Nos. 26-1330, 26-1331, 26-1332, 26-1333, 26-1334

IN THE 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; *et al.*,

Debtors,

NATIONAL PUBLIC FINANCE GUARANTEE CORPORATION; U.S. BANK NATIONAL ASSOCIATION, IN THE CAPACITY AS PREPA BOND TRUSTEE; *et al.*

Movant-Appellants,

v.

THE FINANCIAL OVERSIGHT AND MANAGEMENT BOARD FOR PUERTO RICO, AS REPRESENTATIVE FOR THE PUERTO RICO ELECTRIC POWER AUTHORITY (PREPA),

Debtor-Appellee,

INSTITUTO DE COMPETITIVIDAD Y SOSTENIBILIDAD ECONÓMICA DE PUERTO RICO (ICSE);

Respondent-Appellee.

On Appeal from the U.S. District Court
for the District of Puerto Rico, Case No. 17-bk-04780
The Honorable Laura Taylor Swain

AMICI CURIAE BRIEF OF IOWA AND 12 OTHER STATES IN SUPPORT OF APPELLANTS AND REVERSAL

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INTERESTS OF AMICUS CURIAE

Amici curiae are the State of Iowa, Alabama, Alaska, Florida, Georgia, Kansas, Louisiana, Missouri, Montana, Nebraska, Oklahoma, South Carolina, and Texas. As explained in an earlier appeal (Case No. 23-2036), *amici* have a powerful interest in correctly applying the Bankruptcy Code to the repayment of municipal revenue bonds. How municipal bonds are treated in bankruptcy affects States' ability to finance public services for their citizens and to ensure market confidence in municipal bond investments.

In the earlier appeal, this Court addressed bondholder litigation against Puerto Rico's energy utility, the Puerto Rico Electric Power Authority ("PREPA"). *See In re Fin. Oversight & Mgmt. Bd. for P.R.*, 121 F.4th 280, 301 (1st Cir. 2024). In a Trust Agreement with its bondholders, PREPA had pledged "Net Revenues" from electricity generation to secure the bonds. *Id.* at 297. But after defaulting on its repayments, PREPA argued the bondholders had no security interest in PREPA's future revenues. This Court rejected that argument, holding the bondholders have a perfected, secured lien on PREPA's net revenues, including its future net revenues. *See id.* at 301.

In the intervening two years PREPA has spent about $3.7 billion of those net revenues on expenditures not authorized by the Trust Agreement, while refusing to continue debt services. Bondholders filed a claim for an administrative expense for the unlawful use of secured property during proceedings under Title III of the Puerto Rico Oversight, Management, and Economic Stability Act ("PROMESA"), 48 U.S.C. § 2170.

The district court denied the claim and blessed PREPA's unauthorized use of secured property, holding that "there is no restriction on PREPA's right to use its collateral." D.E. 6063, at 39. That ruling, if upheld, will have disastrous consequences on the municipal bond market.

Amici are major participants in that market as issuers of bonds. Thus, they have a compelling interest in the case and are well-suited to advise the Court on the practical implications of its decision.

SUMMARY OF THE ARGUMENT

This Court should reverse the district court's ruling that PREPA can use cash collateral without limitation during Title III proceedings.

First, ruling below has no basis in the Code or PROMESA, which explicitly require debtors to continue paying pledged special revenues to

bondholders, *see* 11 U.S.C. §§ 902(2), 922(d), subject only to "necessary operating expenses," 11 U.S.C. § 928(b). Given the constitutional and practical importance of municipalities upholding those pledges and continuing debt services, the deduction of "necessary operating expenses" is limited to what is necessary to keep a utility "in good, not perfect, condition," and it is confined by the parties' prepetition contract. *In re Jefferson Cnty.*, 503 B.R. 849, 900 (Bankr. N.D. Ala. 2013).

By removing all restrictions on PREPA's use of bondholders' cash collateral, the district court misinterpreted PROMESA and, paradoxically, gave territorial debtors under PROMESA more latitude to use bondholders' cash collateral than sovereign states in Chapter 9 proceedings. That could not have been Congress's intent, both because it inverts federalism principles and removes the protections for special revenue bonds on which Congress was uniquely focused.

