Court Rules PREPA Bondholders Do Not Have a Secured Claim on Current and Future Net Revenues

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The Puerto Rico Electric Power Authority ("PREPA") has been in debt adjustment proceedings since 2017 under the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), which was signed into law in 2016.

As a part of those proceedings, in response to cross-motions for summary judgment, on March 22, 2023, U.S. District Judge Laura Taylor Swain ruled that PREPA bondholders ("Bondholders") have a secured claim only in that portion of its revenues which have been deposited into certain accounts established under the trust agreement pursuant to which the outstanding PREPA revenue bonds (the "Bonds") were issued (the "Trust Agreement")[1]. While that decision is based largely on the Court's interpretation of certain Trust Agreement provisions which are specific to the case at hand, many revenue bond indentures or trust agreements contain provisions similar to the contested Trust Agreement provisions. Therefore, this decision, particularly if affirmed by the United States Court of Appeals for the First Circuit, should cause concern in the municipal debt market about the possible wider application of the Court's decision which undermines the broader market's understanding that a pledge of "special" revenues under a revenue bond structure should provide for a lien and charge on all current and future revenues of the particular system or project.

Background

The Commonwealth of Puerto Rico (the "Commonwealth") organized PREPA under the Puerto Rico Electric Power Authority Act, Act. No. 83 of May 2, 1941, P.R. Laws Ann. Tit. 22 §§ 191, et seq. (as amended, reenacted, and supplemented, the "Authority Act"). PREPA supplies virtually all of the electricity consumed in the Commonwealth. Between 1974 and 2016, PREPA issued approximately $8.3 billion of Bonds under the Trust Agreement.

Due to the serious and ongoing fiscal emergency in the Commonwealth, in 2016, Congress enacted, and the U.S. president signed into law, 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."

On July 2, 2017, the Oversight Board filed a petition commencing a debt adjustment proceeding for PREPA under PROMESA (the "Title III Case"). Between the date the petition was filed and the March 22, 2023, ruling there were failed negotiations to resolve claims related to the Bonds and delays and extensions of deadlines due to earthquakes and COVID-19 among other issues. In addition, during this time U.S. Bank National Association, as trustee for the Bonds ("Bond Trustee"), filed a secured claim of approximately $8.5 billion ("Secured Claim"). The Oversight Board thereafter sued the Bond Trustee to the extent that the Bond Trustee's Secured Claim extended beyond amounts actually deposited into the "Sinking Fund" created under the Trust Agreement for payment of principal of and interest on the Bonds and certain other funds explicitly subject to liens in favor of the Bondholders under the terms of the Trust Agreement.

The Bond Trustee and the Bondholders contended that the Trust Agreement provides the Bondholders with enforceable liens on all present and future revenues of PREPA, including revenues not yet collected, and therefore the Bondholders claim to be fully secured by all of PREPA's current and future revenues in perpetuity in an amount necessary to pay the outstanding principal of and accrued but unpaid interest on the Bonds.

The Bondholders' Claims

The Bondholders argued that the Trust Agreement and the Authority Act require PREPA to raise rates and collect revenues sufficient to deposit $8.4 billion (plus interest) to the credit of the Sinking Fund, and the Bondholders agreed to be paid out of the Sinking Fund. The Trust Agreement obligates PREPA to set and collect reasonable rates to generate electric system revenues ("Revenues") sufficient to pay the principal of and interest on its bonds.

The Bondholders indicate that before filing its Title III Case, PREPA induced the Bondholders to refrain from exercising their rights under the Trust Agreement by agreeing to address its chronic mismanagement. During the summer of 2014, as PREPA faced a liquidity crisis, PREPA and its creditors engaged in negotiations resulting in a series of forbearance agreements among PREPA, the Government Development Bank, and major financial creditors, including the Bondholders. The Bondholders agreed to refrain from exercising remedies against PREPA and to amend the Trust Agreement to temporarily suspend PREPA's obligation to make transfers to the Revenue Fund or the Sinking Fund pursuant to the Trust Agreement. In so doing, the Bondholders agreed to forego their rights under Section 922(d) of the Bankruptcy Code to seek the Court to lift any stay of application of pledged special revenues.

The Bondholders contend that PREPA induced the Bondholders to enter into these forbearance agreements by signaling its intent to restore its fiscal health and improve its mismanaged operations, including by agreeing to appoint a professional chief restructuring officer, and to respect the Bondholders' liens and satisfy its repayment obligations with regard to the Bonds in all material respects. PREPA retained an outside consultant and achieved one-time savings of $267 million and annual recurring operating expense savings of $212 million. In 2015, PREPA entered into a restructuring support agreement ("RSA") with its creditors under which PREPA agreed to rectify its chronic mismanagement by appointing a board of directors composed of a majority of professional, independent members and consumer representatives.

