Nos. 18-1165, 1166 (Consolidated)

United States Court of Appeals for the First Circuit

IN RE: THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE COMMONWEALTH OF PUERTO RICO; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO HIGHWAYS & TRANSPORTATION AUTHORITY,

Debtors,

(For Continuation of Caption See Inside Cover)

On Appeal from the United States District Court for the District of Puerto Rico, San Juan in Nos. 3:17-AP-00155-LTS, -00156-LTS (Hon. Laura Taylor Swain, Judge)

BRIEF FOR THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS' BRIEF AND REVERSAL AND REMAND

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ASSURED GUARANTY CORPORATION; ASSURED GUARANTY MUNICIPAL CORPORATION; FINANCIAL GUARANTY INSURANCE COMPANY; NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION,

Plaintiffs – Appellants,

v.

THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE COMMONWEALTH OF PUERTO RICO; FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO; PUERTO RICO FISCAL AGENCY AND FINANCIAL ADVISORY AUTHORITY; THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO HIGHWAYS & TRANSPORTATION AUTHORITY; RICARDO ROSSELLO NEVARES; GERARDO JOSE PORTELA FRANCO; CARLOS CONTRERAS-APONTE; JOSE IVAN MARRERO-ROSADO; RAUL MALDONADO GAUTIER; NATALIE A. JARESKO,

Defendants – Appellees,

JOSE B. CARRION, III; ANDREW G. BRIGGS; CARLOS M. GARCIA; ARTHUR J. GONZALEZ; JOSE R. GONZALEZ; ANA J. MATASANTOS; DAVID A. SKEEL, JR.; CHRISTIAN SOBRINO,

Defendants.

CORPORATE DISCLOSURE STATEMENT

Pursuant to FED. R. APP. P. 26.1, the Securities Industry and Financial Markets Association has no parent corporation, nor does a publicly held corporation own more than 10% of its stock.

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STATEMENT OF THE IDENTITY AND INTEREST OF THE AMICUS CURIAE[1]

Amicus, the Securities Industry and Financial Markets Association (*"SIFMA"*), represents the shared interests of hundreds of securities firms, banks, and asset managers, including many that actively participate in the revenue bond market.[2] SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation, and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

SIFMA and its members are uniquely concerned with the continued viability of the municipal revenue bond market and the importance of financing municipal improvement projects, including those required to maintain and upgrade infrastructure across the United States and its territories.

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1 Pursuant to FED. R. APP. P. 29(a)(4)(E), no party's counsel in this case authored this brief in whole or in part, and no party, no party's counsel, nor any other person, other than SIFMA, its members, or its counsel, contributed money intended to fund the preparation or submission this brief.

By accompanying motion, SIFMA seeks leave of the Court to file this brief in accordance with FED. R. APP. P. 29(a)(3).

2 The SIFMA Asset Management Group (*"AMG"*) is the voice for the buy-side within the securities industry and broader financial markets. The AMG's members represent U.S. asset management firms whose combined assets under management exceed $34 trillion. The clients of AMG member firms include, among others, registered investment companies, separate accounts, ERISA plans, and state and local government pension funds.

Access to the revenue bond market to finance infrastructure projects and provide necessary services is critical to the financial stability of local governments, including U.S. territories like Puerto Rico. Their ability to access the revenue bond market depends in large part on investor confidence, which in turn depends on the financial viability of the projects to be financed and investors' ability to evaluate the risks associated with municipal defaults. For the sake of both investors and municipalities, it is imperative that federal law provide reliable and consistent rights and remedies in municipal bankruptcy proceedings. Reliability and consistency permit municipalities to borrow at lower rates and provide investors in the municipal market with a reliable, risk-adjusted investment rate of return.

The issue presented in this appeal is of core importance to SIFMA's membership: whether or not a municipal debtor must honor its agreement to apply pledged special revenues to pay debt service in the event of the municipality's bankruptcy. If, as the District Court has held, such special revenues may be so diverted, Congressional intent and investor expectation informed by compelling precedent and the plain meaning of the applicable statutes will be upended and the revenue bond market and the municipalities it supports will be irreparably harmed, to the detriment of municipalities and citizens alike.

Revenue bond investors have long relied upon special revenue pledges to provide assurance that, so long as an underlying project continues to produce

sufficient revenues, investors will continue to be paid regardless of the financial distress or a bankruptcy of the borrower municipality. Revenue bonds are unique in that investors in such bonds typically do not have recourse to the taxing power or assets of the issuing municipality. Instead, revenue bondholders typically look only to a dedicated revenue stream for payment. Because of the unique nature of revenue bonds, Congress has recognized the importance of these mechanisms and has legislated to ensure that special revenue pledges are protected. Courts that have addressed revenue protections in municipal insolvencies have similarly recognized the importance of such mechanisms and Congress's intent to protect them.

