

First Circuit Rules PREPA Bondholders Have a Secured Claim on Current and Future Net Revenues

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In a decision that should help restore investors' faith in the protections afforded municipal bondholders under the United States Bankruptcy Code (the "Bankruptcy Code"), on June 12, 2024, the United States Court of Appeals for the First Circuit (the "First Circuit" or the "Court") held that the bondholders (the "Bondholders") of certain Puerto Rico Electric Power Authority ("PREPA") electric revenue bonds (the "Bonds") have a non-recourse claim against PREPA's estate in PREPA's reorganization proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C. §§ 2161-78 ("PROMESA"), for the full principal amount of their outstanding Bonds, plus matured interest, of approximately \$8.5 billion, and that the Bonds are secured by PREPA's current and future Net Revenues (as defined below).¹

First Circuit's Ruling

Among other things, the First Circuit's ruling reversed the portion of the results-driven March 22, 2023, decision by Judge Laura Taylor Swain of the United States District Court for the District of Puerto Rico (the "District Court") that held that the Bondholders are secured only by security interests in "moneys actually deposited to the Sinking Fund and the [Subordinate Funds]"² (as further defined below, the "Liened Funds") established by the trust agreement (the "Trust Agreement") under which the Bonds were issued.³ The First Circuit also reversed the District Court's determination that the Bondholders' "right to payment arose from a right to an equitable remedy for breach of performance" subject to estimation under Section 502(c)(2) of the Bankruptcy Code, giving rise to an unsecured deficiency claim of \$2.4 billion against future Net Revenues (as defined below) of the estate. Instead, the Court found that the proper amount of the Bondholders' claim on PREPA's estate is the principal plus matured interest of the Bonds, or roughly \$8.5 billion.

The First Circuit's decision increases the Bondholders' potential recovery in the PREPA proceeding by billions of dollars and should give municipal bondholders some confidence that the protections afforded bondholders under the Bankruptcy Code remain viable in the First Circuit. Such viability had been called into doubt when the Court upheld Judge Swain's previous misinterpretation of the municipal bondholder safe harbors under the Bankruptcy Code. The First Circuit's ruling, however, does not overturn or address the Court's previous decision of March 26, 2019, in a related Title III Proceeding (as defined below), which wrongly affirmed the District Court's holding in that proceeding that a debtor under a Title III Proceeding may, but is not required to, make post-petition payments on municipal special revenue bonds.⁴ Thus, even with the benefit of the First Circuit's current ruling, the Bondholders likely will not receive payments immediately on their claims and their actual recovery on the outstanding Bonds remains to be determined.

Background

PREPA, a public utility, was created under the Puerto Rico Electric Power Authority Act (the "Authority Act"), P.R. Laws Ann. tit. 22, § 191. For more than 80 years, it was the sole electric utility in Puerto Rico. The Authority Act permits PREPA to raise money by issuing revenue bonds secured by its gross or net revenues and present or future income. Under such authority, PREPA issued the Bonds under the Trust Agreement. In July 2017, under the authority provided by PROMESA, the Financial Oversight and Management Board (the "Board") commenced a bankruptcy-type restructuring proceeding for PREPA (a "Title III Proceeding"), which resembles a municipal bankruptcy proceeding under Chapter 9 of the Bankruptcy Code.⁵

In 2017, PREPA defaulted on its obligations under the Trust Agreement, including its obligation to pay the Bondholders. But for the passage of PROMESA, the Bondholders could have pursued remedies under the Authority Act and the Trust Agreement. The Board filed an adversary proceeding within PREPA's Title III Proceeding to define the rights and remedies of the Bondholders, which the Board subsequently agreed not to prosecute after the parties negotiated a

restructuring agreement for PREPA in 2019. In March 2022, the Commonwealth of Puerto Rico (the “Commonwealth”) terminated the restructuring agreement and the Board subsequently filed an amended complaint, which is the operative complaint for this appeal (the “Complaint”).

