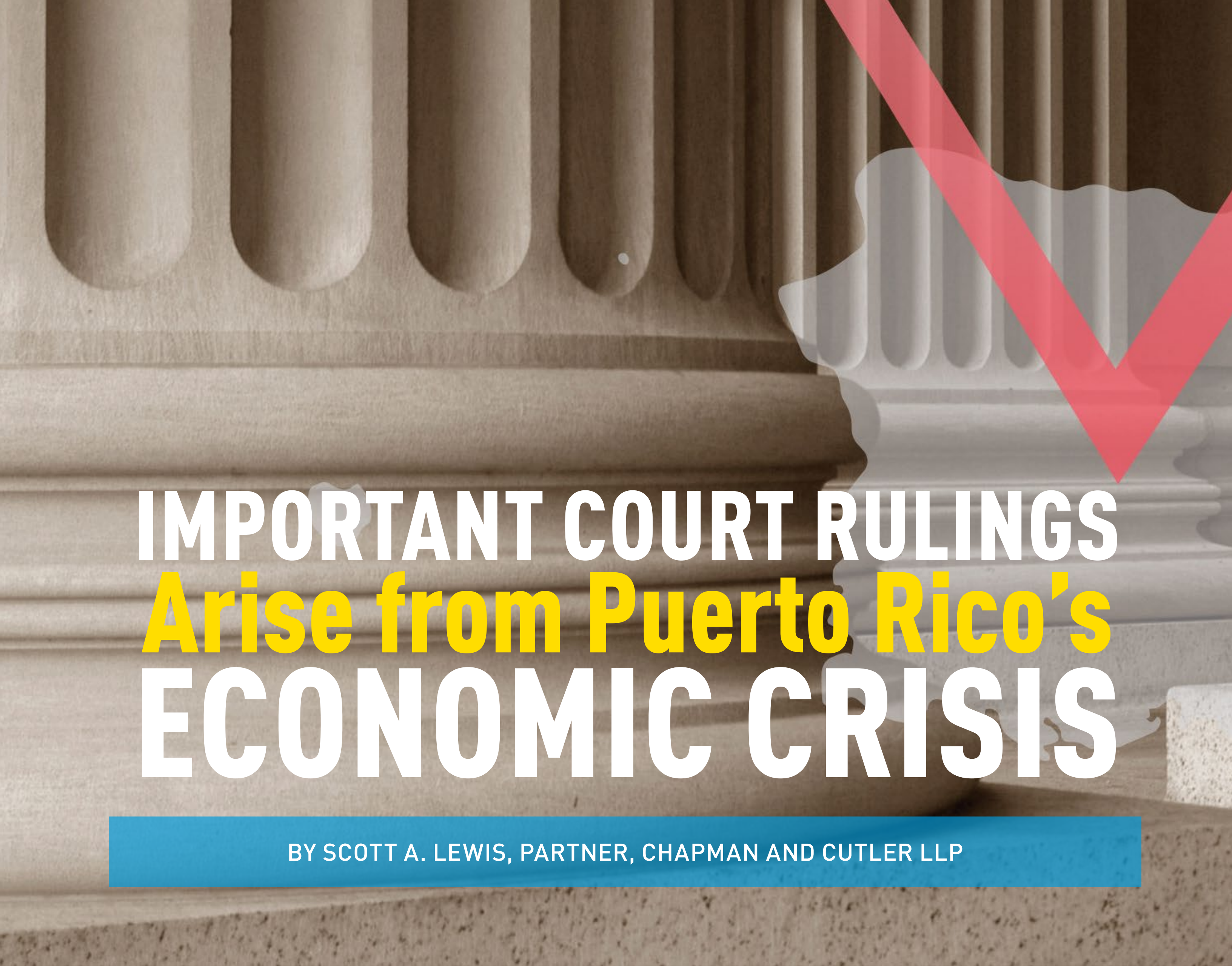

IMPORTANT COURT RULINGS Arise from Puerto Rico's ECONOMIC CRISIS

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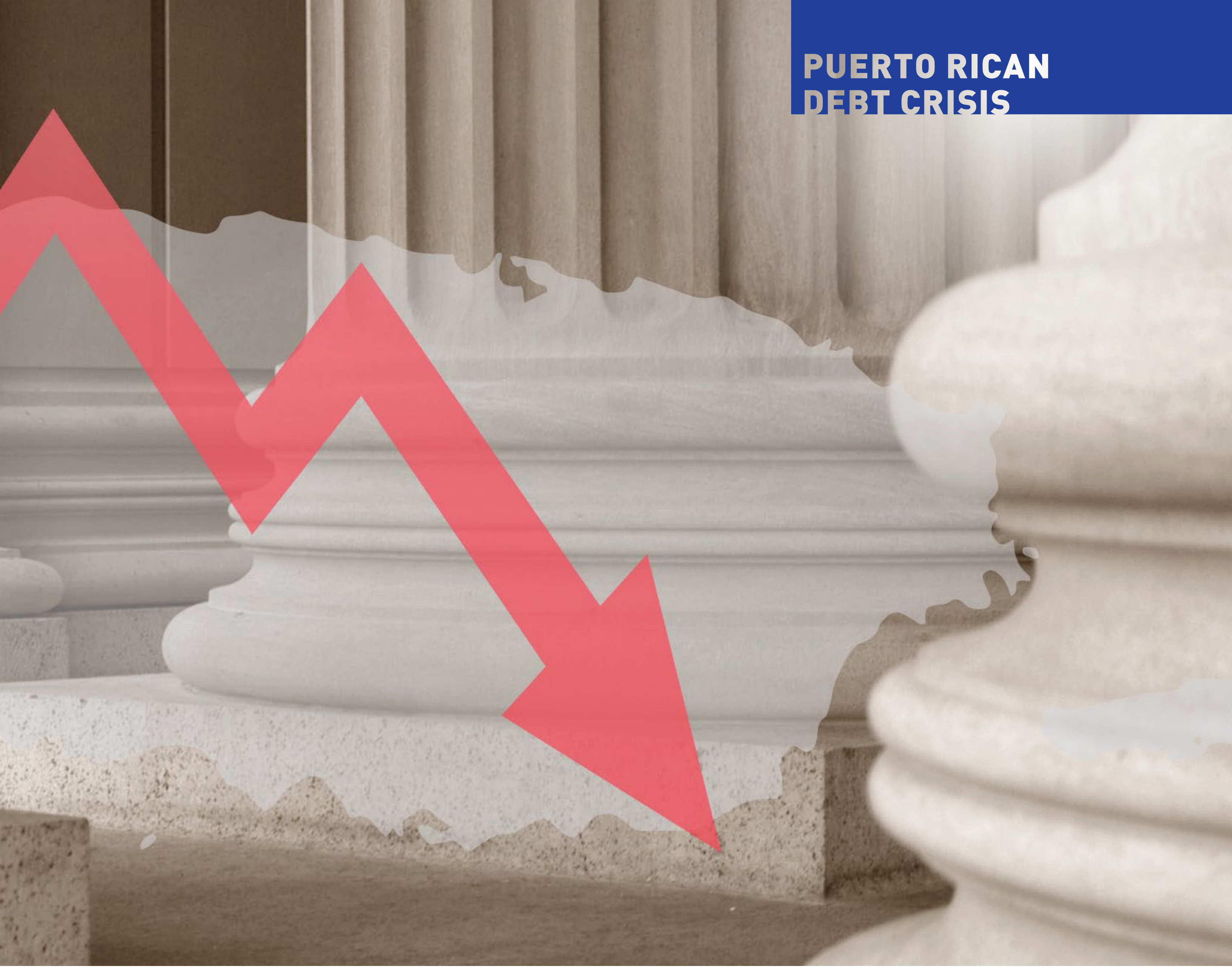
On January 18, 2022, the U.S. District Court for the District of Puerto Rico entered an order under the Puerto Rico Oversight, Management, and Economic Stability Act, 48 U.S.C. §2101 et seq. (PROMESA), confirming a plan of adjustment for the Commonwealth of Puerto Rico and certain of its instrumentalities. The plan's confirmation is a major milestone for the commonwealth and its creditors and is the largest municipal restructuring in U.S. history. Puerto Rico's financial distress and its effects upon municipal finance will be long-lasting. Some of the most important cases to arise from the proceedings are discussed in this article.

Puerto Rico's economic disaster had many origins but, prior to the enactment of PROMESA, few solutions. Like individual states, Puerto Rico is ineligible for relief under the U.S. Bankruptcy Code. However, unlike states' qualifying political subdivisions, public agencies, and instrumentalities (collectively referred to under the Bankruptcy Code as "municipalities"), Puerto Rico's municipalities also are ineligible for relief. As a result, Puerto Rico initially had to address its financial crisis without the benefit of the Bankruptcy Code or any other federal insolvency scheme.

