MUNICIPAL BANKRUPTCY — PREEMPTION — PUERTO RICO PASSES NEW MUNICIPAL REORGANIZATION ACT. — *Puerto Rico Public Corporation Debt Enforcement and Recovery Act*, 2014 P.R. Laws Act No. 71.

The Commonwealth of Puerto Rico is facing the most critical fiscal situation in its history. Its public corporations[1] are especially compromised, overwhelmed by growing deficits and unsustainable debt loads but barred from reorganizing under federal law. On June 28, 2014, Puerto Rico enacted the Puerto Rico Public Corporation Debt Enforcement and Recovery Act[2] (Recovery Act), which allows eligible public corporations to restructure their debt burdens.[3] The Recovery Act is likely preempted by federal bankruptcy law. However, its (un)constitutionality notwithstanding, the passage of the Recovery Act was sufficient, and perhaps necessary, to motivate temporary consensual relief.

Puerto Rico is facing fiscal crisis due to massive government debt,[4] prolonged economic recession,[5] and population decline.[6] Numerous attempts to rehabilitate Puerto Rico have been unsuccessful, leading to a downgrade of Puerto Rico's general obligation bonds[7] and prompting the legislature to declare a fiscal emergency.[8] The fiscal crisis has

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[1] The term "public corporations" refers to corporations that are government owned, not to corporations that are publicly held or traded.

[2] 2014 P.R. Laws Act No. 71 [hereinafter Recovery Act].

[3] Some public entities, including the Commonwealth itself, are excluded from reorganization under the Recovery Act. *See id.*, Statement of Motives, pt. E.

[4] *See* Mary Williams Walsh, *Worsening Debt Crisis Threatens Puerto Rico*, N.Y. TIMES, Oct. 7, 2013, http://dealbook.nytimes.com/2013/10/07/worsening-debt-crisis-threatens-puerto-rico [http://perma.cc/5QQM-HYWA]; *see also Greece in the Caribbean*, THE ECONOMIST (Oct. 26, 2013), www.economist.com/node/21588374 [http://perma.cc/LXF9-AAHB] ("With $70 billion of debt outstanding . . . [Puerto Rico] is more indebted than any of America's 50 states."). Puerto Rican bonds were particularly attractive to investors for their high yields and "triple tax-free" status: they are exempt from federal, state, and local taxes. *See* 48 U.S.C. § 745 (2012); Michael Corkery, *Investors Crave a Taste of the Island*, WALL ST. J. (Mar. 9, 2012, 12:01 AM), http://online.wsj.com/news/articles/SB10001424052970203961204577269862654681728.

[5] *See* Reid Wilson, *Looming Puerto Rico Debt Deadlines Have Investors Nervous*, WASH. POST: GOVBEAT (July 24, 2014), http://www.washingtonpost.com/blogs/govbeat/wp/2014/07/24/looming-puerto-rico-debt-deadlines-have-investors-nervous [http://perma.cc/4CPN-4HBU] (noting that the unemployment rate, which has surpassed 10% for over a decade, was around 13.1% in the summer of 2014).

[6] *See* Lizette Alvarez, *Economy and Crime Spur New Puerto Rican Exodus*, N.Y. TIMES, Feb. 8, 2014, http://www.nytimes.com/2014/02/09/us/economy-and-crime-spur-new-puerto-rican-exodus.html [http://perma.cc/KS86-ETH5].

[7] Michael A. Fletcher, *Puerto Rico Bonds Downgraded to Junk Levels*, WASH. POST (Feb. 4, 2014), http://www.washingtonpost.com/business/economy/puerto-rico-bonds-downgraded-to-junk-levels/2014/02/04/c9495a22-8ddf-11e3-833c-33098f9e5267_story.html [http://perma.cc/4U6A-BLF5].