Second, the district court's order defies this Court's previous ruling, which recognized that Congress "passed section 928 to alleviate the concern that municipalities would use section 552(a) to avoid 'long-term pledges of [project-specific] revenues.'" *In re Fin. Oversight & Mgmt. Bd.*, 121 F.4th at 302. But that is, in effect, what PREPA is doing here by

making unauthorized expenditures with bondholders' cash collateral so that there is nothing left for debt services. While this Court recognized that the bondholders' lien on special revenues is subordinate only to "necessary post-petition operating expenses," *id.*, on remand the district court allowed PREPA to subordinate the lien to any expenditures it wanted to make.

Beyond defying this Court's ruling, the decision below threatens to upend municipal bond markets and investor confidence around the country. State and local governments issue municipal bonds to pay for projects that benefit the public. But they can do so on reasonable terms and interest rates only when bond purchasers have confidence their investments will be repaid and the legal system will protect them from unfair impairment. If courts fail to protect those secured interests, investors will demand punishing interest rates to cover their risk or simply not invest at all. Both outcomes threaten State and local budgets and impedes States' ability to provide for the general welfare of their citizens.

ARGUMENT

I. Congress Intended to Provide Unique Protections to Special Revenue Bonds, in Both Chapter 9 and PROMESA

Municipal bankruptcy under Chapter 9 raises constitutional and prudential concerns. While only Congress can promulgate a uniform system of bankruptcy (*see* U.S. CONST. art. I, § 8, cl. 4), Congress must respect State sovereignty and their municipal subdivisions, limiting federal courts' ability to control municipal functions. *See* U.S. CONST. amend. X; *Ashton v. Cameron Cnty. Water Imp. Dist. No. 1*, 298 U.S. 513, 532 (1936).

Congress must also ensure that municipalities do not use reorganization to impair their contractual obligations. U.S. CONST. art. I, § 10, cl. 1. Since *Ashton*, Congress has been careful to balance federalism, the Contract Clause, and the need to "create a mechanism to be responsive to the financial troubles of a municipality," S. Rep. No. 100-506, at 3, a tricky endeavor.

In the 1970s, Congress tried to apply "general business bankruptcy provisions" to municipal bankruptcies. H.R. Rep. No. 100-1011, at 2. Those changes raised concerns that the amendments were "inconsistent with principles of municipal finance, particularly with respect to public

works projects financed by revenue bonds." H.R. Rep. No. 100-1011, at 2; *see also* S. Rep. No. 100-506, at 4. The "most prominent[]" issue was the ability of a debtor to use § 552(a) to avoid "a lien resulting from a pre-petition security interest on property acquired post-petition." H.R. Rep. No. 100-1011, at 2; *see* 11 U.S.C. § 552(a) ("[P]roperty acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case."). Revenues that came in after the petition would go to and be used by the estate without being used to pay those who bargained for a pledge of revenue streams from the asset financed by their secured investment. H.R. Rep. No. 100-1011, at 2–4.

Congress responded by amending the Code in 1988 to remove pledged revenue streams from lien avoidance under § 552(a), recognizing that "special revenues" from public works needed additional protection. 11 U.S.C § 902(2)(A) (defining "special revenues" as "receipts derived from the ownership, operation, or disposition of projects or systems of the debtor that are primarily used or intended to be used primarily to provide transportation, utility, or other services"). The Senate Report made clear

that constitutional concerns under the Tenth Amendment and the Contracts Clause weighed in favor of prohibiting municipalities from breaking their pledges of special revenues by filing for Chapter 9 bankruptcy. S. Rep. No. 100-506, at 6–7. That was also the best outcome to stabilize bond markets: As the Senate Report explained, "it would be needlessly disruptive to financial markets for the effectuation of the pledge to be frustrated by an automatic stay." S. Rep. No. 100-506, at 21.