Because the ruling of the United States District Court for the District of Puerto Rico (the *"District Court"*) is inconsistent with the statutory framework, market expectations, and established case law, SIFMA respectfully urges this Court to reverse the District Court's Order and Judgment.[3]

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3 *Opinion and Order Granting Plaintiffs' Motion to Dismiss the Complaint Pursuant to Fed. R. Civ. P. 12 (b)(1) and (b)(6) of the United States District Court for the District of Puerto Rico*, dated and duly entered by the Clerk of the District Court on January 30, 2018 (ECF No. 125 in Adv. Proc. No. 17-155-LTS and ECF No. 121 in Adv. Proc. No. 17-156-LTS) (the *"Order"*); and Judgment dated and duly entered by the Clerk of the District Court in Adv. Proc. No. 17-155-LTS and Adv. Proc. No. 17-156-LTS on January 30, 2018 (ECF No. 126 in Adv. Proc. No. 17-155-LTS and ECF No. 122 in Adv. Proc. No. 17-156-LTS) (the *"Judgment"*).

SUMMARY OF THE ARGUMENT

SIFMA seeks to foster stability in, and the continued availability of, a robust municipal bond market to assist local governments to finance infrastructure, provide vital services, and invest in projects required to compete on a global scale. Stability requires a set of laws that are interpreted in a uniform manner and as intended by Congress. The District Court's decision injures not only SIFMA's membership, but also our nation's municipalities and their residents, by needlessly requiring them to spend more to finance vital projects.

Understanding the paramount importance of stability and uniformity in the municipal markets, Congress in 1988 amended the U.S. Bankruptcy Code (the *"1988 Amendments"*) to create important protections for investors, and for municipalities who wanted to participate in the municipal revenue bond market.[4] The District Court's decision weakens these important protections that have been applied and relied upon for 30 years without issue.

In 1987, municipalities issued approximately $60 billion in revenue bonds. In 2017, by contrast, U.S. municipal revenue bond issuances totaled $247 billion.[5] Taking inflation into account, the 2017 municipal revenue bond market was over

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

5 *See* SIFMA, *US Municipal Bond Issuance* (last updated Mar. 1, 2018), https://www.sifma.org/wp-content/uploads/2017/06/municipal-us-municipal-issuance-sifma.xls.

50% larger than its pre-1988 Amendments counterpart, and part of this enormous increase likely was due to the stability provided to the market by the 1988 Amendments.[6]

The 1988 Amendments were designed to ensure that important traditional municipal revenue bond financing principles, such as the use of a revenue pledge to secure bonds, would survive a municipal issuer's bankruptcy filing and insulate investors from resulting harms. In particular, the amendments (as defined below, the *"Special Revenue Provisions"*) provided that: (i) a municipal revenue bondholder's lien continues to apply to postpetition special revenues;[7] (ii) the automatic stay is inapplicable to the application of pledged special revenues;[8] (iii) the debtor may only use pledged revenues derived from a project or system to pay for the necessary operating expenses of such project or system[9]; and (iv) unless the

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6 Inflation calculated using U.S. Bureau of Labor Statistics CPI Inflation Calculator. U.S. BUREAU OF LABOR STATISTICS, *Calculation of Inflation*, https://www.bls.gov/data/inflation_calculator.htm (input dollars, set initial date as November 1988 and current date as March 2018, and click "Calculate").

7 11 U.S.C. § 928(a).

8 *Id.* § 922(d).

9 *Id.* § 928(b).

underlying bond documents permit otherwise, a creditor secured by a pledge of special revenues may not seek repayment from other payment sources[10].

In light of the unprecedented financial emergency in Puerto Rico, on June 30, 2016, Congress enacted the Puerto Rico Oversight, Management and Economic Stability Act (PROMESA).[11] Title III of PROMESA provides for a process by which Puerto Rico might restructure its debts similar to that established for municipal bankruptcy in Chapter 9 of the U.S. Bankruptcy Code.[12] Congress specifically incorporated the Special Revenue Provisions into PROMESA in order to extend to Puerto Rico the uniformity created by the 1988 Amendments.[13] Through section 301(a) of PROMESA, each of the Special Revenue Provisions has been made applicable to Title III cases like the one from which this appeal arises.

While the Special Revenue Provisions have not been extensively litigated, courts have relied on the legislative history of such provisions to recognize that

10 *Id*. § 927, and together with §§ 928 and 922(d), the "*Special Revenue Provisions*".

11 48 U.S.C. § 2121(b)(1).

12 11 U.S.C. §§ 901-946. Chapter 9 and Title III proceedings are referred to collectively herein as "Municipal Bankruptcy" cases.

13 *See* 48 U.S.C. § 2161; *see also* U.S. CONST., art. I, § 8, cl. 4 (Congress shall have the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States") (hereinafter the *"Bankruptcy Clause"*). Because the U.S. Constitution requires Congress to establish uniform bankruptcy laws, consistency among Bankruptcy Code provisions and/or similarly worded PROMESA provisions should be presumed.

during Municipal Bankruptcy cases, bonds secured by a pledge of special revenues should continue to be paid pursuant to the underlying contract, even if contested.[14] Municipal revenue bond investors have relied on Congressional pronouncements contemporaneous to the introduction of the Special Revenue Provisions, as well as existing case law, to continue to invest in the municipal revenue bond market.