In response, the commonwealth in 2014 enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act, which contained many provisions similar to those of the Bankruptcy Code. The Recovery Act, however, was struck down by the U.S. Supreme Court in 2016. Later that year, Congress enacted PROMESA to help the commonwealth and its instrumentalities combat the crisis. Title III of PROMESA created a bankruptcy scheme modeled on the reorganization process for municipalities that is codified under Chapter 9 of the Bankruptcy Code.

Non-Consenting Creditors

In *Puerto Rico v. Franklin California Tax-Free Trust*, 136 S.Ct. 1938 (U.S. 2016), the Supreme Court struck down the Recovery Act and clarified that the Bankruptcy Code pre-empts state bankruptcy laws that enable insolvent municipalities to restructure their debts over creditors'



objections. The case was decided prior to PROMESA's enactment. The Supreme Court held that municipalities must restructure such debts under Chapter 9. Its ruling relied upon Section 903(1) of the Bankruptcy Code, which provides as follows:

> a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition.

The phrase "composition of indebtedness," however, is not defined in the Bankruptcy Code. The Supreme Court's ruling also did not expressly define the phrase, but the court implicitly adopted a creditor-friendly interpretation.

Prior to the Supreme Court's holding, the few courts that had addressed the phrase "composition of indebtedness" generally had taken a narrow view. For example, in *Ropico, Inc. v. City of New York*, 425 F.Supp. 970, 978-82 (S.D.N.Y. 1976), the court noted, in referencing the predecessor statute to Section 903(1), that "a composition is a present settlement and an extension is a moratorium, and that the two are entirely distinct and separate. If the proposal is to reduce debts, it is a composition; if the proposal is merely to postpone payment, it is an extension...."

In striking down the law, however, the Supreme Court remarked that Chapter 2 of the Recovery Act created a consensual debt modification procedure that permitted Puerto Rico's instrumentalities to "propose changes to the terms of the outstanding debt instruments, for example, changing the interest rate or the maturity date of the debt" under a process that would be binding on all creditors if a supermajority of creditors so approved.

The District Court for Puerto Rico, whose ruling was affirmed by both the 1st U.S. Circuit Court of Appeals and the Supreme Court, also described interest rate adjustments and maturity extensions as examples of impermissible compositions. The lower court, among other statements, had asserted:

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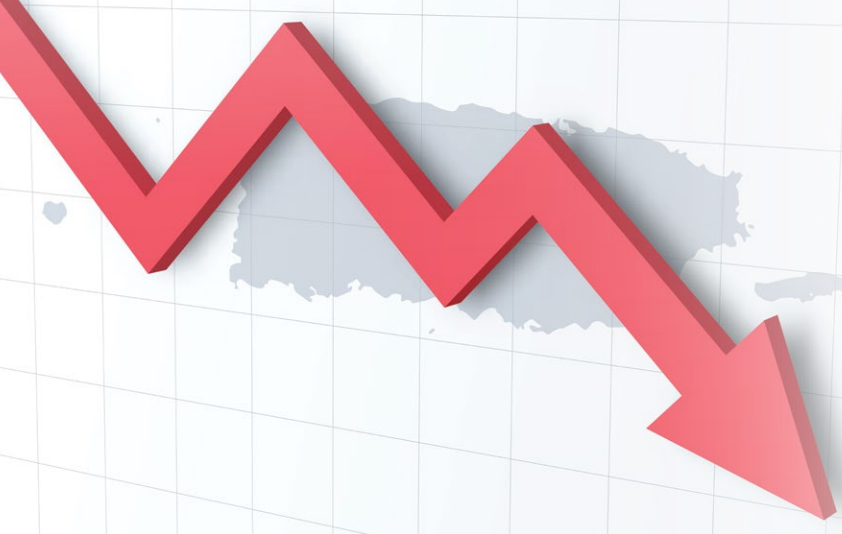

The 1st Circuit's opinion shocked the municipal debt market. To date, no other circuit court has adopted its holding.

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> Chapter 2 of the Recovery Act permits an eligible public corporation to 'seek debt relief from its creditors,' Recovery Act §201(b), through 'any combination of amendments, modifications, waivers, or exchanges,' which may include 'interest rate adjustments, maturity extensions, debt relief, or other revisions to affected debt instruments,' [citations omitted]. Chapter 3 of the Recovery Act permits an eligible public corporation 'to defer debt repayment and to decrease interest and principal' owed to creditors [citations omitted].
>
> Thus, *both* Chapters 2 and 3 of the Recovery Act create procedures for indebted public corporations to adjust or discharge their obligations to creditors. Therefore, the Recovery Act prescribes a method of composition of indebtedness, which is exactly what section 903(1) prohibits. [Emphasis added.]