[8] Recovery Act, Statement of Motives, pt. A (citing the Special Law for the Fiscal and Operational Sustainability of the Government of the Commonwealth of Puerto Rico, 2014 P.R. Laws Act No. 66).

also compromised the liquidity of the Government Development Bank (GDB), which serves as the Commonwealth's "financial adviser and fiscal agent."[9]

Puerto Rico's public corporations are especially compromised. The three main public corporations — the Electric Power Authority (PREPA), the Aqueduct and Sewer Authority (PRASA), and the Highways and Transportation Authority (PRHTA) — run massive deficits and have taken on a combined debt load of nearly $20 billion.[10] Historically, Puerto Rico's public corporations have either issued bonds in the capital markets or received financial support from GDB to cover budget deficits and fund capital improvements; however, the Commonwealth's fiscal crisis has effectively foreclosed both sources of funding and put public corporations at risk of default.[11] In the summer of 2014, PREPA's default seemed imminent, with deadlines on lines of credit totaling more than $650 million coming due in late July and early August.[12] Default could render PREPA unable to purchase the oil necessary for power generation, leading to blackouts across Puerto Rico.[13] With Puerto Rico on the verge of crisis, Governor Alejandro García Padilla introduced the Recovery Act on June 25, 2014, and Puerto Rico's Legislative Assembly passed it immediately.[14]

Prior to the Recovery Act, Puerto Rican public corporations had no statutory basis under which to restructure. There was no Commonwealth statute providing for such a regime.[15] Nor can Puerto Rican public corporations reorganize under the U.S. Bankruptcy Code (the Bankruptcy Code). First, they are excluded from restructuring under Chapter 11 of the Bankruptcy Code, which governs corporate reorganization, because they are "governmental units."[16] Second, they are in-

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[9] *Id.*

[10] *See* Sonia Colón & Javier Vilariño, *Puerto Rico's Extraordinary Case*, AM. BANKR. INST. J., Oct. 2014, at 38, 38; Michelle Kaske, *Puerto Rico's Default Plan May Spread Pain Beyond Utility*, BLOOMBERG (June 30, 2014, 9:29 PM), http://www.bloomberg.com/news/2014-06-30/puerto-s-rico-default-plan-may-spread-pain-beyond-utility-1-.html [http://perma.cc/5FS7-UBZ9].

[11] *See* Michael Corkery, *Puerto Rico's Indebted Power Utility Adds to Island's Problems*, N.Y. TIMES, July 1, 2014, http://dealbook.nytimes.com/2014/07/01/puerto-ricos-indebted-power-utility-adds-to-islands-problems [http://perma.cc/3FHQ-TLC6].

[12] *See* Wilson, *supra* note 5.

[13] *See* Mary Williams Walsh, *Puerto Rico Power Supplier Saved from Cash Squeeze*, N.Y. TIMES, Aug. 14, 2014, http://dealbook.nytimes.com/2014/08/14/puerto-rico-power-supplier-saved-from-cash-squeeze/ [http://perma.cc/37ZT-KRQE].

[14] Aaron Kuriloff, *Puerto Rico Moves to Restructure Debt*, WALL ST. J. (June 26, 2014, 11:54 AM), http://online.wsj.com/articles/puerto-rico-governor-proposes-law-to-restructure-public-entities-1403724012.

[15] *See* Recovery Act, Statement of Motives, pt. B.

[16] Only a "person" — an "individual, partnership, [or] corporation" — can be a debtor in a Chapter 11 reorganization. 11 U.S.C. § 101(41) (2012). The term "person" does not include "governmental unit[s]." *Id.*; *see, e.g.*, *In re* N. Mar. I. Ret. Fund, No. 12-00003, 2012 WL 8654317 (D.

eligible for restructuring under Chapter 9 of the Bankruptcy Code, which governs municipal reorganization, because Congress specifically excluded entities in Puerto Rico and Washington, D.C., from the ambit of municipal bankruptcy.[17]

The stated purpose of the Recovery Act was to "allow[] public corporations . . . (i) to adjust their debts in the interest of all creditors affected thereby, (ii) provide[] procedures for the orderly enforcement and, if necessary, the restructuring of debt . . . , and (iii) maximize[] returns to all stakeholders."[18] The Act became effective immediately; it expires on December 31, 2016, unless extended by law.[19]

