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Introduction

Puerto Rico has experienced severe economic problems for several years now. Its economy has been contracting or stagnant at least since 2006, and unemployment, poverty, and inequality levels are extremely high, especially when compared with the fifty states in the mainland.

To put the situation in perspective, note that Puerto Rico's per capita income is one-third of United States' and close to one-half of that of the poorest state, Mississippi; its poverty rate is 45% in comparison with 15% in the United States as a whole; and 37% of its population receives nutritional assistance, while only 13% of the population in the fifty states receives such assistance.

In addition, the island has been running budget deficits for the past fifteen years, tax evasion is rampant, government corruption pervasive, the informal economy massive, its real economic productive base weak, and perhaps most important, Puerto Rico's economy is essentially a mirage based on high consumption levels that have been sustained by a monetary illusion, that is, by having access to a stronger currency—the U.S. dollar—than its economic fundamentals would warrant.

Notwithstanding this dismal economic situation, the island managed to triple its public debt from $24 billion in 2000 to $72 billion in 2015. Indeed, during this period Puerto Rico's public indebtedness grew at a compound annual rate of 7.6%, while its national income (GNP) grew at a nominal rate of only 3.5%. Given that Puerto Rico's indebtedness has grown at an average annual rate that is two times faster than the growth rate of its GNP during the past fifteen years, it should not be surprising that Puerto Rico's total public debt currently exceeds its GNP.

Recently, the governor of Puerto Rico announced that the island's public debt of $72 billion, equivalent to 103% of its GNP, was "unpayable" and needs to be restructured. We at CNE agree that Puerto Rico needs to restructure at least a portion of its debt.

Multiple Debtors

However, Puerto Rico's debt is spread across of variety of debtors (17 issuers in total) representing a complex web of claims in an uncertain regulatory and legal framework. This situation makes it very difficult for creditors to work as a class because one set of creditors will worry that any relief they provide the island will simply make it easier for a different set of creditors to recover a larger amount of their claims.

In game theory terms, Puerto Rico faces a game in which there are multiple players, which sometimes have common and sometimes opposing interests, and not making a deal leaves everyone worse off. In this type of game the final outcome could be one of any number of possible "Nash equilibria", which would generate sub-optimal results for all parties involved.

Therefore, if Puerto Rico wants to address this problem in an orderly fashion it is imperative that it develop a rational framework to address coordination and information failures that so far have precluded the island from reaching agreement with its manifold creditors on a debt restructuring mechanism that would, over the medium to the long-term, benefit both Puerto Rico and its creditors.

Chapter 9 Helps But There Are Caveats

Congress could help Puerto Rico figure a way out of this

conundrum by approving legislation to authorize the Puerto Rican government to allow its distressed agencies, instrumentalities, and municipalities to file for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code.

This congressional act would remedy an inexplicable historical oversight, as Puerto Rico is currently treated as a state for purposes of all other sections of the federal Bankruptcy Code; would not cost the federal government a single cent; and allow Puerto Rican government agencies and instrumentalities to avail themselves of a coherent, well-structured process to negotiate debt adjustment plans with their respective creditors.

However, while we support allowing Puerto Rico to avail itself of Chapter 9 procedures to adjust its debt and believe it would provide a helpful framework for addressing existing coordination and information failures, we also stress that it is by no means a complete or perfect solution to all of Puerto Rico's troubles, not even to its debt crisis.

Assuming Congress allows Puerto Rico to avail itself of Chapter 9 under the same terms and conditions as the fifty states, the first hurdle to clear is procedural. Only "municipalities" can file for relief under Chapter 9. The term "municipality", in turn, is defined as a political subdivision, public agency, or instrumentality of a state.

Thus, at the outset, this limitation would preclude Puerto Rico from filing a petition for adjustment with respect to its general obligation bonds because such bonds are issued by the central government of the Commonwealth of Puerto Rico, which by definition is not a "municipality". However, an interesting case would arise in the event of a Chapter 9 filing by a Puerto Rico government instrumentality, such as the Public Buildings Authority ("PBA"), whose debt has been guaranteed by the Commonwealth. Would a Chapter 9 judge consider the PBA a "municipality" for purposes of a debt adjustment petition, even-though the Commonwealth