The rulings by the Supreme Court and the lower courts suggest that a state law adjusting a municipality's outstanding debt's interest rate or maturity date, without creditors' consent, is prohibited outside of a Chapter 9 proceeding. Such rulings signal that the scope of the Bankruptcy Code's pre-exemption of state-law municipal insolvency schemes may be much broader and more creditor-friendly than held in *Ropico*, which indicated that a state law is a composition only if it reduces debts.

The scope of Section 903(1) and the impact of the Supreme Court's ruling are subject to further case law development. However, states and creditors should be on notice that municipal debts may not be restructured without creditors' consent, either directly through paying less than the amount due or perhaps even indirectly by adjusting interest rates or extending maturities, except through Chapter 9 of the Bankruptcy Code.

Special Revenue Bondholders

In *In re Financial Oversight and Management Board for Puerto Rico*, 919 F.3d 121 (1st Cir. 2019), the 1st Circuit ruled under PROMESA that the "special revenues" provisions of the Bankruptcy Code did not compel the payment of debt service on certain municipal bonds issued by the Puerto Rico Highways and Transportation Authority (PRHTA) during the pendency of a PROMESA proceeding.

The plaintiffs, bond guarantee insurers, had sought an order to compel payment of certain of PRHTA's toll and excise taxes that secured the bonds. The defendants, which included PRHTA and Puerto Rico, argued that Section 305 of PROMESA, which is similar to Section 904 of the Bankruptcy Code in all material respects, deprived the court of jurisdiction to grant relief. The 1st Circuit ruled for PRHTA and the commonwealth, which overturned market expectations.

The plaintiffs had alleged, among other things, that the bonds were secured by a pledge of "special revenues" under the Bankruptcy Code, and thus, PRHTA's failure to make payments due on the bonds violated Sections 922(d) and 928(a) of the Bankruptcy Code, which PROMESA made applicable to the proceedings. In the corporate bankruptcy context, revenue pledges are generally cut off with respect to revenues generated after commencement of the case. In municipal bankruptcy, however, special revenue pledges are afforded preferred treatment.

Special revenues include receipts derived from the ownership or operation of projects and systems and certain excise taxes, among other revenues, as further described under the Bankruptcy Code. Section 928 provides that in the case of special revenues, bondholders' security interest therein remains valid and enforceable even with respect to revenues that are generated after a Chapter 9 bankruptcy filing. Section 922(d) of the Bankruptcy Code, which was at issue in the case, provides:

> Notwithstanding section 362 of this title and subsection (a) of this section, a petition filed under this chapter does not operate as a stay of application of pledged special revenues in a manner consistent with section 927 of this title to payment of indebtedness secured by such revenues.

Prior to the 1st Circuit's opinion, the municipal debt market understood that following bankruptcy filings, municipal debtors would be required to continue to pay special revenue obligations when due. The 1st Circuit, however, upheld the lower court's decision that Section 922(d) did not compel a municipality to continue to make special revenue debt service payments after bankruptcy but rather only permitted a municipal debtor to pay voluntarily. Section 922(d)'s language solely establishes that the application of pledged special revenues is not a violation of the automatic stay, the 1st Circuit noted.

The 1st Circuit's opinion shocked the municipal debt market. To date, no other circuit court has adopted its holding. However, market participants should consider that, whether rightly or wrongly decided, the 1st Circuit's opinion is a wake-up call that market expectations, even if long-held, are not necessarily controlling. Further, when market expectations are based, in whole or in part, upon legislative history, such expectations may be especially suspect.

The protections for special revenues were incorporated into Chapter 9 of the Bankruptcy Code by Congress in 1988.[1] Various sources make clear that Congress's intent in enacting those 1988 amendments was to "provide assurances to the capital markets that special revenues essential to municipal financing remain unimpaired in the event of a Chapter 9 filing."[2] Based on legislative history, the 1st Circuit wrongly decided the case. However, the 1st Circuit's *de novo* review of the lower court's ruling did not consider legislative history. Its analysis was based solely on the Bankruptcy Code's text.

