

# **Bond Case Briefs**

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## **Fitch: Nacogdoches Hospital (TX) Bondholders Not Insulated from Weak Operations.**

Fitch Ratings-New York-19 July 2018: Recent news that Nacogdoches County Hospital District, Texas (NCHD) has retained attorneys to consider debt restructuring has sparked commentary that this is an example of uncertain bondholder protections in bankruptcy. Fitch Ratings believes this case demonstrates the importance of making a cautious and accurate assessment of the legal protections afforded to bondholders.

### **BONDS DO NOT MEET HIGH FITCH BAR FOR RATING DISTINCT FROM IDR**

The sales tax bonds benefit from an ordinary pledge and security structure for municipal debt and are in our view at risk of automatic stay under Chapter 9 of the U.S. bankruptcy code (the code) and an interruption of payment during the proceedings. There is a plausible argument for special revenue treatment, but we set a high bar for considering debt as supported by special revenues under section 902(2)(E) of the code. (For more information, see “Fitch Rates Marin Healthcare District, CA’s Series 2017 GO Bonds ‘AAA’, dated Aug. 23, 2017.) Even in the event of a stay, an issuer can choose to continue to pay debt obligations while in bankruptcy, and NCHD has that option with respect to the sales tax bonds. Nevertheless, Fitch has rated the debt below investment grade since April 2017, with a current rating of ‘CC’, indicating that default of some kind appears probable.

### **RATING MIGRATION REFLECTS WEAK FUNDAMENTALS**

In April 2017 we concluded a review that resulted in a downgrade of NCHD’s sales tax revenues bonds to ‘B’/Rating Watch Negative due to weakness in its revenues and operations, as well as its unwillingness to tap unused property tax capacity to support its operating solvency. We also concluded that the bonds did not meet our high bar for special revenue analysis and had not been issued under a specific state securitization law. In September 2017 we downgraded the rating to ‘CC’ based on continued deterioration of operations and severely weak liquidity.

In April 2016 Fitch revised its criteria for rating tax supported debt. In that revision we introduced the Issuer Default Rating (IDR) as a measure of an issuer’s operating solvency, and we clarified and provided strict limitations on when we felt there was a reasonable basis to rate a dedicated tax supported security distinct from and higher than an issuer’s IDR. Ratings could be distinct from an IDR under three legal structures that have clear protection in a Chapter 9 bankruptcy proceeding: “special revenue” obligations under section 902(2) of the bankruptcy code, securities issued through a securitization structure and intercept structures under state law. We also considered in the review whether the untapped taxing capacity of a hospital district or hospital authority should be incorporated into an IDR. In August 2016, we placed ratings related to NCHD and 24 other hospital districts and authorities on Rating Watch Evolving as we evaluated the underlying legal structures.

### **FITCH REVIEW OF PRIOR LEGAL OPINION**

At the time of the initial downgrade and assignment of a ‘B’ IDR in April 2017, Fitch reviewed a legal opinion provided by outside counsel that concluded that the transaction is essentially a sale of the tax revenues to the bond trustee acting for the benefit of bondholders and not a borrowing by

NCHD. Counsel further concluded on that basis that the tax revenues are not property of NCHD and would not be within its bankruptcy estate.

Fitch had two concerns with the analysis that leads to this legal conclusion. One, Fitch does not believe that there is sufficient legal precedent for us to adopt the true sale analysis in our rating based on the Texas statute cited. Further, as the opinion itself indicated, there is no common law precedent that addresses the proper characterization of the transfer of assets by a municipality in this type of situation. Two, as a factual matter, the transaction is described in all offering materials as a borrowing and is reported in the accounting statements of the municipality as a borrowing. There is no indication that the parties intended to treat the transaction as a true sale.

As a result, it is Fitch's assessment that there is not a reasonable basis to support a rating above the issuer's IDR. Fitch will only rate a transaction as a true sale in the context of a specific state statutory scheme authorizing the sale as a part of a comprehensive securitization law such as those adopted in New York and Illinois for tax revenues and other revenue sources in various states. For more information see "What Investors Want to Know: Chicago Sales Tax Securitization" dated Nov. 28, 2017.

#### ELEMENTS OF SPECIAL REVENUE ANALYSIS

Legal opinions serve as the basis for Fitch's consideration of whether bonds are secured by pledged special revenues. In addition, the following elements must be present that make clear the pledged revenues are not general operating revenues for general purposes of the debtor, sufficiently reducing the incentive to challenge special revenue status in a bankruptcy:

- A statutory scheme limiting the authority to levy a specific tax to the financing of capital projects.

- An express statutory prohibition on use of any revenues from the taxes for operations of the municipality, unless Fitch has a reasonable legal basis by which to determine that the pledged revenues would not be subordinated to operating expenses in a bankruptcy. If any residual revenues can be used for the entity's operations and are at risk of being subject to netting, Fitch will consider them to be general revenues and rate the issue as unsecured debt.

- An identification of specific capital projects in a ballot initiative or in a resolution limiting the use of proceeds of the debt to those capital projects; for refunding bonds, it should be clear that the bonds being refunded meet this criterion.

- A structure in which bondholders do not have a claim on general revenues of the municipality, where the bonds are solely secured by a dedicated tax (general obligation bonds supported by the entity's full faith and credit will typically not meet this criterion).

- A statutory requirement that a governmental official outside the municipality (e.g. the county) collects and remits the tax revenues to the paying agent, placing the funds outside the control and direction of the municipality. A statutory lien on the pledged revenues reduces the incentive to challenge special revenue status sufficiently to substitute for this requirement.

Clarity that the pledged taxes are property of the municipality and would not be considered at any point the property of the entity collecting and remitting the tax revenues; absent this, the rating would be capped at the collector's rating.

Since NCHD's pledged revenues are a general sales tax available for operations as well as debt service, Fitch had no basis to consider the bonds to be secured by pledged special revenues.

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