the lien constitutes an unconstitutional taking. Assured had previously been unsuccessful in its attempt to lift the automatic stay. In light of the facts surrounding the diversion of the pledged revenues and the subsequent actual default, however, perhaps another attempt will be better received, giving Assured another opportunity to seek protection of its lien. Regardless of the actions to be taken by Assured and the other Insurers, the market will continue to watch this case closely, considering its potentially wide-ranging ramifications.

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