



Not Your Father's Revenue Bond

Federal court voids longstanding revenue bond legal protections in Puerto Rico bankruptcy case

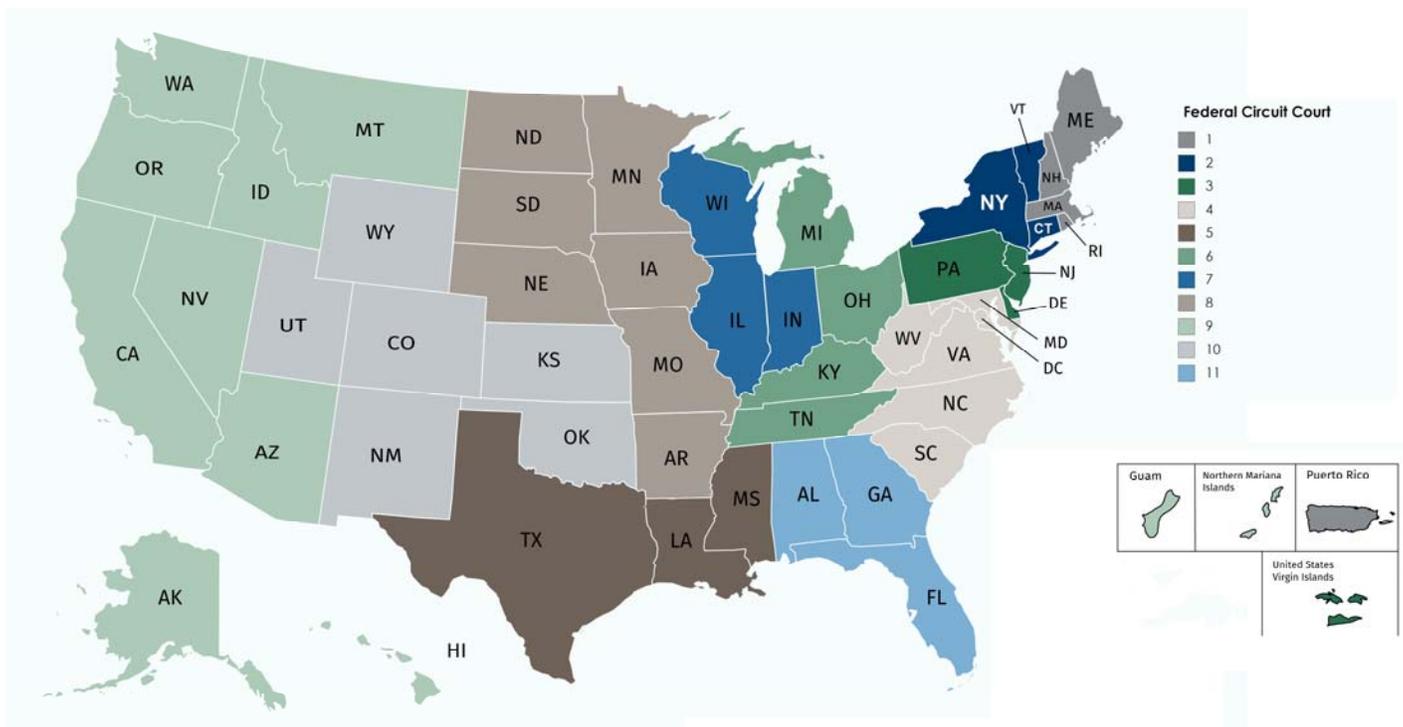
May 2019

5 Questions / Answers Municipal Bond Investors Should Know

A recent decision by one of the major US federal appeals courts broke past precedent in the municipal bond market. The court ruled that basic protections afforded to investors holding revenue bonds in previous municipal bankruptcy cases do not apply in the Puerto Rican bankruptcy. More specifically, the appeals court ruled that pledged revenue streams that secure revenue bonds, technically defined under municipal bankruptcy law as “special revenues,” can be interrupted in bankruptcy. The appeal, filed by Assured Guaranty Corp. (Assured) and three other bond insurers, is in regard to a defaulted bond of a toll road system in Puerto Rico. Despite the limited jurisdiction of the court, the ruling will likely have implications for the entire municipal bond market. Other types of “special revenue” bonds secured by taxes and/or various fees may also be affected by the decision. Nonetheless, municipal revenue bonds are the focus of this piece since the sector is by far the most impacted by this court ruling.

