



EXECUTIVE SUMMARY
PUERTO RICO'S DEBT STRUCTURE AND
ARGUMENTS IN FAVOR OF CHAPTER 9

1. Perhaps the best way to analyze the strength of the protection afforded to bondholders by the multiplicity of Commonwealth issuers is to imagine a set of concentric circles with the most secured bonds set forth right in the middle and less secured bonds spreading outward from that circle.
2. First in line are **General Obligation** bonds backed by the good faith, credit and taxing power of the Commonwealth, which would sit right in the middle of our imaginary set of concentric circles.
 - a. **Open Issue:** The Spanish and English versions of the Puerto Rico Constitution contain slightly different wording for Article VI, Section 8, which establishes this first claim on Commonwealth resources.
 - b. **Open Issue 2:** While it is clear that GO bondholders have a “first claim” on available resources of the Commonwealth it is not clear what *remedies* they may seek in order to enforce that claim.
3. Second in terms of bondholder protections would be **Bonds and Notes Guaranteed by the Commonwealth’s Good Faith and Credit**. In theory, bonds and notes guaranteed by the Commonwealth are considered “public debt” for purposes of the Constitution and enjoy the same priority of payment and protection.
4. Third in line would be bonds issued by the **Puerto Rico Sales Tax Financing Corporation**, otherwise known as COFINA.
 - a. **Open Issue:** According to an opinion of the Secretary of Justice of the Commonwealth, the portion of the Commonwealth sales and use tax allocated to COFINA is not available for the payment of principal of and interest on General Obligation bonds. The validity of this legislative allocation, however, has not been challenged in or ruled upon by any court and *thus remains an open question*.
 - b. **Open Issue 2:** Article VI, Section 7 of the Puerto Rico Constitution, which states that “The appropriations made for any fiscal year shall not exceed the total revenues, including available surplus, estimated for said fiscal year **unless the imposition of taxes sufficient to cover said appropriations is provided by law.**” Most of the proceeds of COFINA bond offerings were in fact used for deficit financing or to cover current expenses, financial uses that *prima facie* appear to be Constitutionally prohibited. However, in the absence of a court decision this legal issue remains open to judicial interpretation.

5. Next in line are bonds issued by the **Municipal Finance Agency**. These bonds are secured by *ad valorem* taxation, without limitation as to rate or amount, on all taxable property within the issuing municipalities. The good faith, credit and unlimited taxing power of each issuing municipality are pledged for the payment of its general obligation municipal bonds and notes.
 - a. **Open Issue:** Are municipal tax revenue streams subject to the Constitutional Clawback? To the best of our knowledge this is an unresolved legal question.
6. Fifth in line would be revenue bonds issued by **Puerto Rico State-Owned Enterprises or Public Corporations**, as they are commonly known. These bonds *are payable solely* from the revenues generated by each of these public corporations, *with the exception*, as we stated above, of those public corporation bonds that have been expressly guaranteed by the Commonwealth of Puerto Rico. Bondholder rights and remedies are set forth in the Trust Indentures executed by each state-owned enterprise.
 - a. **Open Issue:** 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 its rates to pay for its operating expenses. However, how would a court ultimately resolve this issue is an open legal question.
7. Sixth in line is debt supported by **Commonwealth Appropriations or Taxes**. These obligations depend on action(s) by the Puerto Rico legislature for their repayment. Bondholders, in general, cannot sue at law or equity to require that a law be enacted, thus, their expected recovery is at the mercy of the political process.
8. Seventh in the line up would be bonds issued by the **Employees Retirement System**. These bonds are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth and its instrumentalities after the issuance of the bonds. The Commonwealth *does not* guarantee such bonds.
9. Finally, limited obligation and non-recourse debts offer the weakest bondholder protection.
10. Article VI, Section 8 of the Puerto Rico Constitution declares that: "In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other disbursements shall thereafter be made *in accordance with the order of priorities established by law.*"
 - a. In summary form, these priority norms are:
 - i. First, the payment of the interest on and amortization requirements of the public debt (again, defined to include *only* Commonwealth general obligations and guaranteed debt for which the Commonwealth's guarantee has been exercised);

- ii. Second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit and good faith of the Commonwealth;
 - iii. Third, current expenditures in the areas of health, public safety, education, welfare, and retirement systems; and
 - iv. Fourth, for all other purposes.
 - b. This statutory “waterfall” is useful in providing some guidance as to how government funds would be allocated in the event of a liquidity crisis, but the statutory language is so ambiguous as to practically invite litigation.
11. Allowing the Commonwealth of Puerto Rico and its distressed agencies, instrumentalities, and municipalities to file for bankruptcy under an enhanced version of Chapter 9 of the U.S. Bankruptcy Code could be a useful mechanism to obtain needed debt relief:
- a. First, bankruptcy protection is not a federal bailout as it would not cost the federal government a single cent. Furthermore, it could be argued that the probability of a bailout by the federal government would *increase* significantly if Puerto Rico and its agencies and instrumentalities *were not allowed* to restructure their debt under Chapter 9.
 - b. Second, as we have demonstrated above, Puerto Rico’s debt is spread across a variety of debtors (18 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.
 - c. A court-supervised process would help ensure fair treatment to all parties, including small, retail investors currently not “at the table”. The alternative—an untested and potentially disorderly process with numerous creditor lawsuits and years of scorched-earth litigation—would depress the local economy, increase restructuring costs, and make long-term recovery harder to achieve. **In sum, no one benefits from the chaos of a disorderly default, years of nonpayment, protracted multi-forum litigation, and social unrest in Puerto Rico.**
 - d. Third, the proposed restructuring regime would provide all the essential protections of bankruptcy: a stay on creditor collection actions, priority for new private short-term cash flow financing, and voting by creditor classes on any proposed restructuring.
 - e. Fourth, an orderly debt restructuring process would allow Puerto Rico to ensure the uninterrupted provision of essential public services. In the words of former bankruptcy Judge Steven Rhodes: “The advantage of bankruptcy is that people will still continue to get their police, their fire, their emergency medical, their roads, their educations, their power, their water, even though

the defaults are taking place". The continuous provision of these government services is critical to avoid a humanitarian and social crisis in Puerto Rico.

- f. Fifth, postponing the inevitable restructuring only increases economic and social costs over the long-term.
 - g. Finally, it is in the best interests of the United States for Puerto Rico to successfully ride out this economic crisis. If Puerto Rico becomes an international embarrassment for the United States, it will only weaken the moral standing of the American government and its ability to effectively utilize its "soft power" in the international arena when it argues, for example, for better treatment for Hong Kong by China, for the Palestinians by Israel, or for Greece by members of the Eurozone.
12. We support that in exchange for obtaining some form of debt relief, Puerto Rico should be required, just like any other debtor obtaining relief under the Bankruptcy Code, to *implement substantial reforms* to address the fundamental problems that caused the island's government to become insolvent in the first place.
13. In this context we strongly recommend that any savings derived from a reduction in debt service be dedicated *exclusively* to develop and implement a new industrial policy for Puerto Rico.