The District Court's opinion undercuts Congress's express intent by jeopardizing bondholders' rights to special revenues in Municipal Bankruptcies. It will materially and detrimentally affect the revenue bond market and municipalities' access to revenue bond financing, which will affect financially troubled municipalities the hardest. If the District Court's decision is allowed to stand, two things are likely: (i) the risk premium imposed by the market on such bond issuances will increase, causing municipalities and their residents to pay more for critical infrastructure; or (ii) participant interest in the revenue bond market will cool and investors will leave the market on account of the new uncertainty the decision introduces, in either event depriving municipalities of the benefits of the revenue-backed bond market that Congress sought to protect.

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14 *See In re Jefferson Cty., Ala.,* 474 B.R. 228, 236 (Bankr. N.D. Ala. 2012) (hereinafter *"Jefferson County"*).

BACKGROUND

I. MUNICIPAL REVENUE BONDS

Municipal bonds provide essential financing to state and local governments, including U.S. territories. "Municipal bonds are debt securities issued by states, cities, counties and other governmental entities to finance capital projects . . . and to fund day-to-day obligations."[15] Although municipalities may issue "general obligation" bonds that are paid solely by unlimited property, or similar taxes, municipalities may also issue revenue bonds, like the bonds at issue in the Order and Judgment. Revenue bonds are secured solely by, and repaid solely from, the revenues generated from the projects or systems that they finance, or from a dedicated special tax stream. Additionally, revenue bonds allow municipalities to finance infrastructure and other improvement projects without saddling taxpayers with higher property taxes. Revenue bonds also provide financing for projects where debt limits or other restrictions imposed on general obligation financing make municipal general obligation debt unavailable.

Because state law ordinarily does not permit a municipality to mortgage a project or system, revenue bonds typically are not secured by the underlying assets of the improvement project or enterprise. Because of this, measures to preserve the

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15 U.S. SEC. & EXCH. COMM'N, *Municipal Bonds*, http://www.sec.gov/answers/bondmun.htm (last modified Jan. 28, 2011); *see also* U.S. SEC. & EXCH. COMM'N, *Report on the Municipal Securities Market* (2012), https://www.sec.gov/news/studies/2012/munireport073112.pdf.

value of the pledged revenues and to ensure their continued application to the revenue bond obligations provide the principal security for revenue bond investors. Typically, investors rely on a “flow of funds” structure in a trust indenture or bond resolution that is designed to earmark revenues. This structure requires all revenues, including future revenues, from the financed project to be transferred to and held in trust by the indenture trustee who services the debt obligations and approves their withdrawal for other authorized uses.[16] These revenues are pledged as security for the revenue bonds, allowing the indenture trustee to take possession of the revenues in the event of a default.[17] This ensures that revenues generated from the project are allocated solely according to the underlying agreements and used to meet debt payment obligations before they may be applied to other expenditures or returned to the municipality’s general fund.

The flow-of-funds structure provides important assurances to revenue bond investors that the underlying project revenues will be sufficient, remain intact and be applied properly to the payment obligations to which they are pledged. In turn,

16 *See, e.g.,* NAT’L ASS’N OF BOND LAWYERS, *Model Trust Indenture* §§ 4.01–4.09, 5.01 (2012) (hereinafter *“Model Indenture”*), https://www.nabl.org/portals/0/documents/nablformalreportsmodeldocs-nablformtrustindenture.pdf.

17 *See, e.g.,* Model Indenture § 2.02.

investor confidence in the revenue bond market provides municipalities, including those facing difficult financial conditions, access to project financing.

II. THE U.S. MUNICIPAL REVENUE BOND MARKET

In 1987, shortly before Congress considered the 1988 Amendments,[18] revenue bonds accounted for approximately $60 billion of the nearly $94 billion total municipal bonds issued that year.[19] The municipal bond market has grown substantially since then. In fact, 2017 saw more municipal bond issuances than any prior year on record, with municipalities issuing approximately $448 billion in municipal bond obligations; revenue bond issuances accounted for more than $247 billion of that amount.[20]

Revenue bonds are necessary to maintain our country's competitive advantage and standard of living. The United States contains the most extensive public works system in the world, comprised of 4,154,727 miles of roadways, 614,386 bridges, 1,471 local bus systems, 19,536 airports, more than 25,000 miles of inland and intercoastal waterways, at least 90,000 dams, more than 2 million miles of pipe in water supply systems and 14,748 wastewater treatment plants, all

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18 Pub. L. No. 100-597, 102 Stat. 3028 (1988).