Measured by par value, revenue bonds make up over 50% of municipal bond issuance, prompting many pundits in the industry to predict that the decision will have broad implications for the municipal bond market, particularly on the viability and creditworthiness of revenue bond financings. While Wasmer Schroeder (WS) shares many of these concerns, we believe that this is another example of “playing the long game” in the municipal bond market. In the following discussion, WS examines the court decision and its potential short- and long-term impacts on the municipal bond market.

Geographical Jurisdictions of the US Federal Appellate Courts



1. What is the substance of the federal court ruling?

On March 26, 2019, the United States Court of Appeals for the First Circuit (the “First Circuit”) supported a prior ruling by bankruptcy Judge Laura Taylor Swain in 2018, representing the United States District Court for the Southern District of New York, the court supervising the Puerto Rico bankruptcy. The First Circuit’s ruling affirmed the lower court’s view that investors that hold Puerto Rico Highways and Transportation Authority special-revenue bonds are not entitled to critical and basic legal protections afforded to investors in previous municipal bankruptcy cases. More specifically, the appeals court ruled that pledged revenue streams that secure revenue bonds, technically defined under municipal bankruptcy law as “special revenues,” can be interrupted in bankruptcy, including the bankruptcy proceeding of a parent municipal government. Prior to this decision, most revenue bonds associated with bankrupt municipal governments were impervious to default, as pledged special revenues readily flowed to investors even when the parent municipal government was going through the bankruptcy process.

While the First Circuit’s decision is only binding in states within its jurisdiction (the map on the previous page shows the geographical jurisdictions of each circuit court), it may have broad implications for the entire municipal bond market—the First Circuit is one of 13 federal appellate courts that sit below the US Supreme Court, and to date, it is the highest profile court ruling ever on this issue. Prior to the ruling, these protections were viewed by the industry as fundamental with limited vulnerability to challenge, based on Chapter 9 law, Congressional intent, and past Chapter 9 bankruptcy rulings. Now, certain revenue bonds could be subject to significant collateral damage if a related parent municipal government files for bankruptcy relief.

2. Was the First Court’s ruling legally sound?

As courts often do, the First Circuit review failed to consider a bold and comprehensive view of the law. Instead, it took an exceptionally narrow reading of the municipal bankruptcy code after reviewing two provisions of the law in isolation, cited by the plaintiffs [Sections

928(a) and 922(d) of the US Bankruptcy Code]. The First Circuit concluded that based on the readings of these clauses, **municipal bankruptcy law allows but does not require continued payment of special revenues during municipal bankruptcy proceedings.** We agree with the court’s interpretation after reviewing these clauses. However, we also agree with many experts in the municipal bond industry that believe the court, by not taking a broader review of Chapter 9 bankruptcy law, including legislative intent and past precedent, impeded its ability to make an informed decision. For example, Congressional intent, which the court did not consider, appears to be unambiguous on this issue: the US Congress amended municipal bankruptcy law in 1988 to specifically enhance the rights of revenue bondholders during the bankruptcy of a parent municipal government, including granting revenue bondholders an *unimpaired* right to pledged project revenues. The amendments also prevented owners of revenue bonds from taking any recourse against a bankrupt municipality.

In WS’s view, one the primary intentions of the 1988 amendments was to enhance investor confidence in revenue bond structures by making it clear that revenue bond and general obligation (“GO”) financings were separately secured, free of cross defaults. Otherwise, what value can investors assign to revenue bonds as alternatives to GO bonds if they both get caught up in the same bankruptcy of a parent municipal government? The court’s decision also conflicts with the outcomes of other bankruptcy cases in Stockton, CA, Jefferson County, AL and Detroit, MI. The courts supervising these cases considered the broad context of municipal bankruptcy law and ultimately protected revenue bond structures. However, rulings by these lower bankruptcy courts carry less weight than a US court of appeals, which are known for setting legal precedents. Since revenue bonds are a primary source of financing for highly-essential infrastructure such as bridges, roads, mass transit systems, seaports, hospitals, utility systems and more, the recent decision leaves the viability of a critical funding source for US infrastructure in an uncertain place until the issue is permanently settled.

Since the court decision has virtually no direct effect on sector credit quality except for revenue bonds already in distress or in bankruptcy, bankruptcy frequencies should remain low at below .5% of the market.