To that end, the Code explicitly required that special revenues would remain subject to pre-petition liens, *see* 11 U.S.C. § 928(a), that pledged special revenues would continue to be paid to bondholders during the pendency of the bankruptcy notwithstanding the automatic stay, 11 U.S.C. § 922(d), and that such payments would be made subject only to "necessary operating expenses." 11 U.S.C. § 928(a).

In the Jefferson County bankruptcy, the court addressed the meaning and scope of "necessary operating expenses." *Bank of N.Y. Mellon v. Jefferson Cnty.*, 482 B.R. 404, 408 (Bankr. N.D. Ala. 2012). There, the county wanted to use sewer revenue to pay for, among other things, future expenses and capital improvements. *Id.* at 409–10. The bondholders argued these were not "necessary operating expenses"

because, under the bond contract, only payments that came due monthly counted as expenditures that could be taken from future sewer revenues. *Id.* at 410.

In a meticulous opinion evaluating the meaning of "necessary operating expenses," the bankruptcy court looked to the 1988 amendments, and determined that Congress wanted "to ensure that revenue bondholders receive the benefit of their bargain with the municipal issuer and that they will have unimpaired rights to the project revenues pledged to them." *Id.* at 433 (quoting S. Rep. No. 100-506, at 12). Congress did not want municipalities to spend on anything they wanted, but only to "keep the system or project operating followed by payment of interest and principal to lenders." *Id.* at 434; *see also id.* at 437 ("[P]ayment of operating expenses—*those necessary to keep the project or system going*—must be protected so that the project or system can be maintained in good condition to generate the [revenue] to repay bondholders.") (quoting H.R. Rep. No. 100-1011, at 8 (emphasis added)).

Accordingly, Congress meant for "necessary operating expenses" to include only expenses that "keep the system or project operating in the

sense that . . . [it] is kept in good repair and generating the special revenues, not improvements or enhancements." *Id*. at 437.

By contrast here, the court held that "there is no restriction on PREPA's right to use its collateral." D.E. 6063, at 39. In that way, the court interpreted PROMESA to give Puerto Rico more discretion than even municipal entities in Chapter 9, which have specific limitations on their use of pledged special revenues. *Jefferson Cnty*, 482 B.R. at 437. That was not what Congress's enacted.

For one, as discussed, Congress was uniquely concerned with the protection of special revenue bonds in the 1988 amendments, which ultimately led to enactment of §§ 902(2), 922(d), 928. Those sections were, in turn, incorporated into PROMESA. *See* PROMESA § 301.

States have an inherent sovereignty guaranteed by our Federalism that warrants equal or better treatment than territories. Thus, it does not make sense to afford Puerto Rico more discretion in bankruptcy than political subdivisions of a state. Puerto Rico is territory, and Congress has "Power to dispose of and make all needful Rules and Regulations respecting the Territory or other Property belonging to the United States." U.S. CONST. art IV, § 3, cl. 2; *see Puerto Rico v. Sanchez Valle*,

579 U.S. 59, 77 (2016) ("Congress has broad latitude to develop innovative approaches to territorial governance."); *see also Harris v. Rosario*, 446 U.S. 651, 651–52 (1980) (per curiam) (Congress "may treat Puerto Rico differently from States so long as there is a rational basis for its actions"); *Simms v. Simms*, 175 U.S. 162, 168 (1899) ("In the territories of the United States, Congress has the entire dominion and sovereignty."). States, by contrast, have "a residuary and inviolable sovereignty." *Murphy v. NCAA*, 584 U.S. 453, 470 (2018) (quoting The Federalist No. 39, at 245 (J. Madison).

PROMESA does "afford[] a degree of protection and respect to the decisions of governmental entities that is not afforded to the decisions of private debtors." *In re Fin. Oversight & Mgmt. Bd. for P. R.*, 432 F. Supp. 3d 25, 29 (D.P.R.), *aff'd*, 954 F.3d 1 (1st Cir. 2020). But so does Chapter 9. Indeed, the statutes contain identical language on that point. *Compare* 48 U.S.C. § 2165 (preventing PROMESA oversight board from "interfer[ing] with . . . any of the political or governmental powers of the debtor" or "any of the property or revenues of the debtor") *with* 11 U.S.C. § 904 (imposing identical limitation on Chapter 9 court).