The following provisions of the Trust Agreement, among others, frame the issues:

- 1) The Preamble, as further discussed below.
- 2) Article I, which defines the terms “Revenues” and “Net Revenues,” among other relevant terms.⁶
- 3) Article V, which establishes a waterfall-like structure for distributing PREPA’s “Revenues” into certain funds.⁷
- 4) Articles IV and V, which grant Bondholders security interests in certain funds both within and outside the waterfall-like structure (such funds collectively, the “Liened Funds”).⁸

The District Court’s Analysis of PREPA’s Revenue Pledge

Under the Complaint, the Board alleged that the Bondholders had security interests only in the moneys actually deposited in Liened Funds and not in PREPA’s current or future Revenues or Net Revenues, unless those current or future Revenues or Net Revenues were actually deposited in a Liened Fund. The Board alleged that the Bondholders have perfected security interests only in the Liened Funds and that the Board could avoid any remaining unperfected security interests of the Bondholders, if any, under the Board’s avoidance powers under Section 544(a) of the Bankruptcy Code (which is incorporated into the Title III Proceeding by PROMESA). The Board also alleged that the Bonds were non-recourse, such that the Bondholders could only recover amounts owed on the Bonds from the amounts actually deposited in the Liened Funds.

The Bondholders filed an answer denying the Board’s allegations. They also filed a counterclaim alleging, among other things, that PREPA had misappropriated moneys for uses “other than Current Expenses instead of paying the Bondholders,” as required under the Trust Agreement. The Bondholders further asked for a declaratory judgment that PREPA was in breach of trust under the Trust Agreement and for an order requiring an accounting of PREPA’s revenues.

In its March 22, 2023, partial summary judgment ruling, the District Court agreed with the Board that the Trust Agreement granted the Bondholders security interests only in moneys actually deposited in the Liened Funds and not a broader security interest in PREPA’s Revenues or Net Revenues. The District Court suggested that a confirmed plan of adjustment would discharge PREPA’s contractual obligation under the Trust Agreement to replenish the Liened Funds. The District Court also held that the Board could avoid any of the Bondholders’ unperfected security interests under Section 544(a) of the Bankruptcy Code. However, the District Court rejected the Board’s argument that the Bonds were non-recourse. Further, the District Court ruled that even though the Bondholders lacked a security interest in PREPA’s Revenues or Net Revenues, the Trust Agreement allowed the Bondholders to sue in law or equity for specific performance of any covenant or agreement contained in the Trust Agreement, which, the District Court decided, provided the Bondholders an unsecured deficiency claim on PREPA’s future Net Revenues in the Title III Proceeding, which the District Court subsequently estimated to be in an amount of approximately \$2.4 billion. The District Court derived this amount by estimating how much Net Revenue a receiver would be able to direct into the Liened Funds (while complying with the rest of the Trust Agreement) over the next 100 years, then discounting that figure to present value. In its final summary judgment ruling on November 23, 2023, the District Court also concluded that the Bondholders had failed to state a claim for breach of trust and that an accounting under the Authority Act did not require the sweeping restitution remedy that the Bondholders had requested from the District Court.

Upon the District Court’s final summary judgement order, the Bondholders and the Board both filed appeals with the First Circuit. The Bondholders challenged the District Court’s findings that (1) they lacked a security interest in PREPA’s current or future Revenues or Net Revenues, (2) any such security interest was potentially avoidable by the Board under Section 544 of the Bankruptcy Code, and (3) the Bondholders had failed to state a claim for breach of trust and were not entitled to an accounting of misappropriated PREPA moneys. The Bondholders also challenged the District Court’s estimation of the unsecured deficiency claim. On the other hand, the Board argued that the District Court erred in allowing the Bondholders any unsecured deficiency claim on PREPA’s Net Revenues as, in the Board’s view, the

Bonds were non-recourse and the Bondholders could only recover from their collateral (*i.e.*, the moneys actually deposited in the Liened Funds). In the alternative, the Board argued that the District Court's \$2.4 billion unsecured deficiency claim estimation for the Bondholders should be affirmed. Finally, the Board asserted to the First Circuit that if the Bondholders had a lien on Net Revenues, it should be avoided as unperfected.