3. What is the probably that the court decision is reversed?

Time will tell. For now, plaintiff remedies are limited, in our view. Since the ruling, Assured and the other insurers have filed a petition to the First Circuit Court to reconsider the case, but the historical success of such requests are limited. The plaintiffs' only remaining option is an appeal to the US Supreme Court (SCOTUS). SCOTUS, however, has a history of not accepting cases unless there is conflict between any of the 13 federal circuit courts, which is not the case here. Finally, the states could come together and enact laws expanding the rights of revenue bond investors, as the municipal bankruptcy code generally cannot limit or impair a state law. We have not observed an organized effort by state representatives since the decision was announced in March 2019, though. To the extent that these options are unsuccessful in overturning the case, it might take several years for another US court of appeals to rule on a future municipal bankruptcy case.

4. What are the potential short-term impacts of the First Court's ruling?

While the ruling technically only affects bonds issued in the First Circuit's jurisdiction in Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island, the weight and precedent set by the First Circuit is meaningful. Given that this is the highest-profile court to weigh in on municipal bankruptcy law, we predict that the ruling will have some near-term pricing and rating implications for some municipal revenue bonds. Of course, revenue bonds that are currently in financial distress will likely be impacted to the extent that special revenue is still being distributed to investors. Further, highly-rated revenue bond structures with strong credit profiles that are associated with weak parent governments (i.e. Chicago) may also be vulnerable to multiple notch downgrades, but in most cases will still likely remain investment grade. Importantly, the vast majority of municipal local governments are currently rated in the triple-A and double-A categories, multiple notches above the City of Chicago, which is rated in the double-B category by Moody's and the triple-B category by Standard & Poor's and Fitch.

Consequently, systemic downgrades of revenue bonds across the market will not occur in the short term, in our opinion. Other types of revenue bonds insulated from the ruling include revenue bond issuers not owned by municipal governments, and airports, which are prohibited by federal law from diverting airport revenue for non-airport purposes. **It is important to emphasize that the**

only situation where the enforceability of revenue bond legal provisions is in doubt is during bankruptcy. Since the court decision has virtually no direct effect on sector credit quality except for revenue bonds already in distress or in bankruptcy, bankruptcy frequencies should remain low at below .5% of the market. Consequently, the creditworthiness of the vast majority of revenue bonds should remain unaffected by the decision even over the long term.

5. What are the potential long-term impacts of the First Court's ruling—any silver linings?

While we believe the impact on credit quality will be limited even over the long term, the current ruling, if it were kept in place, could very possibly damage the market in other ways. Specifically, we believe the rating agencies would likely adjust affected revenue bond ratings downward; however, as a significant percentage of revenue bonds are highly rated, most would remain investment grade. Further, if the ruling becomes final, it could permanently crimp revenue bond financings in the future if investors can no longer rely on basic and longstanding legal protections, which are important for revenue bonds typically targeted for higher-yielding strategies. Curtailed revenue bond issuance caused by compromised security or meaningful issuer penalties would lead to less funding for critical infrastructure (a bad thing given the need) and a more homogenous municipal market that would likely be over-reliant on general obligation financing. Not only would this be more costly for municipal issuers, it would likely result in less diversification options for investors and lead to less market interest.

Conversely, if the ruling is overturned in favor of investors, we believe that confidence in revenue bond financings would be stronger than ever. Given the important role of revenue bonds in funding critical infrastructure, the 1988 amendments to Chapter 9 bankruptcy law were clearly designed to strengthen revenue bondholder rights during bankruptcy. A ruling in favor of investors that gives consideration to the 1988 amendments would reduce investor uncertainty that has existed for years due to limited Chapter 9 case law. Based on the legal merits cited in this paper, WS believes this case is an excellent candidate for further judicial review. Most participants in the market, including investors and municipal bond issuers, agree. For these reasons, we believe that the market will remain patient and orderly until a final ruling is in place.

What does the First Circuit's decision mean for WS's revenue bond holdings?

WS revenue bond holdings across all investment strategies should be minimally impacted from a credit perspective regardless of whether the First Circuit's decision ultimately stands or is reversed. Most of our revenue bond universe benefits from very high credit quality and is associated with municipal governments that are highly rated. Our credit research staff has determined that revenue bonds held in our higher-yielding strategies and their parent governments, if applicable, have a low probability of entering bankruptcy, which is the only scenario where the enforceability of key revenue bond investor protections is in doubt. It is important to note that none of WS's high-grade or lower-grade municipal holdings have ever been involved in bankruptcy filings. We believe that these results stem from the factors discussed above. WS is still in the process of reviewing its revenue bond book to identify names that may be vulnerable to rating downgrades below strategy mandates or subject to significant pricing volatility as a result of the recent court decision. To date, we have not discovered any significant concerns. However, WS will not hesitate to make portfolio adjustments to the extent necessary.



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