The Recovery Act, which "mirror[s] certain key provisions" of the Bankruptcy Code,[20] provides two paths for public corporation restructuring: Chapter 2, a consensual out-of-court process, and Chapter 3, a judicially managed in-court process.[21] Chapters 2 and 3 are nonexclusive: a public corporation can seek relief under either chapter simultaneously or sequentially.[22]

Chapter 2 provides a process for out-of-court negotiations between debtor corporations and their creditors. Under Chapter 2, the public corporation, or "obligor," selects the debt securities to renegotiate and commits itself to a recovery program that allows it to become financially self-sufficient.[23] Filing for Chapter 2 activates a suspension period of up to 270 days, staying debtholders from exercising any remedies for nonpayment or for covenant breach, giving the obligor time to negotiate with all of its creditors.[24] Relief under Chapter 2 becomes effective for a class of creditors upon: (i) written approval by GDB; (ii) a supermajority vote, requiring at least 50% participation by debtholders of a particular class and approval by at least 75% of those participants; and (iii) court approval.[25] An oversight committee is established for each obligor to monitor compliance with its recovery plan.[26]

N. Mar. I. June 13, 2012) (holding that a government-run pension fund was an instrumentality of the government not eligible for Chapter 11).

[17] *See* 11 U.S.C. § 101(52). In July 2014, Pedro Pierluisi, the Resident Commissioner of Puerto Rico to the U.S. Congress, introduced a bill treating Puerto Rico as a state for purposes of Chapter 9. *See* Puerto Rico Chapter 9 Uniformity Act of 2014, H.R. 5305, 113th Cong. (2014).

[18] Recovery Act, Statement of Motives, pt. D.

[19] *Id.* § 401.

[20] *Id.*, Statement of Motives, pt. E.

[21] The Recovery Act also establishes a new court, the Public Sector Debt Enforcement and Recovery Act Courtroom of the Court of First Instance, with "exclusive competence and jurisdiction over all matters arising under or related to th[e] Act." *Id.*, Statement of Motives, pt. F.

[22] *Id.*, Statement of Motives, pt. E.

[23] *Id.* § 201.

[24] *Id.* § 205.

[25] *Id.* § 202.

[26] *Id.* § 203.

Chapter 3 provides for a restructuring process with enhanced judicial oversight. The process under Chapter 3 is initiated when a petition is filed with the court, either by the corporation itself or by GDB on its behalf.[27] The filing of the petition activates an automatic stay,[28] similar to that under federal bankruptcy law.[29] The court then appoints a committee to represent creditors.[30] After an eligibility determination by the court,[31] either the obligor or GDB may file a plan for restructuring or for disposition of the corporation's assets.[32]

In order for the court to confirm a plan under Chapter 3, the plan must satisfy both procedural and substantive requirements. Procedurally, it must be approved by at least one class of affected debtholders with a majority of votes representing at least two-thirds of the aggregate amount of debt in that class.[33] Substantively, it must "provide[] for every affected creditor . . . to receive payments and/or property having a present value of at least the amount the affected debt . . . would have received if all creditors holding claims . . . had been allowed to enforce them on the date the petition was filed."[34] Each creditor not satisfied in full "shall be entitled to receive . . . its pro rata share of 50% of the petitioner's positive free cash flow" for up to ten years, until it is paid in full.[35]

The passage of the Recovery Act spurred challenges to its constitutionality, even prior to any public corporation seeking relief under the Act.[36] Although the Recovery Act was justified as a valid exercise of the Commonwealth's police power,[37] the statute is likely unconstitutional under the Supremacy Clause.[38] Where state law conflicts with federal law — as does the Recovery Act with section 903 of the Bankruptcy Code — the state law is preempted. Yet despite the Recovery Act's probable constitutional infirmity, the threat of potential public corporation default exerted sufficient pressure to motivate temporary consensual relief. Voluntary forbearance by PREPA's creditors (including holders of 60% of its bonds) mere days after the Recovery