The First Circuit's Analysis of the Appeals

Initially and most importantly, the First Circuit held that the Trust Agreement granted the Bondholders a lien on PREPA's Net Revenues, even if not deposited in a Liened Fund.⁹ The Court's analysis focused on the Trust Agreement's Preamble (the "Preamble"), which provided:

Now, Therefore, This [Trust] Agreement Witnesseth, that ... in order to secure the payment of [the Bonds] ... [PREPA] does hereby pledge to the Trustee the revenues of the System ... and other moneys to the extent provided in [the Trust Agreement] as security for the payment of the [Bonds] ... and it is mutually agreed and covenanted ... as follows

The Bondholders argued that the Preamble granted them a lien on all of PREPA's Revenues. The District Court had found instead that the Preamble was only a non-binding prefatory clause rather than a granting clause and that the Bondholders had no such lien on Revenues or Net Revenues under the Trust Agreement. The Board did not defend the District Court's Preamble interpretation on appeal, although another appellant and certain intervenors did defend it. The First Circuit, however, found that the language of the Preamble reflected a promise from PREPA to the Bondholders rather than an aspiration or a description of background facts and cited as support Commonwealth law, which governed the Trust Agreement. No magic words like "lien" or "charge" were required to create a security interest under Puerto Rico law, the First Circuit stated. Further, the Authority Act stated that PREPA may "pledg[e]" its current or future revenues to "secure payment of [revenue bonds]" and the First Circuit held that it would therefore be paradoxical to hold that the identical language in the Preamble did not create such an interest for the Bonds.

Having concluded that the Preamble created a security interest, the First Circuit then addressed the scope of the security interest granted to the Bondholders by the Preamble in the "revenues of the System ... and other moneys to the extent provided in [the Trust Agreement]," which operative terms were not expressly defined. The Court held that the security interest extended to PREPA's Net Revenues. The Court first recognized that the Preamble's use of the phrase "revenues of [PREPA]" rather than "Revenues" or "Net Revenues" as defined in the Trust Agreement left unclear precisely what was being pledged to the Bondholders under the Trust Agreement. To resolve this ambiguity, the First Circuit purported to read the Trust Agreement "as a whole." Specifically, the Court noted that the provisions of the Trust Agreement required an opinion of counsel (the "Opinion of Counsel") be delivered in connection with the Bond issuance that would confirm the Bondholders' rights and responsibilities and describe the security that PREPA purported to provide thereto. The Trust Agreement provided that the Opinion of Counsel must state that the Trust Agreement "creates a legally valid and effective pledge of the Net Revenues ..." as security for the Bonds (emphasis in original). Based on the agreed-upon description the parties had drafted to direct future counsel, the First Circuit interpreted the phrase "revenues of the System" in the Preamble to mean "Net Revenues" (*i.e.*, gross revenues minus Current Expenses) rather than "Revenues" (*i.e.*, gross revenues).

Regarding the phrase in the Preamble "to the extent provided in [the Trust Agreement]," the Board argued that the Bondholders' security only attached to those Net Revenues that have actually flowed into the Liened Funds, as such phrase modified both the terms "revenues of the System" and "other moneys." The First Circuit disagreed and found that the phrase "to the extent provided in [the Trust Agreement]" did not modify the term "revenues of the System" in the Preamble. In addressing the issue, which the First Circuit characterized as a "classic antecedent puzzle," the Court noted opposing canons of statutory interpretation that supported each party's position. However, the First Circuit again turned to the language in the description of the Opinion of Counsel in the Trust Agreement ("Opinion Clause") which requires that the Opinion of Counsel must state that the Trust Agreement established a "legally valid and effective pledge of the Net Revenues ... and of the moneys, securities and funds held or set aside under this [Trust] Agreement as security for the bonds" (emphasis in original). The First Circuit found that the mutually agreed-upon language of the Opinion Clause drew a clear grammatical distinction between the pledge of the "Net Revenues" and the pledge of the

“moneys, securities, and funds held or set aside under [the Trust Agreement],” which distinction ran directly counter to the Board’s assertions. The First Circuit also discounted the Board’s argument that if the Bondholders have a lien on Net Revenues, then the pledges of amounts in the Liened Funds were superfluous as, in the First Circuit’s opinion, superfluidity in bond agreements was not unheard of and such a belt-and-suspenders approach likely offered additional assurance to the Bondholders. The First Circuit noted that it is loath to read ambiguous language in the Trust Agreement in a manner suggesting that the Trust Agreement calls for investors to be misled, as would be the case if it were to hold that the Bondholders’ collateral was limited to moneys in the Liened Funds.

