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Court Plunges Into Puerto Rico Defaults That Put Bond Market on Edge.

The industry warns that bait-and-switch tactics could endanger trillions of dollars in debt and push local governments “off the precipice.”

BOSTON (CN) — In a pair of cases that could send shockwaves through the multitrillion-dollar municipal bond market and dramatically increase borrowing costs for governments at all levels, the First Circuit heard arguments Thursday on whether Puerto Rico bondholders could collect on collateral for almost \$4 billion worth of defaulted loans.

Puerto Rico and other parties that want the money claim the [security interest of the bondholders is worthless](#), despite the common industry assumption that similar bonds are backed by an underlying revenue stream.

“They are asking you to believe that the bondholders lent billions of dollars with no security interest,” their lawyer, Neal Katyal, told the court in Boston on Thursday. “But even the most fly-by-night payday lenders know that if there’s no collateral, the interest rates have to go through the roof.”

Puerto Rico’s claim “makes no sense,” added Katyal, a partner at Hogan Lovells who was U.S. solicitor general in the first term of President Obama.

“I wouldn’t lend someone \$3,000 on those terms, let alone \$3 billion,” he said.

Another attorney, Milbank’s Atara Miller argued that Puerto Rico’s stance leaves the bondholders with “an umbrella that we can only use on sunny days.”

The cases involve so-called “revenue bonds,” which are cheaper for municipalities to issue than traditional general-obligation bonds because they’re backed by a specific revenue stream. Two-thirds of all U.S. municipal bonds are revenue bonds, representing some \$2.68 trillion in outstanding debt.

One of the cases that the [First Circuit tackled Thursday](#) turns on \$3 billion in bonds backed by Puerto Rico highway tolls and excise taxes; the other, [\\$800 million in debt](#) secured by taxes on rum paid to Puerto Rico by the federal government. In both cases the revenues were supposed to be paid into a trust fund that protected the bondholders’ interests.

When the Puerto Rico agencies that issued the bonds defaulted, the insurers for the bondholders tried to collect from the trust funds, only to discover that the government had been diverting the money away.

Ultimately a federal judge ruled that the bondholders didn’t have the security interest in the revenue streams that they thought they had but rather a security interest in the trust funds — a decision that shocked the bond market. And since the funds were nearly empty, the bondholders were out of luck.

This was a “bait and switch,” according to an [amicus brief](#) filed by the Securities Industry and Financial Markets Association.

Represented by Faegre Drinker Biddle & Reath, the association argued that allowing the Puerto Rico agencies to get away with such trickery would mean that revenue bonds would be no safer for bond buyers than general-obligation bonds. As a result, bond buyers would stop accepting lower interest rates for them and borrowing costs for municipalities across the country would go sky-high.

Moody's has already downgraded both Illinois highway bonds and Cleveland water bonds as a result of the lower court's ruling, SIFMA said, adding that the ruling “risks shoving the municipal revenue bond market off the precipice on which it is balanced — with issuers paying the price.”

Katyal told the First Circuit that the bondholders are entitled to relief from the [bankruptcy](#), namely an automatic stay, as long as they have a “colorable” claim to a secured property interest.

That argument appealed to U.S. Circuit Judge Kermit Lipez.

“We read the briefs for one side and say, ‘Okay, that makes sense,’ and then we read the other side’s briefs and say, ‘That makes sense,’ so why doesn’t that create at least a colorable claim?” asked Lipez, a Clinton appointee.

“We will acknowledge that the documents could have been drafted better,” defense lawyer Michael Mervis answered. “They’re hard to read. But just because something isn’t well-written doesn’t mean it’s ambiguous. One reading is a lot more plausible than the other.”

The defense argument is that the bonds in this case are different from standard revenue bonds because the underlying documents and statutes never obligated Puerto Rico to deposit the money in the trust funds and never said the money in the funds couldn’t be removed for other uses.

The Puerto Rico highway authority issued the bonds, but the excise taxes were levied by the commonwealth, and the commonwealth never ceded its taxing authority to the highway authority, said Mervis, who practices with Proskauer in New York.

If the bondholders win, they would have to sue the commonwealth on behalf of the highway authority, which would create a “procedural morass,” argued Luc Despina of Paul Hastings in New York, who represents the unsecured creditors’ committee.

But the cases before the court presented their own procedural morass. The bondholders are pursuing a separate remedy in the Puerto Rico insolvency proceedings, and the judges repeatedly badgered the bondholders’ lawyers about why they shouldn’t decline to rule and let the other proceeding sort things out, especially since the other proceeding was more advanced and might produce a quicker result.

“Why doesn’t the parallel proceeding satisfy your rights?” asked U.S. Circuit Judge O. Rogerie Thompson, an Obama appointee. “From a practical point of view, we’re trying to figure out how this advances your cause.”

“The fastest way to get it resolved is to get it done in the [other] court,” suggested U.S. Circuit Judge Sandra Lynch. “God knows how long it would take” in the lower court, she said.

But Katyal told the court that the judge in the other proceeding couldn’t lift the automatic stay.

“Right now, every day that passes is a day that they are spending our collateral and commingling it

and the other court cannot stop that,” Katyal complained.

But that’s “100% totally false,” insisted Martin Bienenstock, because the other court “can decide every conceivable claim they have lobbed.”

Bienenstock, also with Proskauer in New York, said the bondholders were just forum-shopping because the other court also seemed inclined to rule against them. “They have everything they want” in the other proceeding,” he said, “other than a different judge.”

Katyal said relief from the automatic stay would be simple, however, and would allow the bondholders to act immediately. “This isn’t about judge-shopping,” he said, “it’s about seeking a court that can provide appropriate relief.”

Lynch, a Clinton appointee, said the bondholders were taking a gamble in asking the First Circuit to rule.

“It strikes me that you’re rolling the dice here,” she said. “If you want us to reach the merits, you may regret the result you get because a ruling from us is binding on the lower courts, whereas otherwise the lower courts could change their minds.”

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