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Puerto Rico court recognizes limit to Bankruptcy Code's statutory lien definition

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Following a recent decision by the Court overseeing the Commonwealth of Puerto Rico's bankruptcy-like Title III proceeding, bondholders should continue to pay close attention to the pledge securing their bonds to determine how those bonds would be treated in a bankruptcy proceeding.

In the case of *Peaje Investments LLC v. Puerto Rico Highways & Transportation Authority*, the court denied a preliminary injunction sought by Peaje Investments LLC, the plaintiff, finding that because the lien did not arise from specific statutory language, it is unlikely that the bonds in question are secured by a statutory lien and, thus, the Puerto Rico Highways & Transportation Authority ("PRHTA") was permitted to continue to divert revenues pledged to bondholders for other uses.[1]

Readers are cautioned, however, that the Court has not issued a decision on the merits of the plaintiff's argument, but rather has determined that it is unlikely that the plaintiff would succeed on the merits of its claim.

Additionally, other parties-in-interest in the PRHTA proceeding have separately challenged the PRHTA's diversion of revenues.

The plaintiff has filed a notice of appeal to the U.S. Court of Appeals for the First Circuit.

BACKGROUND

The plaintiff in *Peaje* is the beneficial owner of approximately $65 million of bonds issued pursuant to a 1968 resolution (the "1968 Resolution") authorizing the issuance of bonds (the "1968 Bonds") by the PRHTA.

Under the 1968 Resolution, the PRHTA covenanted to deposit certain revenues, including "Toll Revenues" with a fiscal agent on a monthly basis.

The 1968 Bonds, according to the 1968 Resolution, "are payable solely from Revenues and from any funds received by [the PRHTA] for that purpose from the Commonwealth which Revenues and funds are hereby pledged to the payment thereof in the manner and to the extent hereinabove particularly specified."[2]

In short, holders of the 1968 Bonds are secured by the gross toll revenues of the PRHTA.

In April 2016, the Commonwealth of Puerto Rico enacted a moratorium — the Puerto Rico Emergency Moratorium and Financial Rehabilitation Act (the "Moratorium Act") — under which the Commonwealth suspended the obligations of the PRHTA to deposit revenues with a fiscal agent for the ultimate payment of holders of the 1968 Bonds.

Rather than paying bondholders, the PRHTA was ostensibly permitted under the Moratorium Act to divert the pledged revenues for other purposes.

The PRHTA asserted that the revenues it retained were necessary to ensure that the PRHTA's traffic facilities and other transportation infrastructure remained in good working order.[3]

The plaintiff brought its adversary proceeding challenging the moratorium and failure of the PRHTA to deposit the revenues subject to the pledge established in the 1968 Resolution with the fiscal agent.

Holders of bonds issued by a municipal debtor are entitled to special protections depending on the nature of the pledge securing those bonds.

With respect to the court's recent decision that is the subject of this client alert, the plaintiff had sought a court order directing the PRHTA to resume depositing toll revenues with the fiscal agent due to the statutory lien that the plaintiff asserted was attached to those toll revenues.[4]

The court denied the plaintiff's motion in its entirety, finding that the plaintiff had not demonstrated a likelihood of success on the merits of its argument that the bonds issued under the 1968 Resolution are secured by a statutory lien.

PLEDGE OF SPECIAL REVENUES VS. STATUTORY LIEN

The plaintiff's arguments relate to certain provisions of the U.S. Bankruptcy Code (the "Bankruptcy Code") that were incorporated by Congress into the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA") pursuant to which the PRHTA's Title III proceeding had been brought.[5]

Specifically, under the Bankruptcy Code, in a municipal bankruptcy (Chapter 9) proceeding, holders of bonds issued by a municipal debtor are entitled to special protections depending on the nature of the pledge securing those bonds.

Those holders may receive special protections if the underlying bonds are secured by a pledge of "special revenues" or a statutory lien.

Section 902(2) of the Bankruptcy Code enumerates five types of revenues that are "special revenues" under the Bankruptcy Code.

With respect to a pledge of special revenues, Section 928(a) of the Bankruptcy Code provides certain protections to the holders of such pledge in that special revenues acquired by a debtor after a bankruptcy petition has been filed remain subject to such pre-petition lien on special revenues.

However, under Section 928(b), any such lien on special revenues derived from a project or system is subject to the "necessary operating expenses of the project or system."

The *Peaje* court's decision is a helpful reminder to bondholders and municipal entities alike to closely examine the security provided for any bond issuance.