For example, "[n]othing in [Section 922(d)'s] plain language ... addresses actions to enforce liens on special revenues[,]" the 1st Circuit noted. The ruling highlights that the manner in which the law is interpreted and applied likely has shifted over the past decades and that municipal bankruptcy statutes are not immune to this shift.[3] As Supreme Court Justice Elena Kagan recently declared, "We are all textualists now."[4]

While never a preferred method of statutory interpretation, federal courts searching outside a statute's text for its meaning and purpose may now be the rare exception. The 1st Circuit's opinion evidences that market participants whose expectations are grounded in other than the Bankruptcy Code's statutory text should reassess their views or risk continued disappointments from the courts.

Statutory Liens

In *Peaje Investments LLC v. Financial Oversight and Management Board for Puerto Rico,* 899 F.3d 1 (1st Cir. 2018), the 1st Circuit recently held that plaintiff Peaje Investments LLC's bonds were not secured by a statutory lien under PROMESA, which is an important reminder that statutory liens and the protection provided to municipal creditors thereby are narrowly construed under the Bankruptcy Code. A statutory lien is intended to remain unaltered in a Chapter 9 proceeding.[5] It also is intended to provide a continuing right to a lienholder to be timely paid after the case's commencement.[6]

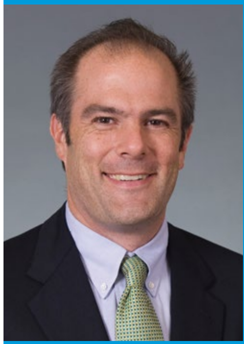
A statutory lien arises solely by force of a statute on specified circumstances or conditions (other than an agreement to grant the lien). Statutory lien examples cited in the 1st Circuit's opinion included mechanics' and tax liens. For both lien types, "the relevant statute specifies a circumstance or condition (the furnishing of labor or the refusal to pay taxes after demand) and provides (often through the use of mandatory 'shall' language) that when the specified circumstance or condition is satisfied, the lien attaches[,]" the 1st Circuit noted.

In the instant case, Peaje was the beneficial owner of $65 million in bonds issued by PRHTA. Peaje asserted that the bonds were secured by a lien on certain PRHTA toll revenues and that PRHTA and the commonwealth were diverting funds to which Peaje was entitled for purposes other than paying amounts due on the bonds. Its enabling act authorized PRHTA to borrow money, issue bonds, and secure those bonds with revenue pledges. The bonds were issued pursuant to a resolution, which established a sinking fund that was held in trust by a third party and contained revenues deposited therein until they were applied to pay bond debt.

The resolution indicated that pending application of those funds the money was "subject to a lien and charge in favor of the holders of the bonds ... and for the further security of such holders until paid out or transferred." Peaje argued that it had a statutory lien that extended not only to toll revenues held in trust but also to PRHTA's toll revenues before they were deposited in that fund.

The 1st Circuit, however, noted that the bond lien authorized under the enabling act differed from a mechanics' or tax lien in that the revenue pledge did not attach automatically when PRHTA passed the resolution. Because the lien did not attach automatically, a statutory lien was not created, the 1st Circuit held. Further, considering the enabling act together with the resolution was of no help to the plaintiff, as the resolution was not a statute.

The 1st Circuit did not address whether Peaje, in the alternative, had a non-statutory lien. Therefore, Peaje had no property interest in the diverted revenues, according to the 1st Circuit. While the 1st Circuit's opinion was not unexpected by the markets, it highlights that municipal bondholders who believe they are secured by a statutory lien should closely examine the source of that lien and the related language. J



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[1] Municipal Bankruptcy Amendments, Pub. L. No. 100-597, 102 Stat. 3028 (1988).

[2] See, *e.g.*, James E. Spiotto, *et al.*, Chapman and Cutler LLP, Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies, 139 (2d ed. 2016).

[3] See Judge Diarmuid F. O'Scannlain, "We Are All Textualists Now": The Legacy of Justice Antonin Scalia, 2 ST. JOHN'S L. REV. 303, 304 (No. 2, Vol. 91, Summer 2017, No. 2), available at https://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=6793&context=lawreview (last visited Feb. 25, 2022).

[4] See *id.*; *Markle Interests, L.L.C. v. U.S. Fish and Wildlife Serv.*, 848 F.3d 635, 649 (5th Cir. 2017) (Jones, J. dissenting from denial of rehearing en banc).

[5] *Supra*, James E. Spiotto, et al., 141.

[6] See *id.*