[27] *Id.* § 301.
[28] *See id.* § 304 (listing the claims to which the automatic stay applies).
[29] *See* 11 U.S.C. § 362 (2012).
[30] Recovery Act § 318.
[31] *Id.* § 306.
[32] *Id.* § 310.
[33] *Id.* § 315(e).
[34] *Id.* § 315(d).
[35] *Id.* § 315(k).
[36] *See, e.g.*, Complaint at 9, 11, Franklin Cal. Tax-Free Trust v. Puerto Rico, No. 14-1518 (D.P.R. June 28, 2014); *see also* Colón & Vilariño, *supra* note 10, at 87–88 (describing the litigation).
[37] *See* Recovery Act, Statement of Motives, pt. C.
[38] U.S. CONST. art. VI, cl. 2. Though not a state, Puerto Rico is nonetheless subject to federal law. 48 U.S.C. § 734 (2012).

Act's passage resulted in an extension on expected principal repayment to March 2015.[39] The Recovery Act may have been the only way for Puerto Rico to provide its public corporations much-needed breathing room.

Under the Supremacy Clause, federal law "shall be the supreme Law of the Land . . . Laws of any state to the Contrary notwithstanding."[40] State laws that are preempted by federal law are thus invalid. Courts have recognized three types of preemption[41]: (1) "express" preemption, where Congress explicitly proclaimed its intent to displace state regulation;[42] (2) "field" preemption, where "[s]tates are precluded from regulating conduct in a field that Congress . . . has determined must be regulated by its exclusive governance;"[43] and (3) "conflict" preemption, where state law conflicts with federal law so as to "stand[] as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[44] In preemption analysis, "[t]he purpose of Congress is the ultimate touchstone."[45]

The Recovery Act is not preempted on the basis of express preemption or field preemption.[46] Rather, the Recovery Act is likely preempted on the basis of conflict preemption, due to its direct conflict with section 903 of the Bankruptcy Code, undermining congressional design and intent.[47] Section 903 of the Bankruptcy Code provides that "(1) a State law prescribing a method of composition of indebtedness of [a state] municipality may not bind any creditor that does not consent to such composition; and (2) a judgment entered under such a law may not bind a creditor that does not consent to such composition."[48] This

[39] *See* Michael Corkery, *Lenders Agree to Give Puerto Rico Electric Power Authority More Time to Repay Debt*, N.Y. TIMES, July 7, 2014, http://dealbook.nytimes.com/2014/07/07/lenders-agree-to-give-puerto-rico-utility-more-time-to-repay-debt [http://perma.cc/4GPB-3DTQ] (describing a temporary agreement reached on July 7, less than two weeks after the passage of the Recovery Act); Walsh, *supra* note 13 (describing the final extended forbearance agreement conditioned on PREPA's completion of a restructuring plan by March 2015).

[40] U.S. CONST art. VI, cl. 2.

[41] *See* 1 LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW § 6-28, at 1176–77 (3d ed. 2000).

[42] *See* Arizona v. United States, 132 S. Ct. 2492, 2500–01 (2012) ("There is no doubt that Congress may withdraw specified powers from the States by enacting a statute containing an express preemption provision.").

[43] *Id.* at 2501.

[44] *Id.* (quoting Hines v. Davidowitz, 312 U.S. 52, 67 (1941)) (internal quotation mark omitted).

[45] Gade v. Nat'l Solid Wastes Mgmt. Ass'n, 505 U.S. 88, 96 (1992) (plurality opinion) (quoting Allis-Chalmers Corp. v. Lueck, 471 U.S. 202, 208 (1985)) (internal quotation marks omitted).

[46] Chapter 9 of the Bankruptcy Code includes no express preemption provision. And section 903 explicitly contemplates the application of state law, confirming that this is not a field that Congress intended for its exclusive control. *See* 11 U.S.C. § 903 (2012) ("This chapter does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State . . . .").

[47] *Cf. Arizona*, 132 S. Ct. at 2501.