Yet, in February 2017, PREPA terminated its engagement with its outside consultant and its chief restructuring officer. According to the Bondholders, in June 2017, although PREPA's creditors offered to extend deadlines under the RSA to accommodate continued negotiations toward a consensual restructuring, PREPA refused to consent to such an extension, resulting in the termination of the RSA. PREPA then filed its Title III Case. According to the Bondholders, PREPA thereafter once again reaffirmed its prior representations and promised to repay the Bondholders in all material respects under yet another RSA, which it continued to support publicly while Bondholders refrained from exercising their rights for several more years. The Bondholders contend that during this time and continuing to this day, PREPA has failed to set, bill, and collect reasonable rates, and through the filing of its Title III proceeding has continued to prevent the Bondholders from exercising their rights under the Trust Agreement and Puerto Rico law.

Critically, despite having induced the Bondholders and the Bond Trustee to refrain for several years from pressing litigation for relief from the stay to seek appointment of a receiver that would have sought to increase Revenues and to compel the deposit of Revenues to the credit of the Sinking Fund as required by the Trust Agreement, PREPA sought through its Title III Case to bar the Bondholders' recourse to those very Revenues. The Bondholders' argued that PREPA's breach of representations, covenants and obligations in the Trust Agreement, which PREPA specifically ratified to induce the Bondholders to forbear from exercising rights and remedies should, among other things, bar PREPA from requesting judicial relief contrary to such representations, covenants and obligations under the equitable estoppel doctrine of *actos propios.*

However, this decision of the Court largely overlooks PREPA's breach of its obligation to set reasonable rates, bill and collect from customers and its failure to deposit Revenues to the credit of the Sinking Fund as required by the terms of the Trust Agreement. The Court observes that the Bond Trustee's authority "to compel PREPA to increase rates to a level to pay the Bondholders in full, is not clear"[2] and in the event that the Bondholders obtained specific performance and a receiver raised rates to satisfy payment of the Bonds, "the receiver would not have the freedom to charge rates that are not "reasonable" or be completely untethered from the Trust Agreement—any such remedies and Revenues would still be subject to the payment restrictions and priorities of the Trust Agreement."[3] Beyond those observations, the Court does not meaningfully contend with PREPA's obligation under the Trust Agreement to set and collect reasonable rates to generate Revenues sufficient to pay principal and interest on its bonds. Nor does the Court meaningfully examine the provisions of the Trust Agreement that require PREPA's Treasurer to transfer from the

General Fund to the Revenue Fund moneys in the General Fund less Current Expenses (i.e. Net Revenues), for further deposit into the Sinking Fund for payment of debt service on the Bonds.

The Court's Analysis of PREPA's Pledge of Revenues

The reasoning of the Court relied primarily on an analysis of the provisions of the Trust Agreement. The Court's review included what Judge Swain's opinion describes as the "Preamble" to the Trust Agreement (which was understood by the Bondholders to be the "Granting Clauses"), as well as specific sections of the Trust Agreement pursuant to which certain liens were granted to the Bondholders.

The Bondholders argued that the language in the Preamble stating that ***"the Authority has executed and delivered this Agreement and has pledged and does hereby pledge to the Bond Trustee the revenues of the System"*** and similar language in other sections of the Trust Agreement provides a security interest in all present and future revenues of PREPA, including revenues not yet collected for electricity not yet generated.[4]

The Oversight Board contended that the Secured Claim should be disallowed to the extent it extends beyond the "Sinking Fund" and certain other funds explicitly made subject to liens for payment on the Bonds.

The Court examines the security provided to the Bondholders by the pledge language in the granting clauses and holds that:

> While the term "pledge" is used in the Preamble of the Trust Agreement with respect to "revenues" and "other moneys[,]" the Preamble contains no reference to any grant of a lien or charge, but instead states that the pledge is "mutually agreed and covenanted by and between the parties hereto[.]" (TA at 13 (emphasis added).) As the Court held when interpreting very similar agreements regarding the Puerto Rico Highways and Transportation Authority, a pledge that lacks "references to a lien or charge or other language indicating" that it is meant to expand the scope of specific lien grants results in a mere "unsecured promise[ ] to deposit Revenues in the manner required by the" agreement. In re Fin. Oversight & Mgmt. Bd. of P.R., 618 B.R. 619, 639 n.19 (D.P.R. 2020) ("HTA"). The Preamble does not grant the Bondholders any security interests.[5]