19 S. REP. NO. 100-506, at 4 (1988) (hereinafter the *"1988 Senate Report"*).

20 *Supra* note 5.

provided mostly by municipal entities.[21] The American Society of Civil Engineers (*"ASCE"*), in its 2017 Report, estimates the cost to maintain infrastructure at a passable level will be $4.59 trillion by 2025, or more than three times the annual tax revenues for all state and local governments.[22] Inattention has caused this number to increase by $1 trillion in 5 years.[23] Any further deferral of needed infrastructure improvement could have devastating results.[24] With this as a backdrop, the District Court's decision creates significant uncertainty and may

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21 *See* BUREAU OF TRANSP. STATISTICS, https://www.bts.gov/sites/bts.dot.gov/files/docs/browse-statistical-products-and-data/national-transportation-statistics/217651/ntsentire2017q4.pdf (last visited Apr. 19, 2018); U.S. ARMY CORPS OF ENG'RS, *Nat'l Inventory of Dams* (2016), https://www.publications.usace.army.mil/Portals/76/Publications/Engineer Pamphlets/EP_360-1-23.pdf?ver=2016-12-21-154355-163; U.S. ENVTL. PROT. AGENCY, EPA 815-R-09-001, *Community Water System Survey* (2006), https://nepis.epa.gov/Exe/ZyPDF.cgi?Dockey=P1009JJI.txt; AM. SOC'Y OF CIVIL ENG'RS, *Infrastructure Report Card, Wastewater*, https://www.infrastructurereportcard.org/cat-item/wastewater/.

22 *See* AM. SOC'Y OF CIVIL ENG'RS, *Infrastructure Report Card* (2016) https://www.infrastructurereportcard.org/the-impact/economic-impact/.

23 In 2013, ASCE's number for the next 5 years was $3.6 trillion. AM. SOC'Y OF CIVIL ENG'RS, *Infrastructure Report Card* (2013), http://2013.infrastructurereportcard.org/.

24 *See* AM. SOC'Y OF CIVIL ENG'RS, *Failure to Act: Closing the Infrastructure Investment Gap for America's Economic Future* (2016), https://www.infrastructurereportcard.org/wp-content/uploads/2016/10/ASCE-Failure-to-Act-2016-FINAL.pdf/; U.S. CENSUS BUREAU, *2017 Quarterly Summary of State & Local Tax Revenue Tables (Table 1)*, https://www.census.gov/data/tables/2017/econ/qtax/ historical.html/.

result in further repair and modernization delays and an increase in infrastructure cost that our country's municipalities simply cannot afford.

Revenue bond financing is vital to state and local governments to provide the infrastructure improvement and capital expenditures that are required to provide municipal services and benefits. Without the assurance of timely payment, including in a municipal bankruptcy proceeding, municipalities' access to revenue bond financing could be drastically limited, or the price of financing could rise higher than desirable or practicable. The vital need for financing for required infrastructure improvements cannot be reasonably disputed.

Within the First Circuit, recent revenue bond-financed projects include student housing construction and capital improvements at Massachusetts schools, infrastructure improvements in Maine, and economic development projects in New Hampshire.[25] These and thousands of similar projects provide important services to the citizens of state and local governments across the country. By providing financing for these projects—often where no viable alternative exists—revenue bonds serve a critical role in the vitality of American municipalities.

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25 *See* Search of Revenue-Bond Financed Projects in the First Circuit, MUNICIPAL SECURITIES RULEMAKING BOARD'S ELECTRONIC MUNICIPAL MARKET ACCESS (*"EMMA"*), http://emma.msrb.org/Search/Search.aspx?hlt=search (follow "Security Information" hyperlink, select state and search, then follow "Disclosures" hyperlink, enter "Posting Date 01/01/2018 to 04/19/2018", click box for "Official Statements and Other Primary Market Documents" and search).

The 1988 Amendments have granted investors the comfort needed to provide borrowers with lower-cost methods of borrowing, while allowing municipalities to maintain their critical infrastructure without incurring additional general tax burdens. The District Court's decision risks destroying this delicate balance.

ARGUMENT

The District Court's decision upends the uniformity on which investors have relied when investing in the municipal bond market. Because the Special Revenue Provisions were specifically incorporated into PROMESA, and because the U.S. Constitution requires a uniform bankruptcy law, Congress's intent in approving the Special Revenue Provisions is important.[26] In 1988, Congress amended Chapter 9 of the Bankruptcy Code to expressly protect municipal revenue bond financing by clarifying that: (i) municipal revenue bondholders' liens continue to apply to postpetition special revenues; (ii) the automatic stay is inapplicable to the application of pledged special revenues; and (iii) debtors may only use pledged revenues derived from a project or system to pay for the necessary operating expenses of such project or system. Consistent with the purpose and requirements of the 1988 Amendments, this Court should interpret the federal statutes in this

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26 U.S. CONST., art. I, § 8, cl. 4.

case to protect Appellants' interests in the special revenues pledged to pay the bonds in question.

By their plain meaning and attendant legislative history, Sections 902, 922(d), and 928 of the Bankruptcy Code require the timely payment of postpetition special revenues in accordance with the underlying bond documents, subject only to necessary operating expenses of the relevant project or system. Any other result could be disastrous to the country's most financially distressed municipalities.

