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What Does the Puerto Rico HTA Ruling Mean for Special Revenue Bonds? Likely Not as Much as Feared.

Municipalities have long issued “special revenue” bonds, as defined by the federal bankruptcy code, to finance essential service infrastructure projects including water waste and electric utilities. The bankruptcy code provides special revenue bonds with unique features that benefit creditors during an issuer’s bankruptcy. One key provision, Section 922, addresses the timely payment of debt service by an issuer by exempting the payment of special revenues from an automatic stay in bankruptcy.

Last March, the 1st U.S. Circuit Court of Appeals affirmed the decision by the Puerto Rico bankruptcy court, which had stated that Section 922 provides a bankrupt issuer the option, but not the requirement, to pay debt service. On 13 January 2020, the Supreme Court decided it would not hear an appeal in the case, effectively upholding the rulings of the lower courts.

Taken together, the decisions of each of the courts surprised some investors in the \$3.8 trillion U.S. municipal bond market. Investors saw them as contrary to the intent of the U.S. Congress when it incorporated the concept of special revenues into the bankruptcy code in 1988. In addition, the rulings differ from established precedent in past municipal bankruptcies. Some investors fear the rulings tarnish the appeal of bonds backed by special revenues and could result in wider credit spreads for issuers.

Fallout is likely limited

Despite these concerns, PIMCO does not expect the HTA ruling to trigger meaningful spread widening in any sector, nor will it likely result in a sustained increase in borrowing costs for higher-quality borrowers. In part, this is because we expect actions by rating agencies will affect only a limited number of credits in cases where large ratings gaps exist between a municipality’s special revenue bonds and its general fund obligations.

Bonds backed by special revenue were never completely insulated from the risk of a payment disruption. A distressed municipality may use the threat of a payment disruption on an essential service enterprise to increase its bargaining power over creditors. Arguably, the negotiating leverage of municipalities has increased modestly following the HTA rulings, but the risks have always been present. Consider that when the City of Detroit declared bankruptcy in 2013, the special revenue bonds issued by the Detroit Water and Sewerage Department suffered a significant price decline, but were ultimately paid in full. Thus, issuers of special revenue bonds could face more price volatility if their parent government is of low quality and falls further into distress.

In addition, the lower court’s ruling does not strip away all the unique features granted by the bankruptcy code to bonds backed by special revenues. For instance, the security interest granted to special revenues under Section 928 remains intact and enforceable after bankruptcy; that is to say, even after a municipal utility exits bankruptcy, it remains bound by its pledge to use service charges to make interest payments on special revenue bonds. The continuation of the security interest is the

most important defining characteristic of special revenue bonds, in our view. It prevents these bonds from becoming unsecured general obligations during bankruptcy.

The HTA ruling may increase the issuance of special tax bonds that have even greater structural protections for investors. An example is debt issued by the Sales Tax Securitization Corporation created by the City of Chicago in 2017. The issuer is a bankruptcy-remote entity and provides a statutory lien over pledged revenues, and the City's transfer of sales tax revenue to the issuer is structured as a true sale. Similar designs could help lower-quality borrowers access cheaper financing for refunding purposes and displace more traditional special tax and general obligation supply.

Ultimately, we believe the lesson of the HTA ruling is a basic one: There is no substitute for fundamental analysis and thoughtful credit selection. The ruling does not diminish our constructive view of special revenue bonds that we believe are supported by stable cash flows and healthy parent obligors, nor does it change our view of the most important legal protections afforded by special revenue bonds, or the way we approach distressed borrowers whose bonds provide investors with appropriate risk-adjusted return.

by Sean McCarthy, Tom Scgyette of PIMCO, 2/28/20