guarantees all of its debt? Or would he pierce the thin legal veil separating the PBA and the Commonwealth's government and conclude that the PBA's debt is essentially equivalent to debt issued by the Commonwealth and therefore not subject to adjustment under Chapter 9?
In addition, a municipality must: (1) be specifically authorized by a state law to file for relief under Chapter 9; (2) be insolvent (usually on a cash flow basis); (3) be willing to put in effect a plan to adjust its debts; and (4) either (a) have obtained the agreement of creditors holding at least a majority in the amount of claims of each class that the municipality intends to impair or (b) have attempted to negotiate in good faith, but was unable to do so, or it has determined that (i) it was impractical to negotiate with its creditors, or (ii) one or more of its creditors is improperly attempting to obtain a preference over other creditors.
Furthermore, according to James Spiotto: "The fact that a municipality has filed a petition does not necessarily ensure that its debts will be adjusted in that proceeding. Section 921(c) of the U.S. Bankruptcy Code's municipal provisions provides that, after objection to the petition, the court, after notice and a hearing, may dismiss the petition if it can be shown to the bankruptcy court that a petition was not filed in good faith or not in accord with the requirements of Chapter 9." (James E. Spiotto, *Remarks at the SEC Field Hearing on the State of the Municipal Securities Market: Distressed Communities*, July 29, 2011, p. 41).

Special Revenue Bonds

Now, even if a Puerto Rico issuer cleared all the procedural hurdles and its petition for relief survived the inevitable motion to dismiss under section 921(c) that would surely be filed by the affected creditors, that does not imply the road is clear for a Puerto Rico issuer to negotiate a plan of

adjustment with its creditors. The reason is that certain kinds of municipal bonds receive special treatment or protection under Chapter 9.

Bonds secured by a pledge of "special revenues" comprise one such class of protected obligations and Puerto Rico has issued a significant amount of such bonds. Section 902 defines "special revenues" as:

(A) 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, including the proceeds of borrowings to finance the projects or systems;

(B) special excise taxes imposed on particular activities or transactions;

(C) incremental tax receipts from the benefited area in the case of tax-increment financing;

(D) other revenues or receipts derived from particular functions of the debtor, whether or not the debtor has other functions; or

(E) taxes specifically levied to finance one or more projects or systems, excluding receipts from general property, sales, or income taxes (other than tax-increment financing) levied to finance the general purpose of the debtor…

In 1988 Congress legislated this concept of "special revenues" to address a potential conflict between holders of general obligation bonds and holders of revenue bonds. Prior to the 1988 Amendments, the Bankruptcy Code provided that property acquired by a debtor *after* the commencement of a bankruptcy proceeding was not subject to a lien created *prior* to the filing of the bankruptcy petition. The general effect of this provision was to hollow-out the lien of revenue bondholders, whose bonds were secured by, say for example, a lien on revenues generated by a municipal power company, and converted them essentially into "unsecured creditors with a claim against the post-petition

revenues that had previously secured the revenue bonds and their claims would become part of the general obligations of the municipality."(Chapman and Cutler LLP, *Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies*, p. 55).

Congress, therefore, sought a mechanism that would preclude revenue bonds from being converted into general obligation bonds by virtue of a Chapter 9 bankruptcy filing. In specific terms: "The 1988 Amendments were intended to preserve a dichotomy between general obligation and special revenue bonds for the collective benefit of bondholders (to secure the benefit of their bargain), municipalities (to maintain the effectiveness of the revenue financing vehicle) and taxpayers (to ensure that revenue obligations were not transformed into general obligations)." (*In re Hefferman Memorial Hospital*, 202 B.R. 147, 148 (Bankr. S.D. Cal. 1996, as cited in David E. Lemke, Blake D. Roth & Courtney M. Rogers, *Municipal Debtors: "Cram Down" of Special Revenue Debt*, p. 5).

To address this issue, Congress introduced section 928, which provides that special revenue bondholders continue to have a lien on special revenues generated *after* the bankruptcy case. In addition, the 1988 Amendments added a new subsection to section 922 that makes the general automatic stay provision of the Bankruptcy Code *inapplicable* to the payment of special revenues pledged to the holders of municipal indebtedness. The net effect of these two provisions is that holders of special revenue bonds are entitled to receive the revenues pledged to them on a timely basis *regardless* of the bankruptcy petition. However, Congress was cognizant of the fact that municipalities have an obligation to keep the lights on, the water flowing, and the trains running. Therefore, in section 928(b) it legislated that the bondholders' claim to special revenues is subject, essentially subordinated, to the payment

of the necessary operating expenses of the municipal project or system.

Thus, in the case of a bankruptcy petition filed by, for example, PREPA, its bondholders could claim they have a right to be paid regardless of the bankruptcy filing, while PREPA would probably argue that without some sort of debt relief it would not have enough cash left over to pay its debt service in full after paying its operating expenses, at which point the bondholders could argue that PREPA could raise rates and do more to achieve operational efficiencies. The issue then becomes a question of fact to be resolved by a bankruptcy judge.