I. CONGRESS ENACTED THE 1988 AMENDMENTS TO PROTECT THE REVENUE BOND MARKET

The Bankruptcy Reform Act of 1978 (the *"1978 Act"*), for the first time, imported into Municipal Bankruptcy a business bankruptcy provision (11 U.S.C. § 552) that was designed to deal with commercial finance practices.[27] Section 552 cuts off at the bankruptcy petition date a consensual prepetition pledge of property the debtor acquires after the date of the grant of the security interest, except for a security interest in after-acquired "proceeds, products, offspring, or profits" of property to which the security interest had attached prepetition.[28] Section 552 is ill suited to municipal revenue financing because, except in rare circumstances, a

27 Pub. L. No. 95-598, 92 Stat. 2549, 2621 (1978), enacting 11 U.S.C. § 901(a) (1980) (1978 Act; *see* 1988 Senate Report, *supra* note 19, at 4.

28 11 U.S.C. § 552(b).

municipality cannot pledge to bondholders the underlying physical property of the financed project. Thus, postpetition, no after-acquired proceeds exist.

After the enactment of the 1978 Act, Congress quickly recognized the risk that Section 552 could be applied to defease, upon a bankruptcy filing, a lien on future revenues that were pledged to secure a municipal debtor's revenue bonds.[29] Congress observed that this interpretation of the Bankruptcy Code "would effectively destroy the distinction between general obligation debt and limited revenue obligation debt."[30] Moreover, revenue bond investors might demand a premium to provide municipal project financing to a local government because of the risk that their security interests in pledged revenues would terminate upon a Municipal Bankruptcy filing.[31] In short, "[b]ecause the worlds of commercial finance and municipal finance are so diverse, the simple incorporation by reference

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29 *See* 1988 Senate Report, *supra* note 19, at 5.

30 *Id.*; *see also id.* at 4 ("[T]he … application of commercial law concepts to municipal corporations runs afoul of the traditional structure of revenue bond finance."); H.R. REP. NO. 100-1011, at 2 (1988) (hereinafter, *"1988 House Report"*) ("[S]ome of these general business bankruptcy provisions … are inconsistent with principles of municipal finance, particularly with respect to public works projects financed by revenue bonds.").

31 *See* 1988 House Report, *supra* note 30, at 5.

of the 1978 commercial finance concepts into the municipal bankruptcy arena simply did not work."[32]

One year after the new Bankruptcy Code was enacted, Congress was particularly concerned about the situation pertaining to Cleveland, Ohio.[33] In 1979, Cleveland was facing a financial crisis. Cleveland needed additional financing, but lenders were unwilling to lend to the city, and they cited the incorporation of Section 552 into the Municipal Bankruptcy provisions as a reason.[34] That is not surprising, because it is unlikely that a lender would want to lend to a troubled entity if it knew the lien on its only sources of revenue would be cut off upon a bankruptcy filing. Through the 1988 Amendments, Congress sought to protect other potentially troubled municipalities from Cleveland's predicament.

Congress was also aware of other situations where municipal debtors ignored Section 552 and continued to pay on their debt, including in the bankruptcy proceeding of the San Jose Unified School District.[35] Congress saw that the "practical reality" was that a "municipality might well attempt to ignore" Section 552, thus violating the Bankruptcy Code in order to continue to pay its

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32 1988 Senate Report, *supra* note 19, at 3.

33 *Id.* at 4.

34 *Id.*

35 *Id.* at 6.

holders as promised pursuant to the underlying documents and state law.[36] Accordingly, a legislative solution was needed to codify what was already the norm in the municipal markets—that a revenue bond issuance need not be affected by the filing of a Municipal Bankruptcy petition, with exception for the application of necessary operating expenses.[37]

Congress therefore moved to fix the law. Congress ultimately enacted the 1988 Amendments to "insure that revenue bondholders receive the benefit of their bargain with the municipal issuer" and thus "protect the future effectiveness of revenue bond financing."[38] As the legislative history of the 1988 Amendments shows, Congress's main purpose in enacting the 1988 Amendments was to eliminate the possibility that a bankruptcy petition would cut off a revenue pledge as of the bankruptcy petition date, because "[t]he post-petition revenues generated by the asset financed would then not be used to repay holders of revenue bonds."[39]

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36 *Id.*

37 As noted by the 1988 Senate Report, the invalidation of a lien created by an act of a state or municipal legislature by a bankruptcy court is also likely unconstitutional pursuant to the application of *Ashton v. Cameron Cty. Water Improvement Dist. No. 1,* 298 U.S. 513 (1936) and *United States v. Bekins,* 304 U.S. 27 (1938), in which the U.S. Supreme Court addressed the relationship between the federal government and state law in developing a Municipal Bankruptcy scheme. *Id.*

38 1988 Senate Report, *supra* note 19, at 12.

39 *Id.* at 4.

The 1988 Amendments "eliminate this problem by making special revenues still subject to a post-petition lien."[40]

II. THE 1988 AMENDMENTS PROTECT THE REVENUE BOND MARKET BY PROTECTING REVENUE PLEDGES

To understand how the Special Revenue Provisions function, it is important to begin with Section 902(2) of the Bankruptcy Code. Section 902(2) identifies five different potential "special revenue" streams.[41] If a pledge of revenues falls within one of Section 902(2)'s streams—for example, receipts derived from operating a toll-road system or special excise taxes imposed on an activity or transaction—that pledge constitutes a "special revenue" pledge. If a revenue pledge constitutes a pledge of "special revenues" under Section 902(2), and the specific revenues are pledged as a part of the underlying financing documents, then Sections 922(d) and 928 of the Bankruptcy Code govern their treatment in the applicable Municipal Bankruptcy case.