Next, the Court concluded that the Bondholders’ lien on Net Revenues applied to both present and future Net Revenues. In making such holding, the First Circuit again relied on Commonwealth law. The Court cited the Authority Act, which permitted PREPA to pledge its present or future income. It also cited the Uniform Commercial Code (the “UCC”) Puerto Rico had adopted, which contemplates security interests in “after-acquired property.” The Court noted that Section 928 of the Bankruptcy Code makes clear that a lien on “special revenues,” like the one at issue in the case, continues to attach to revenues acquired post-petition and cited case law considering the scope of similar municipal revenue liens that concluded or implied that a revenue lien extends to future revenues.¹⁰ It also explained that the Bondholders’ lien on Net Revenues is best understood as a lien on an “account” under Article 9 of the UCC, and the First Circuit noted that it was commercially reasonable to anticipate that security interests in accounts would include after-acquired property. As relevant here, Puerto Rico’s version of the UCC defines “account” as a “right to payment of a monetary obligation, whether or not earned by performance ... for energy provided or to be provided.” P.R. Laws Ann. tit. 19, § 2212(a)(2) (emphasis added). Further, the Court noted that it strained plausibility to suggest that the Bondholders paid billions of dollars in return for only a pledge of Net Revenues received or due on the day the Trust Agreement was executed.

The First Circuit also concluded that the Bondholders’ lien on present and future Net Revenues could not be avoided by the Board under Section 544(a) of the Bankruptcy Code.¹¹ Under Puerto Rico law, a judgment lien is superior to any unperfected security interest, and if the Bondholders’ Net Revenue lien was unperfected, the Board could avoid it under Section 544(a), the Court noted. However, with respect to Net Revenues that PREPA had already acquired, the Bondholders had taken the necessary steps prepetition to perfect a security interest therein by timely filing a financing statement. With respect to competing theories of perfection regarding PREPA’s not-yet-acquired Net Revenues, the First Circuit indicated that (a) if the Commonwealth adopts the Bondholders’ sweeping view that their perfection of the lien in the Net Revenue “stream” means they already hold a perfected interest in future-acquired Net Revenues, then the lien is clearly unavoidable, (b) if the Commonwealth adopts a modified conception of “stream” theory so that a creditor’s interest in a piece of collateral attaches upon acquisition and is treated as if perfected at the time of the initial financing statement, then the Bondholders’ lien will attach to future Net Revenues when PREPA acquires them, at which point the lien will be treated as if it were perfected at the time of the initial financing statement, and (c) if the Commonwealth adopts no “stream” theory at all, then perfection would occur as soon as PREPA acquires any future Net Revenues. Accordingly, the Court held that under any plausible interpretation of Commonwealth law, the Bondholders’ lien on future Net Revenues would be perfected, at the very latest, immediately upon PREPA’s acquisition of those Net Revenues, and no intervening period existed in which a judgment creditor could obtain a superior lien under Puerto Rico law. Thus, according to the First Circuit, the Bondholders’ lien under the Trust Agreement on future Net Revenues could not be avoided under Section 544(a) of the Bankruptcy Code.

Next, the Court concluded that the amount of the Bondholders’ allowed claim that the Net Revenues lien secured was the principal plus matured interest of the Bonds, or approximately \$8.5 billion. The Court found that the Bondholders’ claim was a right to payment rooted in the covenants of the Trust Agreement and not arising from a right to an equitable remedy for breach of performance, as the District Court had held. The Trust Agreement required PREPA to pay the Bonds in full, the Court noted. The Bondholders could deploy various equitable remedies, like receivership, to enforce the right to payment, but the underlying right to payment was a legal one. The First Circuit noted that when a legal right to payment arises from a debt instrument, the proper amount of the claim is the full face amount of the instrument, which in this instance could be determined by examining the Trust Agreement.

