

Chapman Client Alert

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Current Issues Relevant to Our Clients

Puerto Rico Court Reduces Protections Available to Special Revenue Bondholders

In a decision likely to have a far-reaching effect in the municipal debt markets, on January 30, 2018, the Court overseeing the Commonwealth of Puerto Rico's bankruptcy-like Title III proceeding ruled that holders of municipal obligations secured by a pledge of special revenues are not guaranteed payment during the pendency of a bankruptcy proceeding.¹ The plaintiffs may appeal the decision to the U.S. Court of Appeals for the First Circuit.

In the case, the plaintiffs, insurers of bonds issued by the Puerto Rico Highways and Transportation Authority (the "PRHTA," and such bonds, the "PRHTA Bonds"), brought suit seeking an order that certain toll revenues and excise taxes of the PRHTA, which the PRHTA pledged to secure payment of the PRHTA Bonds, must be disbursed to pay principal and interest on the PRHTA Bonds.² Defendants, including the Commonwealth of Puerto Rico (the "Commonwealth") and the PRHTA, among others, urged the Court to dismiss plaintiffs' action, arguing that Section 305 of PROMESA (defined below) deprived the Court of jurisdiction to grant the relief sought.³ Contrary to market expectations, the Court sided with the Commonwealth, and dismissed the suit.

Background

Due to the serious and ongoing fiscal emergency in the Commonwealth, in 2016, Congress enacted, and the U.S. president signed into law, the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"). In addition to establishing the bankruptcy-like proceeding for the Commonwealth and its instrumentalities under which the present case arose, PROMESA also required that an oversight board (the "Oversight Board") be established to develop "a method [for the Commonwealth] to achieve fiscal responsibility and access the capital markets."⁴ Among other things, PROMESA requires the Oversight Board to certify a fiscal plan for the Commonwealth and its instrumentalities, including the PRHTA.

Relevant to the present case, the Oversight Board has approved two fiscal plans, including one plan for the Commonwealth, and one for the PRHTA (the "PRHTA Fiscal Plan"). Under the PRHTA Fiscal Plan, the Commonwealth was authorized to redirect those toll revenues and special excise taxes that had been pledged for payment on the PRHTA bonds from the PRHTA to the Commonwealth. The PRHTA was required under the PRHTA Bond documents to deposit the

pledge revenues on a monthly basis into certain accounts for ultimate payment of to the bondholders. The 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 Code (11 U.S.C. §§ 101, *et seq.*) (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

PROMESA incorporates many of the provisions of the Bankruptcy Code that would otherwise apply in a Chapter 9 case, including Sections 922 and 928 of the Bankruptcy Code. Of particular importance here, Section 305 of PROMESA⁵ substantially mirrors Section 904 of the Bankruptcy Code, which prohibits the Court from interfering with: (i) the governmental powers of the debtor; (ii) the property or

revenues of the debtor; or (iii) the use or enjoyment of income producing property.⁶

Under Chapter 9 of the Bankruptcy Code as well as under PROMESA, bonds secured by a pledge of “special revenues,” as defined in the Bankruptcy Code, are afforded special protections.⁷ 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.⁸ Thus, according to Chapter 9, 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.

In addition to Section 928, Section 922(d) (with Section 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.”⁹ It was the interpretation of Section 922(d) that was integral to the Opinion. Prior to the Court’s Opinion, although no court had been asked to analyze the application of Section 922(d), participants in the municipal debt markets understood and expected that following bankruptcy filings, municipal debtors would be required continue to pay their special revenue obligations as such obligations become due. In fact, in other Chapter 9 cases, municipal debtors have continued to make payment on their obligations secured by a pledge of special revenues.

The Court’s Opinion

Contrary to market expectations, the Court found 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) *permits* a municipal debtor to pay its special revenue obligations despite the automatic stay of the Bankruptcy Code.

The Court began its analysis with Section 928 of the Bankruptcy Code. According to the Court, the Special Revenue Provisions, specifically Section 928(a), do not “implicate the payment of special revenues to the bondholders or the timing [thereof, rather, according to the Court, the] statute clearly and simply provides that certain pre-petition liens will remain in place after the filing of the petition”¹⁰ despite operation of Section 552(a) of the Bankruptcy Code, which would otherwise cut-off such a pre-petition consensual lien.¹¹ Although Section 928(a) requires that a pre-petition lien in special revenues will remain in place despite the filing of a bankruptcy petition, the Court found that Section 928(a) does not *compel* a debtor municipality to turn over special revenues to bondholders that are collected during the pendency of the municipal debtor’s case.

After finding that Section 928 does not compel a municipal debtor to turn over special revenues to bondholders to which the revenues had been pledged prepetition, the Court then found that Section 922(d) equally does not compel payment. Specifically, the Court found that Section 922(d) “does not address actions to enforce liens on special revenues, which are stayed [by operation of the Bankruptcy Code], and it does not sanction non-consensual interference with governmental properties or revenues. . . .”¹² Thus, according to the Court, Section 922(d) of the Bankruptcy Code does not *require* payment but, despite the application of the automatic stay, *permits* a municipality to pay obligations secured by a pledge of special revenues. Additionally, the Court found that holders have little recourse were a municipality to choose not to pay on its special revenue obligations due to the Bankruptcy Code’s automatic stay. The Court further stated that its “narrow, straightforward reading of Section 922(d)” was consistent with the restrictions on interfering with the debtor’s property contained in Section 904 of the Bankruptcy Code, which is mirrored by Section 305 of PROMESA.¹³

The Court therefore dismissed the plaintiffs’ complaint, finding that they had failed to state a claim on which relief could be granted because the Bankruptcy Code does not compel the continued payment of obligations secured by a pledge of special revenues.

Conclusion

Unless overturned on appeal, the municipal debt markets should be concerned about the wider application of the Court's decision. The Court's decision subverts the expectations of many participants in the municipal marketplace in holding that a municipal debtor may choose whether or not to pay its special revenue obligations. The plaintiffs may appeal the Court's decision to the U.S. Court of Appeals for the First Circuit.

For a more in-depth analysis of the Special Revenue Provisions of the Bankruptcy Code and the potential implications of the Court's decision, see "Puerto Rico's 'Assured' Decision Should be Reconsidered or Reversed" by Jim Spiotto, available [here](#).

For More Information

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- 1 *Assured Guaranty Corp. v. Commonwealth of Puerto Rico (In re The Financial Oversight and Management Board for Puerto Rico, as representative of Commonwealth of Puerto Rico)*, Adv. Proc. Nos. 17-155 and 17-156, Dkt. No. 125 (Jan. 30, 2018) (the "Opinion").
 - 2 *Op.* at 9.
 - 3 *Id.*
 - 4 *Op.* at 6.
 - 5 48 U.S.C.S. § 2165
 - 6 11 U.S.C. § 904.
 - 7 See 11 U.S.C. § 902 for a list of revenue pledges that qualify for special treatment under the Bankruptcy Code as "Special Revenues."
 - 8 11 U.S.C. § 928(b).
 - 9 *Id.* § 922(d).
 - 10 *Op.* at 18.
 - 11 The Court did not consider the concept of adequate protection in relation to the pre-petition lien that remained in place upon the filing of the Title III petition.
 - 12 *Op.* at 20.

- 13 *Op.* at 22. The Court found it unnecessary to address the impact of Section 928(b), which subordinates payment of special revenue obligations to the necessary operating expenses of the project under certain circumstances. However, if the obligation to pay special revenue obligations is essentially discretionary and a creditor cannot compel the application of pledged special revenues to pay debt service, it is unclear what purpose Section 928(b) would serve.

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