Finally, under section 922(d), the filing of a bankruptcy petition does not operate as a stay of the application of pledged special revenues to pay bonds secured by those revenues in a manner that is consistent with Section 928.

A municipal bond may also be secured by a statutory lien, that is, a lien arising solely by force of statute on specific circumstances and conditions.[6]

A statutory lien is created where the force and effect of a state statute's language creates a charge against or interest in specific property, such as a revenue stream. A consensual lien, alone, does not create a statutory lien, but the existence of a consensual lien does not automatically preclude a statutory lien finding.[7]

Generally, a consensual lien on property acquired by the debtor before the case was filed does not attach to property that the debtor acquires after the case is filed.[8]

However, a statutory lien should remain unaltered as a result of a bankruptcy petition and although there could be some delay in payment to bondholders due to the automatic stay in bankruptcy, the lien and rights to the particular revenue stream should remain unaltered without deduction for "necessary operating expenses," as would be the case for a pledge of special revenues.[9]

It was with these background facts and legal predicates that the plaintiff in *Peaje* brought its motion for a preliminary injunction.

DECISION

In the *Peaje* opinion, the Court first looked at whether the plaintiff had made the initial showing that the 1968 Bonds were secured by a pledge of special revenues exempt from the automatic stay provisions of the Bankruptcy Code.[10]

The Court found that the defendants had not contested that the toll revenues in question were "pledged special revenues" and concluded that the plaintiff had demonstrated a likelihood of success on the merits with respect to the first part of its claim.[11]

The Court then reviewed whether the plaintiff had established a likelihood of success on the merits that the 1968 Bonds were secured by a statutory lien.

The plaintiff specifically asserted that the 1968 Bonds were secured by a statutory lien arising from Puerto Rico Act 74-1965 (the "HTA Enabling Act"), and the 1968 Resolution itself.

With respect to the HTA Enabling Act, the Court found that a "grant of authority to create liens does not make liens that [PRHTA] subsequently decided to create statutory in nature."[12]

The court then determined that the plaintiff's assertion that the 1968 Resolution created a statutory lien was not likely to succeed because the 1968 Resolution was not a statute.[13]

The court noted that the PRHTA was a corporation and instrumentality of the Commonwealth of Puerto Rico, and not a legislature.

For these reasons, the court found that there was little likelihood that the plaintiff would succeed on the merits of its claim that the 1968 Bonds were secured by a statutory lien, and denied its motion for a preliminary injunction.

CONCLUSION

The *Peaje* court's decision is a helpful reminder to bondholders and municipal entities alike to closely examine the security provided for any bond issuance.

As noted above, there could be significant differences between a statutory lien, which provides bondholders with significant protections in the event of a bankruptcy proceeding and a pledge of special revenues which provides some protections but are subject to certain carveouts and deductions.

Any assertion of a statutory lien must be closely examined for "mandatory" language, and should flow from an actual statute, rather than a consensual agreement with the issuer.

As noted, the plaintiff has appealed the Court's ruling to the U.S. Court of Appeals for the First Circuit.

NOTES

[1] Opinion and Order Denying Motion for Preliminary Injunction and Motion for Relief from the Automatic Stay, *Peaje Investments LLC v.*

Puerto Rico Highways & Transportation Authority (In re the Financial Oversight and Management Board for Puerto Rico, as representative of the Commonwealth of Puerto Rico) Case No. 17-151 (Dkt. No. 240) (Sept. 8, 2017) (the "Peaje Op.").

[2] Peaje Op. at 6.

[3] *Id*.

[4] The Court's order was on the Motion of the Plaintiff (A) for Temporary Restraining Order and Preliminary Injunction, and (B) for Relief from Stay or, Alternatively, Adequate Protection.

[5] Law 114-187.

[6] *Peaje Op.* at 11; 11 U.S.C. § 101(53).

[7] For further information regarding statutory liens, see Municipalities in Distress? How State and Investors Deal with Local Governmental Financial Emergencies, 2d. 2016, published by Chapman and Cutler LLP.

[8] 11 U.S.C. 552(a).

[9] The interplay between statutory liens and Section 928(b) of the Bankruptcy Code has never been analyzed by a court. However, the existence of a valid lien may create a constitutionally protected property interest under the Fifth Amendment that cannot be impaired without providing just compensation. *See, e.g., Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935). Thus, if a statutory lien existed, appropriating the revenues for payment of "necessary operating expenses" would likely not be permitted.

[10] *Peaje Op.* at 10.

[11] *Id*.

[12] *Id*. at 12-13.

[13] *Id*. at 13.

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