Finally, the Court held that the Bondholders’ \$8.5 billion claim was only secured by the Bondholders’ security interest in the Net Revenues and Liened Funds. Under Section 1111(b) of the Bankruptcy Code, the Court noted, a secured debtor presumptively has “recourse against the debtor on account of [its secured] claim” even if the creditor is otherwise

non-recourse under applicable non-bankruptcy law. However, pursuant to Section 927 of the Bankruptcy Code, Section 1111(b) does not apply to a holder of a claim payable “solely” from the debtor’s special revenues. The Bondholders argued that the Bonds were payable in part from non-special revenue sources such as investment earnings, federal subsidies, or insurance proceeds. The Court found this argument overread the word “solely” in Section 927, as its purpose is to “deny special revenue bondholders any recourse to the general funds of a municipality, which are often subject to ‘statutory or constitutional limits on debt issuance.’”¹² The Court held that the Bondholders were non-recourse creditors and could not file a deficiency claim against PREPA in any amount. Consequently, the First Circuit overturned the District Court’s ruling that the Bondholders were entitled to an unsecured deficiency claim of \$2.4 billion in the Title III Proceeding.

Importantly, the Court also expressly declined to instruct the District Court how to “deal” with the Bondholders’ Net Revenues lien during plan confirmation. In its March 22, 2023, ruling the District Court had suggested that a plan of adjustment would discharge PREPA’s contractual obligations to replenish the Liened Funds and thus the Bondholders’ security interests in the Liened Funds would not grow in value after the confirmation date. The Bondholders argued that the District Court had, therefore, made an incorrect holding that the plan of adjustment could unilaterally “cut off” the Bondholders’ security interest regardless of the interest’s form. However, the First Circuit noted that the District Court’s holding did not address the extent to which the Bondholders’ lien on future Net Revenues was dischargeable in a plan of adjustment and thus, in the first instance and without adequate briefing, the First Circuit declined to address the issue. As a result, the Bondholders’ ultimate recovery on the Bonds in PREPA’s Title III Proceeding remains uncertain.

In regard to the Bondholders’ counterclaims, the First Circuit affirmed the District Court’s dismissal of the Bondholders’ breach of trust claim. When PREPA received Revenues, certain Bondholders argued that PREPA held the Revenues in trust for the Bondholders. The First Circuit, however, noted that the Trust Agreement identified First National City Bank and its successors — and not PREPA — as the trustee under the Trust Agreement (the “Trustee”). The Trust Agreement stated that all moneys received by PREPA “shall be deposited with a Depository or Depository [and] shall be held in trust,” the Bondholders noted, but the First Circuit ruled that nothing in such language indicated that PREPA receives and holds the moneys in trust in the first instance. PREPA also was not a depository, and the text of the Authority Act required PREPA to account “as if” it were the trustee of an express trust, which language would be unnecessary if PREPA already was a trustee, the First Circuit further noted.

The Court, however, reinstated the Bondholders’ accounting claim. The Bondholders suggested in their appellate brief that PREPA had spent Net Revenues on unreasonable Current Expenses, which “starved” the Liened Funds of deposits and slowed debt payment to the Bondholders. Initially, the Court noted that the Authority Act permitted the Bondholders, subject to the terms of the Trust Agreement, to bring an equitable action requiring PREPA to “account as if [it] were the trustee of an express trust.” The Court also noted that the Trust Agreement did not limit such right and the Trust Agreement permitted the Trustee to sue on behalf of the Bondholders to enforce any proper legal or equitable remedy. The concept of “accounting” was not defined in the Trust Agreement, but historically it had been considered an equitable remedy like disgorgement or restitution, according to the First Circuit. The District Court had concluded that, under Commonwealth law, a creditor requesting an “accounting” was only entitled to information about the debtor’s unpaid obligations. The First Circuit distinguished the sources that the District Court had cited to support its holding as applicable to accounting claims brought by debtors or in an agency context. The Court concluded that the Bondholders had properly plead a claim for an equitable accounting, but cautioned that an equitable accounting would not expand the Bondholders’ recourse beyond the Net Revenues and, pursuant to the terms of the Trust Agreement, might only reach moneys available for debt service.