Section 922(d) of the Bankruptcy Code 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

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40 *Id.*

41 11 U.S.C. § 902(2).

> section [928][[42]] of this title to payment of indebtedness secured by such revenues.[43]

The market has always understood this provision to mean that if a bond issuance is secured by a pledge of special revenues, the automatic stay of the Bankruptcy Code does not apply to the application of pledged special revenues and the municipal debtor is required to continue to apply special revenues (*e.g.,* the toll-system revenues) to the payment of the indebtedness secured by such revenues in a manner consistent with Section 928.

Section 928(a) provides that special revenues acquired after the commencement of the case remain subject to any prepetition lien on such revenues, negating the application of Section 552(a) to bonds secured by a pledge of special revenues. Instead of Section 552(a), Section 928(a) expressly mandates that special revenues acquired by the debtor after the commencement of the case "shall remain subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."[44] Thus, the prepetition lien on special revenues continues to attach to postpetition revenues acquired by the debtor, subject only to necessary operating expenses of the project as required by Section 928(b). Taken together, Sections 922(d) and 928 ensure that lien and

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42 Section 922 erroneously cites to Section 927, rather than Section 928.

43 11 U.S.C. § 922(d).

44 11 U.S.C. § 928(a).

payment obligations “ride through” bankruptcy cases unaffected by the Bankruptcy Code insofar as attachment and payment are concerned, subject only to payment of necessary operating expenses of the project, if any, to avoid harming both bondholders and the municipality.

Finally, in tandem with Sections 922(d) and 928, Section 927 of the Bankruptcy Code prevents the holder of a debt secured solely by a pledge of special revenues from having recourse against the general revenues of the debtor municipality.[45] Together, these provisions enact the purpose of the 1988 Amendments—a holder of a bond secured by a pledge of special revenues is entitled to continued payment on the bond, subject to the necessary operating expenses of the project or system from which the revenue was derived. Conversely, that holder is not permitted to seek payment from other revenue streams of the debtor municipality unless otherwise allowed by the prepetition documents. The necessary corollary is that the municipality cannot under the Bankruptcy Code, nor usually under state law, utilize the revenues subject to the special revenue pledge for purposes other than as permitted in the underlying bond documents, with the potential exception of paying the necessary operating expenses of the underlying project or system.

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45 11 U.S.C. § 927.

The District Court, relying on Section 305 of PROMESA, which is substantially identical to Section 904 of the Bankruptcy Code, erroneously found that Section 922(d) "simply carves out one type of action (application of revenues) from the automatic stay, without addressing any other constraints …."[46] The District Court then concluded that because Section 904 does not permit non-consensual interference with debtor property, Congress must have intended Section 922(d) to apply only if a municipal debtor *consents* to the continued payment of special revenue bonds.[47] The legislative history, however, points to the opposite conclusion.

In fact, the Special Revenue Provisions were added to the Bankruptcy Code to clarify that Section 904 *requires* a municipal debtor to continue to honor its underlying special revenue obligations. Specifically, the Senate Report noted:

> In the municipal context, therefore, the simple answer to the Section 552 problem is that Section 904 and the tenth amendment should prohibit the interpretation that pledges of revenues granted pursuant to state statutory or constitutional provision to bondholders can be terminated by the filing of a chapter 9 case. Likewise, under the contract clause of the Constitution (article I, section 10), a municipality cannot claim that a contractual pledge of revenue can be terminated by the filing of a chapter 9 proceeding.[48]

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46 Order at 20.

47 *Id.* at 22.

48 1988 Senate Report, *supra* note 19, at 6.

This intent of Congress is particularly clear with respect to its statement regarding Section 927:

> If a municipality is unable to meet its obligations for general governmental purposes, and for that reason files a bankruptcy petition, the assets of its water department should not be reached to pay general creditors of the municipality unless they could be reached under applicable nonbankruptcy law. Conversely, if water revenues are insufficient to pay operating expenses and the debt service on water revenue bonds, other funds of the city should not be reachable to pay the bonds."[49]

The Senate Report continues:

> Further, the effect of the application of Section 1111(b) to municipal financing is prohibited by Section 904; the transformation of revenue bond (nonrecourse) financing into general obligation bond (recourse) financing permits municipalities to violate state statutory and constitutional provisions which in many cases prohibit such recourse debt (general obligation bonds) above a certain percentage of assessed value or other limits without voter approval.[50]

It is clear based on the interplay of the Special Revenue Provisions, as well as the legislative history surrounding their enactment, that Section 922(d) is not a permissive provision, but rather mandates that a debtor municipality honor its

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49 *Id.* at 8–9.

50 *Id.* at 9; *see also* 1988 House Report, *supra* note 30, at 7 (noting that converting a revenue bond issuance into recourse debt would hinder future financing prospects for troubled municipalities because of concerns over lien statutes and may violate state law).

bargain as approved by either state law or the municipality's legislature, or both. Thirty years of legal precedent and investor expectation support this conclusion.