The case of PRASA, the state-owned water company, provides an interesting twist to this analysis. In 2012, PRASA issued approximately $2 billion worth of bonds secured with a pledge on its **gross revenues**. Thus, in the event of a Chapter 9 filing by PRASA, holders of these bonds could claim that their lien is *not subject or subordinated* to the payment of PRASA's operating expenses. PRASA's options at that point presumably would be to default or increase rates to pay its debt service. However, how would a bankruptcy court ultimately resolve this issue is an open legal question.

Statutory Lien Bonds

Puerto Rico, as well as several states, has issued bonds whose payment is secured by a statutory pledge on a future stream of revenues or taxes. In general, "a statutory lien cannot be canceled on the filing of a bankruptcy petition or by the bankruptcy court." (*Chapman and Cutler LLP, Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies*, p. 58).

This principle was clearly set forth in the case of *In re Sierra Kings Health Care District* (Case No. 09-19728, Bankr. E.D. Cal. Sept. 13, 2010), in which the court "reaffirmed the fact

that a Chapter 9 proceeding and any order or Plan of Adjustment cannot interfere with notes, bonds, or municipal obligations that are paid from the pledge of taxes or revenues that are special revenues or subject to a statutory lien." (Id.) Thus, a Chapter 9 petition would not affect the payment on statutory lien bonds according to their terms.

The Commonwealth of Puerto Rico has assigned certain revenues to the Highways Authority, the Puerto Rico Infrastructure Financing Authority ("PRIFA"), the Puerto Rico Convention Center District Authority ("PRCCDA"), and COFINA. These consist of (i) motor vehicle fuel taxes, crude oil and derivative products excise taxes, cigarette excise taxes and license fees allocated to the Highways Authority; (ii) federal excise taxes imposed on alcoholic beverages and tobacco products produced in Puerto Rico and sold in the United States, which taxes are returned by the federal government to the Commonwealth and allocated to PRIFA; (iii) hotel occupancy taxes imposed by hotels on paying guests, which are allocated to PRCCDA; and (iv) a significant portion of the Commonwealth sales and use tax which has been pledged to pay debt service on the bonds issued by COFINA.

Presumably, under the prevailing doctrine, a Chapter 9 proceeding, order, or plan of adjustment *could not impair, adversely affect or interfere with* the timely payment on any of these bonds.

However, in the case of these statutory lien bonds, a thorny legal issue may arise because holders of the Commonwealth's general obligation bonds could argue that "the assigned taxes and fees are subject to first being applied to the payment of the principal of and interest on the Commonwealth public debt" (defined as general obligation bonds and other debt expressly guaranteed by the Commonwealth), because such public debt has *constitutional* priority under the Puerto Rico Constitution. Therefore, payment to statutory lien

bondholders should be subordinated to payment on the Commonwealth's general obligation bonds, *regardless of Chapter 9 precedent and doctrine*, because payment on Puerto Rico's general obligation bonds have constitutional priority.

Statutory lien bondholders could then rebut that the application of this "clawback provision" is "effective only if and to the extent that all other available Commonwealth resources are insufficient for that purpose", and, as the Commonwealth itself has stated in the past, "since the Commonwealth has never defaulted on its public debt and has never had to apply amounts allocated to the Highways Authority, PRIFA or PRCCDA to the payment of its public debt, *it is not clear how a [GO] bondholder would be able to establish that all other available Commonwealth resources would be insufficient for such purpose,* and therefore require the application of such revenues to the payment of public debt."

Furthermore, statutory lien bondholders could also argue, again, as the Commonwealth itself has represented in the past, that "nothing in the Constitution or in applicable law expressly requires the Highways Authority, PRIFA or PRCCDA to return to the Commonwealth funds already transferred to it, even if other available resources of the Commonwealth are insufficient for the payment of public debt." (Commonwealth of Puerto Rico, Official Statement, issued in connection with the offering of $3,500,000,000 General Obligation Bonds of 2014, Series A, dated March 11, 2014, all citations are from pages 29 and 30).

How would a Chapter 9 judge, or any judge for that matter, resolve this potential conflict between holders of general obligation bonds and holders of statutory lien bonds is unclear at this time.

Additional Policy Action is Needed from both Washington and San Juan

While Chapter 9 could perhaps provide a useful framework for negotiating a plan to adjust some of Puerto Rico's debts, that by itself is insufficient to get Puerto Rico out of the current crisis.

The federal government also needs to establish a comprehensive action program to remove some of the disadvantages imposed on Puerto Rico under the current political arrangement and eliminate some long-standing discriminatory policies.

This comprehensive policy package could include, among other things, exempting Puerto Rico from coastwise shipping laws (Jones Act), which require the use of relatively expensive U.S. vessels for trade between Puerto Rico and the mainland; equal treatment under federal health programs, such as Medicare, Medicaid, and the Affordable Care Act; and extending the federal Earned Income Tax Credit program to Puerto Rico (the EITC could be based on, and used to mitigate the regressive effect of, payroll taxes paid by Puerto Rican workers).

