

Bond Case Briefs

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BANKRUPTCY - PUERTO RICO

In re Financial Oversight and Management Board for Puerto Rico

United States Court of Appeals, First Circuit - November 13, 2024 - F.4th - 2024 WL 4763572

Financial Oversight and Management Board for Puerto Rico filed adversary complaint seeking, inter alia, disallowance of proof of claim filed by parties holding certain revenue bonds that had been issued by the Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA).

Bondholders counterclaimed for declaratory judgment. Numerous entities were allowed to intervene. The United States District Court for the District of Puerto Rico granted in part and denied in part the parties' cross-motions for summary judgment and subsequently granted Board's motion to dismiss remaining counts of bondholders' counterclaim complaint. Bondholders appealed, Board and associated entities cross-appealed, and appeals were consolidated.

The Court of Appeals held that:

- Under Puerto Rico law, preamble of trust agreement under which revenue bonds were issued was not merely prefatory but, instead, was a granting clause;
- Trust agreement granted bondholders a lien on PREPA's "net revenues," not on its gross revenues;
- Bondholders' lien on PREPA's net revenues applied to future net revenues;
- Bondholders' lien was perfected with respect to net revenues that PREPA had acquired, and so lien could not be avoided by the Board using its powers as hypothetical judgment lien creditor;
- Proper amount of bondholders' allowed claim was face value of revenue bonds, that is, principal plus matured interest, or roughly \$8.5 billion;
- Bondholders were nonrecourse creditors and, thus, if their collateral only satisfied part of their claim, they could not file deficiency claim for the remainder;
- PREPA was not itself a trustee with respect to all moneys received and, thus, the Title III court properly dismissed bondholders' breach-of-trust claim; but
- Bondholders properly pled a claim for an equitable accounting.

Under the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), the Financial Oversight and Management Board for Puerto Rico is empowered to place Commonwealth entities into "Title III" bankruptcy-type restructuring proceedings, which resemble municipal bankruptcy proceedings under Chapter 9 of the Bankruptcy Code.

Bondholders' ability to pursue any remedies against the Puerto Rico Electric Power Authority (PREPA) under Commonwealth law was automatically stayed when the Financial Oversight and Management Board for Puerto Rico commenced a Title III proceeding in district court to restructure PREPA pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA).

Under Puerto Rico law, preamble to trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued revenue bonds was not merely a non-binding prefatory clause but, instead, was an operative lien-granting clause; although agreement began with table-setting “whereas” clauses, subsequent “Now, Therefore” clause stated that, in order to secure payment of revenue bonds, PREPA “[did] hereby pledge” to trustee the revenues of its system and other specified moneys, that language reflected a grant, not merely an aspiration or a description of background facts, and evinced an intent to create a security interest, and Commonwealth’s Authority Act, which authorized PREPA to grant liens in its revenues, used same phrasing as preamble and thus expressly contemplated that “pledge” to “secure payment” of bond could create security interest.

Under Puerto Rico law, trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued revenue bonds granted bondholders a lien on PREPA’s net revenues, not on its gross revenues; although agreement did not define “revenues of the System” at issue, its “opinion of counsel” clause, which parties drafted to direct future counsel on how to describe collateral securing revenue bonds in connection with issuance and delivery of any such bonds, stated that agreement “create[d] a legally valid and effective pledge of the Net Revenues” and of “moneys, securities, and funds held or set aside” under agreement as security for bonds, nowhere did agreement state that bondholders’ lien was secured by all of PREPA’s revenues, and so agreement, read as a whole, clearly provided that “revenues of the System” meant “Net Revenues,” that is, gross revenues minus current expenses.

Under Puerto Rico law, in determining scope of lien created by trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued particular revenue bonds, agreement’s driveby references to “Revenues” had to take a back seat to drafters’ focused description of the collateral in agreement’s “opinion of counsel clause.”

Under the Bankruptcy Code, any lien on a Chapter 9 debtor-utility’s “special revenues” is subordinate to the debtor’s reasonable and necessary postpetition operating expenses.

Under Puerto Rico law, trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued revenue bonds granted bondholders a lien on PREPA’s net revenues, even if they were not placed in specified funds created by agreement; agreement’s preamble stated in relevant part that PREPA pledged to trustee “the revenues of the System . . . and other moneys to the extent provided in [the] Agreement . . . as follows,” and although more specific grants within agreement expressly provided for liens in certain “sinking” and “subordinate” funds, agreement’s “opinion of counsel” clause drew clear grammatical distinction between PREPA’s pledge of “Net Revenues” and its pledge of “moneys, securities, and funds held or set aside” under agreement, such that preamble’s modifying phrase “to the extent provided” applied only to “other moneys,” not to “revenues of the System,” and agreement’s pledge of net revenues was not limited to those deposited in sinking and subordinate funds.

Under Puerto Rico law, trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued revenue bonds, which granted bondholders a lien on PREPA’s net revenues, also granted a lien on the utility’s future net revenues; Commonwealth law permitted bondholders to hold a security interest in yet-to-be-acquired net revenues, and the Bankruptcy Code, as incorporated by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which governed PREPA’s Title III restructuring proceeding, made clear that a lien on “special revenues” like those at issue in the case continued to attach to revenues acquired postpetition.

Puerto Rico’s version of the Uniform Commercial Code (UCC) sanctions security interests in after-acquired collateral, i.e., liens extending to property that the debtor does not possess at the time of the underlying security agreement, which are also known as “floating liens.”

Congress has recognized, in the Bankruptcy Code, that a revenue bond can be secured by future income.

Under the Bankruptcy Code, a lien on after-acquired property generally does not attach to property acquired after the debtor files for bankruptcy.