The Court notes that the Commonwealth has adopted revised Article 9 of the Uniform Commercial Code which governs the creation, perfection and priority of security interests. The Court therefore finds that Article 9 thus governs the existence, validity and perfection of security interests in PREPA's property.[6] The Court may have taken this into consideration in focusing on the lack of specific lien or charge language in the pledge of revenues and determining the lack of a grant of a lien on special revenues for purposes of Section 928 of the U.S. Bankruptcy Code, although there is nothing expressly stated on this in the Court's ruling. Section 928 of the U.S. Bankruptcy Code contemplates "any lien resulting from any security agreement entered into by the debtor before the commencement of the case" in the context of "special revenues".[7] To the extent this case is viewed as precedent, query whether a different outcome would arise in jurisdictions where Article 9 does not apply to the pledge of revenues. In any event, whether or not the validity and perfection of a pledge of revenues by a municipal entity is subject to Article 9 is a threshold issue relevant to such pledges regardless of the Court's decision.

The Court later observes that:

> Under the terms of the Trust Agreement…PREPA did not pledge payment out of gross revenues or an unlimited "all revenues," but instead covenanted to pay the Bonds out of the "Net Revenues" of PREPA "in the manner and to the extent hereinabove particularly specified"—in other words, subject to all of the payment provisions and limitations of liability contained within the previous sections of the Trust Agreement. (TA §§ 101, 701.) As discussed above, in HTA this Court held that precisely the same phrase "logically imports the scope of the pledge, mechanics, and detailed limitations contained elsewhere in the" agreement.

It is noteworthy that the Court focuses on the phrase "in the manner and to the extent hereinabove particularly specified" as signaling an express limitation of the pledge of Net Revenues. While it is not unusual for revenue bond pledges to include a variation of such generic language along the lines of "in the manner and to the extent provided herein" as a shorthand means of accounting for the revenue waterfall priorities typically incorporated into a revenue structure, the Court's interpretation of the revenue pledge goes beyond any assessment of waterfall priorities and substantively limits the scope of the pledge to amounts actually deposited into various funds, even though the Trust Agreement does not expressly provide for such a limitation. That such a generic phrase leads the Court to determine that the Bondholders' lien on Net Revenues is limited solely to funds deposited into the Sinking Fund and certain other explicit liens should give the municipal market at large great pause regarding the inclusion of any such generic and customary phrases in a revenue pledge.

The Court decided that only a few sections of the Trust Agreement confer specific grants of liens, and only do so with respect to "moneys" deposited into the Sinking Fund and the Specified Funds. The Court notes:

> Sections 401, 507, and 513 of the Trust Agreement are the only provisions that confer specific grants of liens, and only do so with respect to "moneys" deposited into the Sinking Fund and the Specified Funds…If a security interest had been granted in all current and future income of [PREPA] by the language in the Preamble, the Preamble would render the later specific limited lien grants in sections 401, 507, and 513 superfluous. Such a reading would not only be illogical, it would contravene the basic principle that contracts are to be read in a manner that gives each provision meaning and renders none superfluous.[8]

Therefore, the Court states that the Bondholders have no currently enforceable security interest (indeed no interest at all) in future revenues PREPA has not yet received or deposited into the Sinking Fund.[9] The Court focuses on the particular words (or lack thereof) used in the "pledge" of revenues and finds that pledge language lacking any reference to a grant of a lien or charge does not actually grant a lien on revenues.

The Court's lack of familiarity with revenue pledges and how to interpret them is made further apparent through its misreading of the definition of the bond counsel opinion (i.e., the "Opinion of Counsel") which it views as "corroboration" of its (mistaken) interpretation:

> The scope of the general pledge of the Trust Agreement is best summarized in the section 101 definition of "Opinion of Counsel," which prescribes the following description to be provided to prospective bondholders: *"[the Trust] Agreement creates a legally valid and effective pledge* of the Net Revenues, subject only to the lien of the 1947 Indenture, and of the moneys, securities and funds held or set aside under [the Trust] Agreement as security for the bonds, subject to the application thereof to the purposes and on the conditions permitted by [the Trust] Agreement[.]"[10] (emphasis and underlining added)