In our view the current situation does not allow for piecemeal action by Washington, a comprehensive, wide-ranging plan is needed. The United States' Congress cannot simply continue to ignore its historic and moral obligations with respect to Puerto Rico. Congressional failure to act not only highlights a pusillanimous lack of political will to address the issues of a territory invaded by the United States in 1898, it also weakens the United States' moral position in the international arena, when it argues for better treatment for Hong Kong by China, for the Palestinians by Israel, or for Greece by members of the Eurozone.

Puerto Rico for its part must: increase tax revenues by strengthening and improving enforcement efforts;

crackdown on government corruption; close ineffective tax loopholes; reduce private sector rent-seeking behavior; modernize its property tax system; encourage workers to move from the informal sector to the formal economy; and develop and implement a five-year fiscal adjustment plan with strong support from a broad base of stakeholders in Puerto Rico.

Over the medium term horizon, Puerto Rico also needs to significantly reform an unnecessarily complicated permitting and licensing system that stifles innovation; improve educational standards; and develop a coherent economic development strategy to transform its economy from one based on unsustainable consumption and indebtedness levels to one based on real investment and production.

What Puerto Rico does not need right now is more austerity, because the capacity to repay its debt ultimately depends on restoring economic growth. At the same time, there can be no economic recovery without debt sustainability and that, in turn, is not possible without significantly restructuring at least some of its debt.

Conclusion

As we have argued above, while allowing Puerto Rico to avail itself of Chapter 9 could provide certain procedural benefits, a bundle of complicated legal issues—with respect to debt guaranteed by the Commonwealth, special revenue bonds, and debt secured by statutory liens—would remain open or be left completely unaddressed.

Nonetheless, and for clarity's sake, we reiterate our opinion that negotiations between Puerto Rico and its creditors under a Chapter 9 framework, however imperfect it may be, are certainly preferable to a legal *battle royale*, in which merely disposing of the preliminary motions to resolve issues related to jurisdiction, forum, venue, and applicable law could easily take one year or more.

Having said that, the Puerto Rican people and its

government must understand that Chapter 9 is not the be all and end all solution to the debt crisis nor is it a painless option. In fact when it comes to addressing the debt problem, all the options entail significant economic costs and political pain:

(1) If the government decides to pay all its debt, as currently structured no matter what happens, as a small but influential group of the conservative right and some unimaginative representatives of the business community argue, eventually essential public services in the areas of education, health, and safety will be adversely affected, causing a further deterioration in the quality of life of most Puerto Ricans;

(2) If the government chooses to negotiate new payment terms for some of its debt, with or without the Chapter 9 framework, those negotiations will be extremely costly in terms of (a) fees for accountants, attorneys, financial advisors and other consultants; (b) time; and (c) short-term liquidity because no one will be willing to lend to Puerto Rico until negotiations are finalized;

(3) If, at the other extreme, the government decides to go "full metal jacket" and announces a payment moratorium on all its debt, as a tiny but increasingly vocal group of university students, professors, and leftist intellectuals advocate, then the most likely outcome would be an even more expensive legal free-for-all that could last for years, a state of affairs that would be detrimental to the interests of both Puerto Rico and its creditors; and

(4) If the government decides not to decide, it would still have made a choice, and such (in)decision would not be costless, as it would lead to increased uncertainty, which in turn would have a negative effect on potential investors evaluating Puerto Rico as a place for new investment.

Needless to say, under all four scenarios the most probable outcome would be that Puerto Rico's economy would continue to shrink and migration to the United States would

continue to increase.

Finally, regardless of what the government does, it needs to have the support of at least a bare majority of the Puerto Rican people because the decisions that need to be made are in essence political in nature. In order obtain that political support, the government needs to be transparent as to what are its objectives, how it plans to achieve them, and explain unambiguously how the proposed action plan would affect the average Puerto Rican on the street. So far, the government has failed miserably in all three.

This lack of transparency, in turn, raises some rather difficult questions, such as (1) who should be making these decisions that will affect *all* Puerto Ricans for better or for worse?; (2) which criteria should be used to make these decisions?; and (3) what participation, if any, should the "people" or Puerto Rico's "civil society" (however defined) have in this process? In sum, and regardless of the availability of Chapter 9, if the *political process* for restructuring Puerto Rico's debt and developing a fiscal adjustment plan is flawed from the start, the final plan, no matter how nuanced, sophisticated, or brilliantly conceived, is inevitably bound to fail. Deep structural changes cannot simply be "crammed-down" in a democracy.

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