
Bondholders Beware? First Circuit Ruling's Potential Adverse Impact on Puerto Rico's Long-Term Restructuring Prospects.

Having practiced in Puerto Rico for nearly a decade, including being involved heavily in the ongoing Title III PROMESA proceedings, the recent ruling handed down by the First Circuit could prove to be the most impactful for the Island's long term restructuring prospects and its access to the Bond markets. The controversial ruling, which pertains to the treatment of municipal revenue debt, has left investors with questions about the value and significance of a revenue pledge in a municipal bankruptcy. This blog provides some background and potential ramifications.

Background

The original U.S. District Court decision affected the municipal markets in January 2018, when the court ruled that municipal debtors were permitted, but not required, to apply special revenues to pay related bonds. The ruling reversed long-held practice as to the mandatory application of special revenues following municipal bankruptcy.

The controversy involved several series of bonds (the Bonds) issued by the Puerto Rico Highway and Transportation Authority (PRHTA). 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, both 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) began debt adjustment proceedings for the PRHTA under Title III of PROMESA. 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 Bankruptcy Automatic Stay. On July 3, 2017, PRHTA defaulted on a scheduled payment of $219 million.

The Insurers filed suit against the Commonwealth, the PRHTA and the Board, seeking declaratory and injunctive relief. The Insurers asked the court to declare 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) and 928 of Chapter 9 of the U.S. Bankruptcy Code, which address the treatment of special revenues in municipal bankruptcy.

The court dismissed 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 provision affirmatively required such payments.

The First Circuit heard the Insurers' appeal and, on March 26, 2019, affirmed the lower court ruling, dismissing the Insurers' claims. The First Circuit reasoned 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."

Adverse Effects and Future Outlook

Strong industry concerns have emerged that the ruling will have a broader impact on holders of municipal revenue debt, particularly given the lack of jurisprudence interpreting issues of municipal bankruptcy. The ruling raises 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. This is very pertinent as the market has been closely monitoring the PROMESA proceedings and its potential impact on how future municipality bankruptcies could play out.

It appears that, at least in the short-term, investors may turn to requiring heightened disclosures and modified structures to provide greater protection in future debt issues. Concerns also linger as to the Island's short and long term access to the market, which has provided strong financial backing in the past. There still exists the possibility that this issue will be taken to the United States Supreme Court. In the meanwhile, expect the ramifications to be felt.

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