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BANKRUPTCY - PUERTO RICO

In re Financial Oversight and Management Board for Puerto Rico

United States Court of Appeals, First Circuit - January 30, 2020 - F.3d - 2020 WL 486163

In the debt adjustment cases of the Commonwealth of Puerto Rico and related governmental entities, including the Employees Retirement System of the Government of the Commonwealth of Puerto Rico (ERS), under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the Financial Oversight and Management Board for Puerto Rico (FOMB), as representative of ERS, filed adversary complaint against entities that held bonds issued by ERS prior to PROMESA's enactment, seeking declaratory relief on the "validity, priority, extent and enforceability" of bondholders' asserted security interests in postpetition assets, including employer contributions that were made postpetition.

Parties cross-moved for summary judgment. The United States District Court for the District of Puerto Rico granted FOMB's motion and denied bondholders' cross-motion. Bondholders appealed.

The Court of Appeals held that:

- The section of the Bankruptcy Code governing the postpetition effect of security interests, as incorporated by PROMESA, prevented bondholders' security interest from attaching to postpetition employers' contributions;
- Bondholders did not have "special revenue" bonds; and
- The section of the Code governing the postpetition effect of security interests applied retroactively to the parties' security agreement.

With respect to entities holding bonds issued by the Puerto Rico Employees Retirement System (ERS) prior to enactment of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the section of the Bankruptcy Code governing the postpetition effect of security interests, as incorporated by PROMESA, prevented bondholders' security interest in "pledged property" from attaching to employer contributions that were made postpetition; under applicable Bond Resolution, ERS did not have a prepetition property right, and bondholders did not have a security interest, but a mere expectancy, in any right to receive postpetition employer contributions, such that those contributions were not "proceeds" of any prepetition property right, bondholders did not have liens on "obligations" of employers to solve deficiency in pension system, and amendment to Article 9 of Puerto Rico Uniform Commercial Code (UCC) did not render employer contributions as secured "proceeds."

Entities holding bonds issued by the Puerto Rico Employees Retirement System (ERS) prior to enactment of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) did not have "special revenue" bonds as would have remained subject to any prepetition lien held by bondholders; the Bankruptcy Code, as incorporated by PROMESA, defined "special revenues" as any receipts derived from the ownership, operation, or disposition of systems primarily used or intended to be used primarily to provide transportation, utility, or other services, and, under the plain

language of the statute, the postpetition employer contributions in which bondholders allegedly held a security interest originated in neither ERS' "particular functions" nor its "ownership, operation, or disposition of" a system of "other services," but in the work of employees that generated the contributions and the statutory obligation of employers to contribute, via annual appropriations of the Commonwealth.

In enacting the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) to address Puerto Rico's financial crises, Congress plainly intended to apply the section of the Bankruptcy Code governing the postpetition effect of security interests, as incorporated by PROMESA, retroactively, to security interests agreements created before the enactment of PROMESA; Congress provided an explicit command within PROMESA to apply the provision retroactively.

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