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JULY/AUGUST 2019

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VOLUME 15

NUMBER 5

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Library of Congress Card Number: 80-68780

ISBN: 978-0-7698-7846-1 (print)

ISBN: 978-0-7698-7988-8 (eBook)

ISSN: 1931-6992

Cite this publication as:

[author name], [*article title*], [vol. no.] PRATT’S JOURNAL OF BANKRUPTCY LAW [page number] ([year])

Example: Patrick E. Mears, *The Winds of Change Intensify over Europe: Recent European Union Actions Firmly Embrace the “Rescue and Recovery” Culture for Business Recovery*, 10 PRATT’S JOURNAL OF BANKRUPTCY LAW 349 (2014)

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First Circuit Panel Upends Protections Available to Special Revenue Bondholders

By Laura E. Appleby, James Heiser, and Franklin H. Top III

A three-judge panel of the U.S. Court of Appeals for the First Circuit has ruled that the “special revenue” provisions of the U.S. Bankruptcy Code do not compel the payment of debt service on certain municipal bonds during the pendency of a bankruptcy proceeding. The authors of this article explain the ruling and how it upends the expectations of the municipal bond market.

In a decision that upends the expectations of the municipal bond market, a three-judge panel of the U.S. Court of Appeals for the First Circuit has ruled that the “special revenue” provisions of the U.S. Bankruptcy Code do not compel the payment of debt service on certain municipal bonds during the pendency of a bankruptcy proceeding.¹

Rather, according to the First Circuit panel, the special revenue provisions merely allow the voluntary payment of such debt service during a bankruptcy proceeding by a municipal debtor. In its decision, the First Circuit upheld a decision by the lower court overseeing the bankruptcy-like proceeding involving the Commonwealth of Puerto Rico.

In its ruling, the three-judge panel concluded that the special revenue provisions were unambiguous and therefore it did not need to look beyond the text of the statute and that the lack of “mandatory” language in the statute meant that a municipal debtor’s payment obligations were merely permissive.

BACKGROUND

The plaintiffs, financial guarantee insurers of bonds issued by the Puerto

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¹ *Assured Guaranty Corp. v. The Financial Oversight and Management Board for Puerto Rico (In re The Financial Oversight and Management Board for Puerto Rico, as Representative for the Commonwealth of Puerto Rico, et al.)*, 919 F.3d 121 (1st Cir. 2019).

Rico Highways and Transportation Authority (“PRHTA,” and such bonds, the “PRHTA Bonds”), brought suit seeking an order to compel certain toll revenues and excise taxes of PRHTA that were pledged to secure the PRHTA Bonds to be disbursed to pay principal and interest on the PRHTA Bonds. Defendants, including the Commonwealth of Puerto Rico (the “Commonwealth”) and PRHTA, among others, urged the lower court to dismiss the plaintiffs’ action, arguing that Section 305 of PROMESA (defined below) deprived the court of jurisdiction to grant the relief sought. Contrary to market expectations, both the lower court and the First Circuit sided with the Commonwealth, dismissing the suit.

An oversight board (the “Oversight Board”) established pursuant to the Puerto Rico Oversight, Management, and Economic Stability Act (“PROMESA”) has approved a fiscal plan by PRHTA (the “PRHTA Fiscal Plan”). Under the PRHTA Fiscal Plan, the Commonwealth was authorized to redirect from PRHTA to the Commonwealth toll revenues and special excise taxes that had been pledged to repay the PRHTA Bonds. PRHTA has since defaulted on its debt service payments on the PRHTA Bonds.

The plaintiffs brought suit in the Commonwealth’s bankruptcy like proceeding, alleging, among other things, that the PRHTA Bonds were secured by a pledge of “special revenues” under Title 11 of the United States Code² (the “Bankruptcy Code”) and, thus, PRHTA’s failure to make payments on the PRHTA Bonds as they came due was a violation of Sections 922(d) and 928(a) of the Bankruptcy Code, which have been made applicable to the Commonwealth’s proceeding.

CHAPTER 9 OF THE BANKRUPTCY CODE

Under Chapter 9 of the Bankruptcy Code, bonds secured by a pledge of “special revenues,” as defined in the Bankruptcy Code, are afforded special protections.³ Specifically, Section 928 of the Bankruptcy Code provides that in the case of “special revenues,” bondholders’ security interest in such “special revenues” remains valid and enforceable even though such revenues are received after a Chapter 9 bankruptcy filing. The security interest, however, is subject to the necessary operating expenses of the project or system from which the revenues derive.⁴

² 11 U.S.C. § 101 *et seq.*

³ See 11 U.S.C. § 902 for a list of revenue pledges that qualify for special treatment under the Bankruptcy Code as “Special Revenues.”