III. Although There Is Limited Precedent Interpreting the Special Revenue Provisions, the Market Has Relied on 30 Years of Stability to Function Efficiently

Little case law exists surrounding the Special Revenue Provisions, which is not surprising because Municipal Bankruptcy cases always have been rare occurrences. Of the cases that have analyzed the Special Revenue Provisions, many have done so for limited purposes unrelated to the question here.[51] The only Municipal Bankruptcy case in which the provisions were afforded an extensive analysis was that of Jefferson County, Alabama.[52] However, the District Court mischaracterized the *Jefferson County* proceeding.

In *Jefferson County*, the bankruptcy court specifically considered whether the Special Revenue Provisions required the continued payment on sewer system debt from special revenues that had been pledged to secure the sewer system debt during the municipality's bankruptcy proceeding.[53] In fact, the debtor in *Jefferson*

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51 *See, e.g., In re Heffernan Mem'l Hosp. Dist.*, 202 B.R. 147 (Bankr. S.D. Cal. 1996) (finding that revenue tied to bankruptcy exit financing qualified as a pledge of special revenues) and *In re Sierra Kings Health Care Dist.,* No. 09-19728-B-9, 2010 WL 10018073, at *1 (Bankr. E.D. Cal. Sept. 13, 2010) (finding that underlying bonds were secured by a pledge of special revenues).

52 *See Jefferson County*, 474 B.R. 228 (Bankr. N.D. Ala. 2012).

53 *Id*.

County acknowledged that Section 922(d) applied to revenues in possession of the receiver or indenture trustee for the bondholders at the time Jefferson County filed its bankruptcy petition.[54] It argued, however, that Section 922(d) did not require the continued turn-over of the pledged revenues to the bond trustee on a post-petition basis.[55]

The *Jefferson County* bankruptcy court analyzed the debtor's argument and found that Sections 922 and 928 applied to "all special revenues against which the County granted a lien under the Indenture, not just those in possession of the Indenture Trustee or Receiver" upon the filing of the Jefferson County bankruptcy petition.[56] The *Jefferson County* court continued:

> The structure and intent of what Congress enacted by its 1988 amendments to chapter 9 was to provide a mechanism whereby the pledged special revenues would continue to be paid uninterrupted to those which/whom payment of the sewer systems indebtedness is secured by a lien on special revenues. The result is that [Section] 922(d) excludes continued payment of these "pledged special revenues" to the lienholder from being stayed under [Section 362(a) or 922(a)].[57]

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54 *See* Jefferson County's Opp'n to Receiver's and Indenture Trustee's Stay Mot., *In re Jefferson County, Ala.,* Case No. 11-05736, ECF No. 189 at 51 (filed Nov. 16, 2011) (Bankr. N.D. Ala.).

55 *Id*.

56 *Jefferson County,* 474 B.R. at 272–73.

57 *Id.* at 273.

Importantly for present purposes, the *Jefferson County* court found that Congress intended for Section 922(d) to require a continued flow of pledged special revenues.[58] The *Jefferson County* court noted:

> … Net Revenues are not protected from further action by the Indenture Trustee to acquire them from the County. Subject to this Court's setting of the amount of the Net Revenues, this means that resort to another court for the limited purpose of obtaining the Net Revenues is potentially available should the County not voluntarily remit the Net Revenues to the Indenture Trustee.[59]

Thus, although the District Court erroneously claimed the question of mandated turn-over of special revenues was not before the *Jefferson County* court, the question was squarely addressed by that court, which found that Section 922(d) does require the continued turn-over of pledged special revenues, subject to the necessary operating expenses of the system or project.[60]

IV. THE FINANCIAL IMPACT OF THE DISTRICT COURT'S DECISION WOULD MOST AFFECT DISTRESSED MUNICIPALITIES

For the last 30 years, the Special Revenue Provisions have provided the municipal bond market with the required dedication of payment to provide access to low-cost borrowing to municipalities to maintain and improve vital infrastructure. Municipal bond investors focus on the strength of the underlying

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58 *Id.* at 272.

59 *Id.*

60 *Id.*

revenue stream in pricing revenue bonds because the Special Revenue Provisions grant the holders the comfort that in a Municipal Bankruptcy proceeding they will continue to receive payment, subject only to the necessary operating expenses of the project or system in question. It was precisely this assurance that Congress intended to provide in incorporating the Special Revenue Provisions into the Bankruptcy Code. The District Court's decision creates significant uncertainty in the market, and, if upheld, will remove the guarantees that Congress intended with respect to the Special Revenue Provisions, and on which investors have relied.

