Fitch Rtgs: Puerto Rico ERS Ruling Consistent with Expectations

Fitch Ratings-New York-10 February 2020: The U.S. Court of Appeals for the First Circuit Jan. 30 ruling in the matter of the Employees Retirement System (ERS) of the Government of the Commonwealth of Puerto Rico is consistent with Fitch Ratings' approach to considering provisions of the U.S. Bankruptcy Code in local government ratings. The ruling affirmed the District Court's denial of the plaintiff bondholders' arguments on three distinct points. The bondholders argued that their security interests fit within exceptions under section 552 of the Code, which relates to the disposition of postpetition assets of a debtor in bankruptcy. They also argued that the revenues pledged to them were special revenues under section 902 of the Code, exempting them from the automatic stay in a municipal bankruptcy. Additionally, the bondholders argued that since the bonds were issued before PROMESA was enacted, applying section 552 to the ERS bonds to impair retroactively the bondholders' security interests would violate the Takings Clause of the U.S. Constitution. The First Circuit rejected all three arguments.

The First Circuit decision commented extensively on why the section 552 exceptions do not support the continuation of the lien on employer pension contributions following a bankruptcy petition. Among other factors, the First Circuit cited language in the Official Statement for the ERS bonds that makes clear that legislative appropriations for employer contributions could be reduced if funds were insufficient. In fact, as stated in the ruling, the Commonwealth twice amended the Enabling Act after the bonds were issued to address its financial crisis by altering the required contributions.

The bondholders argued that the pledged revenues for the ERS bonds are special revenues under definitions 902(2)(A) and (D) of the code. Since liens on special revenues continue postpetition, a ruling in favor of the bondholders on this point would have obviated the need for a ruling regarding section 552. Definition 902(2)(A) is generally understood to cover revenue bonds whose pledged revenues are derived from operations of entities such as transportation or utility systems. The First Circuit concluded that 902(2)(A) applies to "physical system[s] of providing services to third parties." Fitch believes it is something of a stretch to consider legislatively appropriated employer contributions to a pension system to be derived from a system, physical or otherwise, as the funds contribute to, but are not generated by, the operation of the system. The payment amount is derived from a percentage of employee payrolls but is paid with general commonwealth revenues. Similarly, definition 902(2)(D) describes revenues derived from a function of the debtor, which does not seem an apt description of pension contributions. In reaching its holding, the First Circuit cited a standard dictionary definition of "derive" to conclude employer contributions are not within the special revenue definitions in the Code.

Even if Fitch believed there was an argument to be made that employer contributions could fall under either definition in section 902(2), we would not rate such bonds as secured by pledged special revenues as there is no assurance that a bankruptcy judge would have the same interpretation. Fitch has a high bar for considering pledged revenues to be special revenues in its rating analysis, and if we believe there is any ambiguity we perform additional legal analysis.

The First Circuit's 2019 ruling on special revenues (in the Puerto Rico Highways and Transportation Authority case) challenged the municipal market's long-held views of the treatment of bonds secured by pledged special revenues in a bankruptcy, but did not alter the interpretation of the definitions of special revenues themselves. As such, Fitch revised its tax-supported rating criteria earlier this year to provide for a notching relationship between dedicated tax bonds and Issuer Default Ratings without changing its method of evaluating whether bonds are secured by pledged special revenues.

Contact:

Amy Laskey
Managing Director
+1-212-908-0568
Fitch Ratings, Inc.
300 West 57th Street
New York, NY 10019

Arlene Bohner
Senior Director
+1-212-908-0554

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com