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## Ensuing Credit Impact From Puerto Rico Ruling

By Andy Shin, CFA and Sherri N. Tilley

The United States Court of Appeals for the First Circuit made headlines in March when they ruled against a group of bond insurers, affirming a Puerto Rico bankruptcy judge's decision that payment of special revenue bonds in municipal bankruptcies is voluntary—not mandatory. Special revenue debt, a portion of the overall municipal revenue market, is qualified by revenue derived from governmental projects or systems providing transportation, utilities or other public services. Essentially, upholding the ruling allows for the diversion of utility revenues in a municipal bankruptcy for unrelated purposes of the issuer, or the governmental entity that created the issuer, and does not require the timely payment of such revenues to revenue bondholders during the bankruptcy proceeding.

Contending the initial bankruptcy ruling, Insurers argued the Puerto Rico Highway and Transportation Authority (PRHTA) bonds were secured by special revenues and were therefore exempt from the PRHTA bankruptcy's automatic stay provision. The Insurers further claimed that failure to make payments violated Chapter 9 of the bankruptcy code. Nonetheless, the First Circuit upheld an earlier decision by a US District Court Judge Laura Taylor Swain. The Insurers have subsequently filed a rehearing motion where they will likely appeal the decision to the US Supreme Court. Still, the Supreme Court is unlikely to hear the case until there is a similar case with a contradicting decision from another circuit court.

The initial January 2018 decision by Puerto Rico Title III bankruptcy Judge Laura Taylor Swain ruled that Puerto Rico debtors were permitted, but not required, to use special revenues for the payment of municipal restructured debt. The original ruling somewhat surprised markets, as it opposed a precedent set by a prior Jefferson County, Alabama sewer bond bankruptcy proceeding that upheld creditor rights to receive debt service payments in the course of the case.

The recent reinforced ruling has left municipal investors with questions around the validity of a revenue obligation during a bankruptcy proceeding. Although the acknowledged decision only technically affects districts within the First Circuit (including Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island), we believe this decision will likely be influential in municipal bankruptcy cases for the rest of the country given a lack of municipal bankruptcy case law. Specific to the Puerto Rico decision, the ruling in and of itself does not change the secured nature of the special revenue debt in question. The ruling merely interrupts the debt service payment during the bankruptcy proceeding and makes the debt service payment subject to the automatic stay provision of the bankruptcy code. Theoretically, the ruling would not affect the ultimate debt recovery due to the secured

nature of the special revenue. Nonetheless, given creditors' strong incentives to settle out of court and an uncertain legal outcome resulting from the lack of legal precedents associated with municipal bankruptcies, the ultimate impairment of the special revenue bonds is likely.

We believe the decision will have implications on how investors view specific special revenue issues going forward. In our view, the impact of the defended ruling will mostly be limited to few credits with very weak underlying government credit profiles. Certain credit rating agencies have placed a select few utility and toll road ratings on negative watch as they shift their analytical approach and tie those ratings to the underlying government ratings.

The court ruling reinforces the importance of strong fundamental credit analysis in investment management, a central pillar to Mellon's active tax-sensitive fixed income investment approach. Consistent and solid performance relies on distinct credit selection. In this instance, that can only be accomplished with a deeper understanding of the legal decision's implication on the broader municipal market.



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