Clearly Congress did not view § 904's limitation on courts interfering with government entities' power and resources as inconsistent with the limitation on spending pledged revenues it enacted later in Chapter 9 at § 922 and § 928. Thus, the identical language found in 48 U.S.C. § 2165 does not preclude that limitation as applied to PREPA.

Indeed, to read that provision otherwise would mean that Congress, using the same language, intended to give a territorial entity more discretion to control special revenues during restructuring than political subdivisions of U.S. states in Chapter 9. Yet that is the upshot of the district court's holding.

II. The Decision Below Nullifies This Court's Earlier Decision and, if Upheld, Could Destabilize Municipal Bond Markets

Previously, this Court held that PREPA's bondholders have a perfected, secured lien in PREPA's revenue streams, including revenues during pendency of the Title III proceedings. *In re Fin. Oversight & Mgmt. Bd. for Puerto Rico*, 121 F.4th at 306 ("[T]he Bondholders have perfected their lien with respect to Net Revenues that PREPA acquires."). It further noted that any lien on special revenues could be subordinate only "to a utility's reasonable and necessary post-petition operating

expenses." *Id.* at 298. But, in effect, the district court subordinated those liens to any expenses Puerto Rico decides, without judicial review.

In so holding, the district court's decision and rationale threaten to disrupt municipal financing, not only in Puerto Rico but nationwide. Here, the court's logic was that because Section 363—which limits a corporate debtor's spending of cash collateral, *see* 11 § U.S.C 363(c)—does not carry over to PROMESA, PREPA has unreviewable discretion to spend cash collateral. But Section 363 also does not apply in Chapter 9, meaning the district court's reasoning plausibly extends to all municipal bankruptcies.

Special revenue bonds are a critical tool for public works. Because many states prohibit municipalities from collateralizing physical assets (like highways, buildings, or energy grids), the only way to obtain financing is to use the project's revenues as cash collateral. *See, e.g.*, Clayton P. Gillette, *Can Public Debt Enhance Democracy?,* 50 Wm. & Mary L. Rev. 937, 967–68 (2008). But the district court's ruling transforms secured municipal bonds into property of the estate that can be used at will by the debtor, making special revenue bonds highly risky.

Indeed, by effectively extinguishing the lien on special revenues, the district court converts secured debt into unsecured debt.

As *amici* previously explained, transforming secured municipal bonds to unsecured debt will only increase municipal bond prices, thus calling into question the continued viability of funding for public projects across the United States. Courts have long recognized that an unsecured debt is riskier than a secured debt. *See, e.g., Miss. State Tax Comm'n v. Lambert (In re Lambert)*, 194 F.3d 679, 683 (5th Cir. 2000) ("[T]he provisions of 11 U.S.C. § 1129(a)(9)(C) apply to unsecured claims and thus the creditors are at a higher risk of not receiving payment."); *In re Westwood Plaza Apartments, Ltd.*, 255 B.R. 194, 197 (Bankr. E.D. Tex. 2000) (holding that "an unsecured loan was inherently riskier than a secured loan and . . . the increased risk would inherently require a higher interest rate").

In turn, that interpretation impedes or even prevents financing for public projects across the United States by substantially increasing rates or preventing investment at all. S. Rep. No. 100-506, at 4 (predicting that uncertainty in the bond market "may have dire effects in the future" because there would be "a number of cities, especially small and medium

sized cities, which may suffer significant budget deficits due to anticipated interest rate increases"). Without the ability to finance projects with special revenue bonds, municipalities would have trouble completing public works, to the detriment of all citizens.

CONCLUSION

For these reasons, and those in Appellants' brief, this Court should reverse the decision below.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

1. This amicus curiae brief complies with Fed. R. App. P. 29(a)(5) because it contains 2,575 words.

2. This amicus 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), as required by Fed. R. App. 27(d)(1)(E), because it has been prepared in a proportionally spaced typeface using Microsoft Word in 14-point Century Schoolbook font.

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