The Court views the definition of "Opinion of Counsel" above as corroboration that the Bondholders have been pledged payment on the Bonds from the Net Revenues of the System, but only to the extent their claim is secured by a lien and charge on moneys actually received and deposited into the Sinking Fund and other Specified Funds. This interpretation reflects an incorrect understanding of the syntax of the provision. The definition of "Opinion of Counsel" describes a pledge that is grammatically modified by two prepositional phrases (each introduced by the preposition "of"). These are adjectival prepositional phrases that tell what the pledge pledges, and the "and" between the two prepositional phrases is crucial. It makes clear that two separate things are pledged, and each pledge has its own modifiers. In other words, the pledge has two objects: (1) Net Revenues and (2) moneys, securities and funds held or set aside under the Trust Agreement as security for the bonds. These two prepositional phrases are in turn modified by more prepositional phrases that apply separately and only to the phrase they modify: (x) the pledge of Net Revenues is subject only to the lien of the 1947 Indenture and (y) moneys, securities and funds held or set aside under the Trust Agreement as security for the bonds are subject to the application thereof to the purposes and on the conditions permitted by the Trust Agreement. Therefore a correct reading of the "Opinion of Counsel" definition does not corroborate the Court's holding, as the "Opinion of Counsel" definition makes clear that the pledge of Net Revenues in favor of the Bonds is not limited

by anything other than the lien of the 1947 Indenture and is therefore not limited by the other terms in the Trust Agreement.

The Court's Analysis of Bankruptcy Code Section 928

In addition to the Court's review of the provisions of the Trust Agreement, the Court considered the Bondholders' argument that U.S. Bankruptcy Code Section 928 requires that the Oversight Board's motion should be denied even if the perfected lien is only on moneys that have been credited to the Sinking Fund. Unfortunately, if the Court refuses to recognize that the pledge provided for in the Trust Agreement creates a lien on revenues of PREPA, it is challenging to make this argument.

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. 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. Thus, according to Chapter 9, subject to the payment of necessary operating expenses, holders of special revenue bonds are intended to be unimpaired in a Chapter 9 proceeding.[11]

The Court reiterated once again that under the Trust Agreement the only moneys that become subject to a lien and charge are moneys that have already been deposited in the Sinking Fund and the other Specified Funds. The Court states that Section 928 of the Bankruptcy Code refers only to "revenues acquired by the debtor after the commencement of the [Chapter 9] case" and the Court takes the position that:

> The language of section 928 of the Bankruptcy Code similarly refers only to "revenues acquired"— in the past-tense—and does not support the Bondholders' interpretation of that statute to the extent the Bondholders claim that it currently captures revenues not yet received by PREPA and deposited into the Funds.[12]

The Court fails to appreciate that Section 928 was in fact enacted to address marketplace concerns that revenues dedicated to the repayment of municipal revenue obligations would be diverted to other purposes once a municipality entered bankruptcy.[13] The Court's ruling, unfortunately, serves only to increase those concerns.[14] The Court did find, however, that the Bondholders' lien on special revenues will persist on any moneys deposited in the Sinking Fund after the commencement of PREPA's Title III Case.[15]

Conclusion

Whether the First Circuit will uphold the Court's decision if appealed, and the effect of this case on PREPA's final agreed or ordered plan of adjustment and future access to the capital markets, remains to be seen.[16] However, the municipal bond marketplace should take note of this decision and the Court's specific albeit problematic examination of particular words and phrases that are included in or excluded from the pledge of revenues under the Trust Agreement.

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1 In re Fin. Oversight, No. 17 BK 3283-LTS , 2023 WL 2589708, 2023 U.S. Dist. LEXIS 56647 (D.P.R. Mar. 22, 2023).

2 Op. at 8.

3 Op. at 26.

4 Op. at 10.

5 Op. at 15.

6 Op. at 20.

7 11 U.S.C.A. § 928.

8 Op. at 15.

9 Op. at 18.

10 Op. at 17.

11 But see Chapman Client Alert, First Circuit Panel Upends Protections Available to Special Revenue Bondholders, dated April 8, 2019.

12 Op. at 18.

13 Senate Report 100-506, at 5 (1988). See also id., at 13 ("[t]he amendment [creating Section 928 of the Bankruptcy Code] amounts to a recognition of a hypothetical mortgage from which revenues are derived where a real mortgage cannot be created either for legal reasons or because of considerations of public policy.")

14 Section 928 was incorporated into the Bankruptcy Code by the Municipal Bankruptcy Amendments, which were adopted in 1988, as part of an Act to Amend the Bankruptcy Laws to Provide for Special Revenue Bonds, and for Other Purposes, Pub. L. No. 100-597 (1988).

15 Op. at 18-19.

16 As of the date of this client alert, the Court's decision has not been appealed.

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