Conclusion

The First Circuit’s ruling should give comfort to the municipal bond market. The First Circuit was able to correct certain fundamental and critical issues in the District Court’s results-oriented decision and affirm that the protections afforded municipal bondholders under the Bankruptcy Code may be relied upon in even the most difficult cases. However, the Court also noted that certain issues remain to be settled and the effect of this opinion on PREPA’s final agreed or ordered plan of adjustment and future access to the capital markets remains to be seen. The Bondholders’ ultimate recovery on the Bonds also remains uncertain.

For More Information

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- 1 *In re Fin. Oversight and Mgmt. Bd. for Puerto Rico*, 2024 WL 2952154, *1 (1st Cir. June 12, 2024).
- 2 *In re Fin. Oversight and Mgmt. Bd. for Puerto Rico*, 649 B.R. 381, 394 (D.P.R. 2023).
- 3 For a detailed analysis of Judge Swain's March 22, 2023 ruling, see Chapman's Client Alert, [Court Rules PREPA Bondholders Do Not Have a Secured Claim on Current and Future Net Revenues](#), dated April 14, 2023.
- 4 Specifically, on March 26, 2019, in a related Title III Proceeding involving the Puerto Rico Highways and Transportation Authority and counter to market expectations, the First Circuit affirmed the District Court's holding that Section 922(d) of the Bankruptcy Code did not compel a debtor to continue to make its debt service payments on special revenue bonds post-petition, but rather that Section 922(d) merely permitted the debtor to pay voluntarily its special revenue obligations despite the automatic stay of the Bankruptcy Code. See Chapman's Client Alert, [First Circuit Panel Upends Protections Available to Special Revenue Bondholders](#), dated April 8, 2019; Spiotto, James, [The First Circuit Court of Appeals Ruling on 'Assured' Should be Reheard or Reversed; Recent Ruling Sends a Harsh Message to Municipal Bond Market](#), April 3, 2019. See also note 5, below.
- 5 PROMESA incorporates various provisions of the Bankruptcy Code directly into the proceedings thereunder, including the sections of the Bankruptcy Code referenced herein.
- 6 "Revenues" are defined under the Trust Agreement to mean (1) "all moneys received by [PREPA] in connection with or as a result of its ownership or operation" of its electricity generation and distribution system, (2) "any proceeds of use and occupancy insurance on the System or any part thereof," and (3) "income from investments made under" either the Trust Agreement or a 1947 predecessor agreement. *Id.* at *1. "Net Revenues" means "any Revenues remaining after deducting reasonable and necessary operating expenses." *Id.* at *1.
- 7 Under the Trust Agreement, "Revenues first flow into the General Fund. PREPA pays its reasonable operating expenses ('Current Expenses') out of the General Fund. The remaining dollars — the Net Revenues — then flow into the Revenue Fund, minus a reserve to cover future operating expenses. From there, Net Revenues flow first into the Sinking Fund, and then into a series of Subordinate Funds. The Net Revenues deposited into the Sinking Fund cover debt service. The Net Revenues deposited into the Subordinate Funds cover internal PREPA operations, such as extraordinary repairs or capital improvements." *Id.* at *2. "There are four Subordinate Funds: the Construction Fund, the Self-Insurance Fund, the Capital Improvement Fund, and the Reserve Maintenance Fund. If there is not enough money in the Sinking Fund to cover PREPA's debt service obligations, Article V (specifically, sections 512 through 512B) [of the Trust Agreement] broadly requires PREPA to draw on the Subordinate Funds — other than the Construction Fund — to pay bondholders." *Id.* at *2.
- 8 The "Liened Funds" under the Trust Agreement are the Sinking Fund, the Construction Fund, the Self-Insurance Fund, the Capital Improvement Fund, and the Reserve Maintenance Fund. See *id.* at *2.
- 9 *Id.* at *5.
- 10 All parties agreed that PREPA's Revenues and Net Revenues are "special revenues" under the Bankruptcy Code. See *id.* at 8; 11 U.S.C. § 902(2).
- 11 "Section 544(a) [of the Bankruptcy Code] grants the bankruptcy trustee [(or, in this instance in a Title III Proceeding, the Board)] the powers of a hypothetical creditor who 'extends credit ... at the [beginning] of the case,' and thereby obtains 'a [judgment] lien on all property on which a creditor on a simple contract could have obtained such a [judgment] lien.'" *Id.* at *13.
- 12 *Id.* at * 19.

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