Bond Case Briefs

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Puerto Rico Ruling Sends Shock Through $3.8 Trillion Muni Market.

- **Puerto Rico ruling may have big implications for muni market**
- **Decision could trigger credit downgrades, debt repricing**

A haven for American investors is looking less bulletproof.

A federal court decision in Puerto Rico's record bankruptcy that departs from past precedent in the $3.8 trillion municipal-bond market is threatening to upend the secure reputation for some types of debt. The legal fight could go all the way up to the U.S. Supreme Court, with the potential to erode the value of billions of dollars in bonds and ripple through a niche that finances roadways, airports and water systems.

That 2018 ruling was upheld by an appeals court last month and lets Puerto Rico's highway agency raid tolls and other fee revenue dedicated to bondholders until the case is settled. It has dashed hopes that the island's bankruptcy case would have little spillover into the U.S. mainland, because the ruling throws into doubt the belief that revenue bondholders will keep getting paid even when a government seeks to cut its debts in court.

"This is a backbone item of the muni market — understanding what your pledge is," said Gabe Diederich, a senior portfolio manager at Wells Fargo Asset Management. "The biggest question is, What is the knock-on effect to confidence in different security pledges?"

The decision from U.S. District Court Judge Laura Taylor Swain contrasts with how special revenue bonds have been treated in all past municipal bankruptcies under Chapter 9 of the U.S. bankruptcy code, said James Spiotto, who specializes in that kind of restructuring as managing director at Chapman Strategic Advisors.

Spiotto was involved in crafting a 1988 Congressional amendment to the bankruptcy code that said revenue bondholders would have an "unimpaired" right to the project revenue pledged to them. He said the latest ruling is inconsistent with that amendment and would have big implications for future municipal bankruptcy cases if it's upheld. "We can all imagine some bankruptcy lawyer from a debtor's perspective saying, 'Here in Puerto Rico, they didn't have to. Why are you shorting your taxpayers?'"

Precedent Setting Collapses

Municipal bankruptcies are so rare that each of them has the ability to set precedents that reshape how investor protections are viewed, and the Puerto Rico decision that casts doubt on revenue bonds marks a shift from the last big case. As part of Detroit's bankruptcy in 2013, some general-obligation bondholders took losses while debt backed by water and sewer revenues emerged unscathed, leading analysts and buyers to favor deals backed by specific revenue streams because of that extra protection.

Now, the pendulum could swing in the other direction. Debt sold for city utilities or airports could be considered at risk of getting sucked into cases of government distress, said Howard Cure, director of municipal bond research at Evercore Wealth Management.

“It’s worrisome and potentially a game-changer in how you analyze special revenue bonds — bonds that you thought were separately secured and somewhat immune from the travails of problem cities,” Cure said.

Fitch Ratings warned on Thursday that it may cut the credit rating of seven different municipal-bond issues if the ruling is upheld. Chicago water revenue bonds that have a much higher rating than the cash-strapped city are among those that could be downgraded. The ratings company said it believes the decision, if upheld, will be influential in future municipal bankruptcies.

Breckinridge Capital Advisors estimated last year that there is $1.2 trillion in outstanding special revenue bonds, which includes dedicated tax, water and sewer, transportation and tax-increment financing bonds. But the firm noted that “very few” special revenue bond investors are at risk of seeing their revenue raided if related governments face financial distress, particularly because some states, including Illinois, don’t allow localities to file for Chapter 9.

The Battle

The U.S. Court of Appeals for the First Circuit in March upheld Swain’s ruling, prompting bond insurer Assured Guaranty Ltd. to request that the court re-hear the case. The issue is of “exceptional importance for municipal bankruptcy law and the municipal bond markets,” the April 9 court filing says. If that effort is unsuccessful, then the ruling could be appealed to the Supreme Court, though the high court rarely intervenes in such petitions.

The National Federation of Municipal Analysts, a trade group, expects that if it stands the prices of some revenue bonds would need to be cut to account for the risk that investors won’t’ be repaid during a bankruptcy.

The group emphasized in a May 2018 court filing that the ruling could hurt localities’ ability to finance infrastructure projects, given that revenue bonds pay for water, energy and transportation systems. That could add anywhere from 5 to 50 basis points in yield on revenue bonds for infrastructure projects, the group said. Even a five-basis point bump in interest rates for infrastructure revenue bonds would translate to $2 billion in increased costs over the next decade, according to the estimate.

In the aftermath of Detroit, cash-strapped localities like the junk-rated city of Chicago began selling bonds that securitized some fees and taxes as a way to separate the revenue stream from the troubled local government, which helped earn them higher credit ratings and lower costs of financing.

But investors have become more skeptical of the protections they may have in a bankruptcy. S&P Global Ratings last year began changing the credit ratings of issuers to account for the risk of a distressed government raiding the revenue meant for bondholders, causing billions of dollars in debt to be both upgraded and downgraded.

Chicago’s Sales Tax Securitization Corp. was downgraded last year by S&P to put it more in line with that of the city’s rating. When it sold such bonds in January, investors demanded 1.7 percentage points in extra yield over benchmark securities, up from 0.9 percentage points more a year earlier — showing investors are starting to price in the risk that a bankruptcy court might shatter the securitization protections.

Erin Ortiz, a managing director at Janney Montgomery Scott, said any bankruptcy ruling in the municipal-bond market is “incredibly important.” But she noted that Swain’s ruling may not be the final decision on the subject.

“In terms of municipal bankruptcy cases, there always remains much uncharted territory,” she said.

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