⁴ U.S.C. § 928(b).

Thus, subject to the payment of necessary operating expenses, holders of special revenue bonds are intended to continue to be fully secured regardless of the bankruptcy filing. Additionally, pursuant to Section 927 of the Bankruptcy Code, special revenue debt is nonrecourse debt, meaning that special revenue holders are not entitled to funds of a debtor that were not specifically pledged to them.

In addition to Sections 927 and 928, Section 922(d) (with Sections 927 and 928, the “Special Revenue Provisions”) of the Bankruptcy Code provides that notwithstanding the automatic stay of the Bankruptcy Code, “a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with [Section 928] to payment of indebtedness secured by such revenues.”⁵

The interpretation of Section 922(d) was at issue. Prior to the lower court’s decision and the First Circuit’s Opinion, participants in the municipal debt markets understood and expected that following bankruptcy filings, municipal debtors would be required to continue to pay their special revenue obligations as such obligations become due.

THE COURT’S OPINION

Contrary to market expectations, the First Circuit upheld the lower court’s position, finding that Section 922(d) does not *compel* a municipality to continue to make its debt service payments as they come due following the municipality’s bankruptcy filing, but rather that Section 922(d) merely *permits* a municipal debtor to pay voluntarily its special revenue obligations despite the automatic stay of the Bankruptcy Code. The First Circuit opined:

Section 922(d)’s plain language establishes that the application of pledged special revenues is not a violation of the automatic stay. It thus permits a debtor to pay creditors voluntarily during the pendency of the bankruptcy case and allows a secured claimholder to apply special revenues in its possession to pre-petition debt without violating the automatic stays of Sections 362 and 922(a). Nothing in the statute’s plain language, however, addresses actions to enforce liens on special revenues, which are specifically stayed [under] the Bankruptcy Code, or allows for the compelling of debtors, or third parties holding special revenues, to apply special revenues to outstanding obligations.⁶

Thus, according to the First Circuit panel, although a municipal debtor may

⁵ *Id.* § 922(d).

⁶ 919 F.3d at 130.

choose to continue to make payment on its revenue bonds using collected special revenues, if a municipal debtor chooses not to turn over such funds, the bond trustee or bondholders have very little recourse to force a turnover of those funds. This, according to the First Circuit panel, is because Section 904, as incorporated into PROMESA Section 305, “prohibits judicial interference with the debtor’s property or revenues” and, consequently, prohibits a bankruptcy court from compelling a municipal debtor to transfer designated funds.

The First Circuit’s opinion is in direct contravention to prevailing market understanding of the Special Revenue Provisions of the Bankruptcy Code, as well as the legislative history surrounding those provisions. Additionally, the First Circuit’s decision creates additional uncertainty in states that permit municipalities to file Chapter 9 petitions,⁷ because, pursuant to the decision, a municipal debtor may choose to use such revenues for other purposes, placing the special revenue bondholders in a position potentially worse than that which had existed before the Chapter 9 filing.⁸ This is because under the Bankruptcy Code, the bondholders only entitlement is to the revenue stream pledged to them, and the bondholders are not entitled to any other funds of the municipal debtor.⁹

The First Circuit panel also left several additional questions unanswered. First, with respect to a municipal debtor, if state law requires that special revenues may only be used to make payment on the applicable revenue bonds, it is unclear, at least in the First Circuit, whether the holders would have any recourse in the event that the municipality attempts to divert such funds during the course of a bankruptcy proceeding.¹⁰

Additionally, because any plan of adjustment under Chapter 9 must adhere to state law, if a municipal debtor were to divert funds it was required to transfer to bondholders under state law, it is unclear what action a secured party would

⁷ Twelve states specifically authorize Chapter 9 filings, another 12 states authorize such filings with certain conditions, three states grant limited authorization, and two states prohibit filing. The remaining 21 states do not have specific authorization, meaning that municipalities in those states are not authorized to file a Chapter 9 petition.

⁸ The First Circuit did not address whether such holders would be entitled to adequate protection under the Bankruptcy Code.

⁹ 11 U.S.C. § 927.

¹⁰ Section 903 of the Bankruptcy Code provides that Chapter 9 “does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality, including expenditures for such exercise”

be required to take were the municipality to divert such funds.¹¹ In these situations, an affected creditor could potentially seek to dismiss the case if payment is not made, but this area of the law is unsettled.

CONCLUSION

Market players have long relied on the Special Revenue Provisions to provide certainty and security to holders of special revenue debt in the event that a municipality was eligible to file and did file a petition under Chapter 9 of the Bankruptcy Code. The First Circuit's decision subverts these expectations in holding that a municipal debtor may choose whether or not to pay its special revenue obligations.

¹¹ 12 U.S.C. § 943(b)(4).