[48] 11 U.S.C. § 903.

provision is unambiguously in conflict with the Recovery Act, which was designed precisely to adjust the composition of indebtedness of Puerto Rico's public corporations.[49] Specifically, the reorganization procedures contemplated by Chapter 2 and Chapter 3 both authorize binding revision of debt composition for nonconsenting creditors.[50]

Though Puerto Rican public corporations are excluded from reorganizing under Chapter 9 of the Bankruptcy Code, section 903 (which is housed in Chapter 9) nonetheless applies to bar Puerto Rico from passing its own state municipal restructuring law. Puerto Rican entities are only excluded from *debtor* treatment under Chapter 9; for all other purposes — including for section 903 — the term "State" in the Bankruptcy Code includes Puerto Rico.[51] The plain language of section 903 itself includes no restriction to Chapter 9 debtors.[52] And it would be implausible to suggest that section 903's unqualified references to "creditors" apply only to creditors of debtors in cases under Chapter 9. Where Congress intended provisions of the Bankruptcy Code to apply only to debtors or creditors under a certain chapter, it made that intention explicit.[53]

The Recovery Act creates an obstacle to achieving Congress's clear intent in passing section 903 of the Bankruptcy Code: to invalidate state municipal reorganization laws. The language codified at section 903 was initially passed by Congress to address state laws "under which the bondholders of a municipality are required to surrender or cancel their obligations," with the purpose of ensuring that "[o]nly under a Federal law should a creditor be forced to accept such an adjustment without his consent."[54] This language was designed to over-

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[49] *See* Note, *Municipal Bankruptcy, the Tenth Amendment and the New Federalism*, 89 HARV. L. REV. 1871, 1898 (1976) ("A composition . . . is defined elsewhere to be an agreement among the parties, made binding upon dissenting creditors by law, to discharge original obligations by scaling down the amounts of principal or interest to be paid.").

[50] *See* Recovery Act § 202 (authorizing "consensual" restructuring under Chapter 2 with approval of 75% of creditors in a given class with 50% participation, i.e., over the possible dissent of up to 62.5% of creditors in a given class); *id.* § 315 (authorizing restructuring under Chapter 3 with approval of "at least one class of affected debt" by a majority of all votes representing at least two-thirds of the aggregate amount of debt in the class, i.e., over the dissent of all other classes of affected debt *and* up to 50% of the holders of the class of debt in question).

[51] 11 U.S.C. § 101(52) ("The term 'State' includes the District of Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 . . . .").

[52] *See* City of Pontiac Retired Emps. Ass'n v. Schimmel, 751 F.3d 427, 431 (6th Cir. 2014) (en banc) (per curiam) ("The plain language of [section 903] is not limited to bankruptcy proceedings.").

[53] *Compare* 11 U.S.C. § 103(i) ("Chapter 13 of this title applies only in a case under such chapter."), *and id.* § 103(j) ("Chapter 12 of this title applies only in a case under such chapter."), *with id.* § 103(f) ("[O]nly chapters 1 and 9 of this title apply in a case under such chapter 9.").

[54] *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the H. Comm. on the Judiciary*, 94th Cong. 2320 (1976) [hereinafter *Bankruptcy Act Revision: Hearings*] (quoting H.R. REP. NO. 79-2246, at 4 (1946)).

rule a 1942 Supreme Court decision upholding a state's right to pass legislation providing for extended maturity and interest rate adjustments on municipal obligations for nonconsenting creditors.[55] Congress again considered and again approved the language currently housed in section 903 with the passage of the Bankruptcy Reform Act of 1978.[56] Thus, the legislative history of the statute makes clear Congress's imperative that nonconsenting creditors not be bound by state legislation modifying the terms of municipal debt obligations.

Preemption by federal law would defang the Recovery Act. Under conflict preemption, the state law is invalid "to the extent it actually conflicts with federal law."[57] In the case of the Recovery Act, the conflict with section 903 of the Bankruptcy Code invalidates any section of the Recovery Act that would modify existing creditor agreements. Without the option to invoke an automatic stay or cram down restructured debt compositions for public corporations, the Recovery Act almost certainly lacks force to mandate municipal reorganization.