Under the Bankruptcy Code, a lien on “special revenues” continues to attach to revenues acquired by a Chapter 9 debtor postpetition, notwithstanding the Code’s general bar on liens on property acquired after the debtor files for bankruptcy.

Congress passed the section of the Bankruptcy Code governing Chapter 9 debtors’ pledges of special revenue to alleviate the concern that municipalities would use the Code provision generally barring liens on property acquired postpetition to avoid long-term pledges of project-specific revenues.

Bankruptcy Code not only recognizes that a Chapter 9 debtor may grant a lien on future revenues — it also expressly states that such liens continue to attach to revenues acquired after the filing of a bankruptcy petition.

Broadly, under the Bankruptcy Code, a creditor maintains a postpetition lien on the “proceeds” of collateral acquired prepetition.

Under Puerto Rico’s version of the Uniform Commercial Code (UCC), a security interest generally cannot attach to property until (1) the property exists, and (2) the debtor has a transferable right in that property.

Under Puerto Rico law, even though floating lien in future net revenues granted to bondholders by trust agreement under which Puerto Rico Electric Power Authority (PREPA) issued revenue bonds did not permit bondholders to demand present payment of net revenues that PREPA would receive in five years, that did not mean that PREPA could not convey an initial overarching interest in any net revenues that would come through the door in five years.

Under Puerto Rico law, lien held by parties holding certain revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was perfected with respect to net revenues that PREPA had acquired by providing electricity, and so lien could not be avoided by Financial Oversight and Management Board for Puerto Rico using its powers as hypothetical judgment lien creditor; bondholders’ security interest was a “general intangible,” bondholders had filed a timely financing statement as required to perfect their interest, and there was no contention that financing statement insufficiently described bondholders’ collateral or suffered from any other flaw that would have rendered the net revenue lien unperfected.

Under the Bankruptcy Code’s preferences section, bankruptcy trustee may avoid a debtor’s prepetition transfer of property to a creditor, if such transfer: (1) was made for an antecedent debt, (2) was made while the debtor was insolvent, (3) was made within a certain time period (usually 90 days), and (4) gives the creditor more than it would receive in a liquidation scenario that did not include the transfer.

Under any plausible conception of Puerto Rico law, lien held by parties holding certain revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), with respect to PREPA’s future net revenues, was not avoidable by Financial Oversight and Management Board for Puerto Rico using its powers as hypothetical judgment lien creditor,

whether under sweeping “stream” theory urged by bondholders, whereby their perfection of lien in net revenue “stream” meant they already held perfected interest in future-acquired net revenues, under modified “stream” theory whereby bondholders’ lien would attach to future net revenues when PREPA acquired them, or under no “stream” theory at all, whereby perfection would occur as soon as PREPA acquired any future net revenues.

Upon determining, on appeal from Title III court’s decision in adversary proceeding in which Financial Oversight and Management Board for Puerto Rico sought disallowance of proof of claim filed by parties holding revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), that bondholders’ lien covered PREPA’s present and future net revenues, and that lien was not avoidable with respect to net revenues already acquired, the Court of Appeals would decline to address how Title III court should account for bondholders’ lien in PREPA’s restructuring; there was no insight from Title III court, which, having held that no net revenue lien existed, had no occasion to discuss how to account for such lien during PREPA’s restructuring, and there was no focused appellate briefing on issue from the parties.

Proper amount of allowed claim held by parties holding revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was face value of bonds, that is, principal plus matured interest, or roughly \$8.5 billion; bondholders had legal “right to payment” rooted in covenants outlined in governing trust agreement, to which Commonwealth’s Authority Act applied, trust agreement clearly required PREPA to pay bonds in full and expressly permitted bondholders to proceed at law to challenge any breach of agreement’s covenants, there was thus no need to estimate their “right to payment” under section of Bankruptcy Code governing allowance of claims or interests, and because bondholders’ legal right to payment arose from debt instrument, proper amount of claim was full face amount of instrument.

Parties holding revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) were nonrecourse creditors and, thus, if their collateral only satisfied part of their claim, they could not file deficiency claim for the remainder; governing trust agreement expressly stated that revenue bonds were not general obligations of the Commonwealth of Puerto Rico, bondholders’ secured claim was thus payable “solely” from special revenues, such that section of the Bankruptcy Code governing limitation on recourse against Chapter 9 debtors applied and bondholders’ recourse was limited to their collateral, and nothing in the trust agreement said otherwise.

Under Puerto Rico law, Puerto Rico Electric Power Authority (PREPA) was not a trustee with respect to revenues and other moneys received, for purposes of breach-of-trust claim asserted by parties holding revenue bonds issued by PREPA before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA); governing trust agreement clearly identified a third-party financial institution and its successors, not PREPA, as trustee, particular section of agreement was properly read as requiring PREPA to deposit moneys with “depositories,” which then held the moneys in trust and applied them in accordance with agreement, and did not make PREPA itself a trustee, and Commonwealth’s Authority Act required PREPA to account “as if” it were the trustee of an express trust, which language would have been unnecessary if PREPA were already a trustee with respect to all moneys received.

Parties holding revenue bonds issued by Puerto Rico Electric Power Authority (PREPA) before it entered reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) properly pled claim for equitable “accounting” against PREPA

under Puerto Rico law; bondholders alleged that PREPA wrongfully diverted net revenues from debt service by spending them on unreasonable current expenses, thereby starving certain funds created by governing trust agreement of cash and slowing debt payments to bondholders, Commonwealth's Authority Act required PREPA to "account as if [it] were the trustee of an express trust," and parties' agreement did not limit that authority.