The inability to utilize the Special Revenue Provisions could adversely affect market access for municipalities. For instance, in January 2017, the City of Chicago, Illinois, sold certain general obligation bonds known as the General Obligation Bonds, Project and Refunding Series 2017A (the *"Chicago GO Bonds"*). The Chicago GO Bonds were rated BBB by S&P Global Ratings and one bond in the series had a yield of 6.2%.[61] By comparison, in June 2017, the City of Chicago sold its Chicago O'Hare International Airport General Airport Senior Lien Revenue Refunding Bonds, Series 2017B, which are secured by a pledge of special revenues (the *"Chicago Revenue Bonds"*). The Chicago Revenue Bonds were rated A by S&P Global Ratings, and one bond in the series

61 *See* EMMA, https://emma.msrb.org/Security/Details/A8B710089256A216D115AEE80B0C28375 (CUSIP No. 167486ZY8, maturing 2038).

had a yield of 3.22%.[62] Neutralizing differences between market timing by comparing the respective yield of the Chicago GO Bonds and the Chicago Revenue Bonds to the Thomson Municipal Market Data AAA Curve (the *"MMD Curve"*)[63], the Chicago GO Bonds were *329 basis points* above the MMD Curve, whereas the Chicago Revenue Bonds were only *62 basis points* above the MMD Curve. In comparison to the Chicago GO Bonds, it is clear that the Chicago Revenue Bonds provided substantial savings for the City of Chicago and provided the City with the ability to spend additional funds to maintain O'Hare International Airport, rather than to pay for the higher cost of borrowing it would have incurred had the Chicago Revenue Bonds not had certain protections, including being secured by a pledge of special revenues.

In fact, given that U.S. municipalities have limited budgets for providing essential governmental services and maintaining infrastructure, an increase in interest rate on an issuance of just 1% (100 basis points) would have a dramatic adverse effect. For example, assume a municipality must make $100 million in

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62 *See* EMMA, https://emma.msrb.org/Security/Details/AEC70F4A94A1FAAD586BFAA42D3C23029 (CUSIP No. 167593A85, maturing 2039).

63 For a discussion of municipal market benchmarks, *see* MUNICIPAL SECURITIES RULEMAKING BOARD, *Understanding Municipal Market Indices, Yield Curves and Benchmarks* (Aug. 2017), available at http://www.msrb.org/msrb1/pdfs/MSRB-Indices-Defined-Report_FINAL.pdf.

required sewer system upgrades for a system originally built in the 1930s. If the municipality were to issue bonds in 2018 in the principal amount of $100 million, maturing in 20 years, callable in 10 years, with annual level debt service consisting of principal and interest payments, any interest rate increase would have a tremendous impact on the municipality's ability to borrow. An increase of 100 basis point in borrowing costs from 4.0% to 5.0% would increase net borrowing costs on those bonds by over $7.8 million in 2018 dollars. The increased costs could have been used for other municipal services, infrastructure, or remained in the pocket of taxpayers.

Court analysis until the District Court's decision recognized, both implicitly and explicitly, the legislative history behind the Special Revenue Provisions—that municipalities are to continue to follow state law during a Municipal Bankruptcy proceeding and respect the benefit of the bargain provided to holders of bonds secured by a pledge of special revenues. The District Court's decision, if upheld, would have a significant negative impact on the municipal marketplace and would reduce market access for more troubled municipalities.

This was precisely the predicament that Congress intended to relieve through its adoption of the 1988 Amendments. Without instilling confidence in the proper functioning of the market, municipalities could lose access to important

project financing.[64] In 1988, Congress was motivated in part by the size of the revenue bond market and the importance of investor confidence in the revenue bond market.[65] As noted above, that market has grown dramatically, making Congress's concerns even more salient today. Contrary to Congress's intent, a ruling like the District Court's in this case, which cuts off or otherwise impairs the effectiveness of a revenue pledge as of the date of the filing of a bankruptcy petition, could materially and adversely affect the revenue bond market access of tens, if not hundreds, of thousands of municipalities, especially those facing difficult financial conditions.[66]

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64 *See* 1988 Senate Report, *supra* note 19, at 4; 1988 House Report, *supra* note 30, at 5.

65 *See* 1988 Senate Report, *supra* note 19, at 4.

66 *Cf.* 1988 Senate Report, *supra* note 19, at 4 (expressing concern for municipalities facing significant budget deficits that "most likely will need continued municipal finance, especially for necessary improvements or maintenance to infrastructure"); 1988 House Report, *supra* note 30, at 5 ("Lenders may be reluctant to advance funds for projects, particularly in municipalities that are having some financial difficulties ….").

CONCLUSION

For these reasons, in addition to those set forth in the Appellants' briefs, this Court should reverse the District Court's ruling permitting misapplication of pledged special revenues.

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CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitations of FED. R. APP. P. 29(a)(5) and FED. R. APP. P. 32(a)(7)(B)(i) because it contains 6,339 words, excluding the parts of the brief exempted by FED. R. APP. P. 32(a)(7)(B)(iii).

2. This brief complies with the typeface requirements of FED. R. APP. P. 32(a)(5) and the type style requirements of FED. R. APP. P. 32(a)(6) because this brief has been prepared in a proportionally spaced typeface using Microsoft Word For Mac Version 16 in Times New Roman Style 14-point font.

/s/ Laura E. Appleby

CERTIFICATE OF SERVICE

I hereby certify that on May 15, 2018, I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the First Circuit by using the CM/ECF system, which will electronically serve all registered counsel of record.

/s/ Laura E. Appleby