Despite the Recovery Act's likely preemption, it may have been Puerto Rico's best option. Prior to the passage of the Act, Puerto Rico's public corporations had only two routes for relief from impending default: Congress or their creditors. Congress's exclusion of Puerto Rico from Chapter 9 reorganization is clear[58] and Puerto Rico's attempt to compel Congress to alter that mandate has been unsuccessful.[59] And creditors were initially unwilling to come to the table, creating the risk of imminent default.[60] In the absence of additional negotiating leverage, Puerto Rico and its public corporations were stuck between the rock of default — with the possible disruption in critical public services for a population already plagued by prolonged recession[61] — and the hard place of passing constitutionally questionable legislation.

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[55] *See id.* ("The proviso . . . retained here, prohibiting state composition procedures was enacted in response to, and overruled the holding of the Supreme Court in, *Faitoute Iron & Steel Co. v. City of Asbury Park*, 316 U.S. 502 (1942)."). In *Faitoute*, the Court upheld a New Jersey law permitting reorganization of municipal debt obligations upon consent of only 85% of creditors — that is, over possible objections of 15% of creditors. *See* 316 U.S. at 504.

[56] Pub. L. No. 95-598, 92 Stat. 2549; *see Bankruptcy Act Revision: Hearings*, *supra* note 54, at 2320.

[57] Cal. Fed. Sav. & Loan Ass'n v. Guerra, 479 U.S. 272, 281 (1987) (plurality opinion).

[58] *See* sources cited *supra* note 17 and accompanying text.

[59] *See supra* note 17. Puerto Rico's political powerlessness in Congress certainly does not help. *See generally* José A. Cabranes, *Puerto Rico: Colonialism as Constitutional Doctrine*, 100 HARV. L. REV. 450, 461 (1986) (reviewing JUAN R. TORRUELLA, THE SUPREME COURT AND PUERTO RICO (1985)) ("Puerto Rico is still not a part of the 'United States' for all constitutional purposes; the island and its people are still subject to the laws and regulations adopted by the political branches of the national government before which they appear only as supplicants . . . .").

[60] *See supra* text accompanying note 11.

[61] *See* Walsh, *supra* note 13.

Even without its invocation, the mere passage of the Recovery Act — despite its likely preemption and other colorable challenges to its constitutionality[62] — was sufficient to immediately motivate consensual negotiation and temporary forbearance of debt repayment.[63] The timing mismatch between the slow burn of a constitutional challenge in federal court and the up-to-the-minute urgency of debt market trading was sufficient to motivate creditors to accept the certainty of an immediate settlement over the faraway (and inevitably uncertain) probability of a court finding the Act unconstitutional.

Although the Recovery Act may ultimately prove, with sufficient time and litigation expense, to be mere "sound and fury,"[64] Puerto Rico's probabilistic constitutionalism sufficiently redrew the possible contours of public law remedies to motivate financial actors to reshape private ordering. This temporary consensual relief provided the public corporations with much-needed time to reorganize their operations to avoid future default. In choosing this approach, Puerto Rico risks weakening outside investor interest in future securities offerings; rewriting the rules of debt restructuring is a risky tactic in a high-stakes, repeat-player market.[65] But perhaps such high-stakes federalism will prompt Congress to reconsider the basis for and desirability of Puerto Rico's idiosyncratic treatment under Chapter 9 of the Bankruptcy Code, and elsewhere in federal law.

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[62] Altering the priority of securities under the Recovery Act may amount to a taking of property without just compensation. *See* U.S. CONST amend. V; Complaint, *supra* note 36, at 11. And depriving creditors of full repayment may amount to unconstitutional contractual impairment. *See* U.S. CONST art. I, § 10, cl. 1; Complaint, *supra* note 36, at 11–12.

[63] *See* Corkery, *supra* note 39 (describing the "conundrum" before PREPA's creditors in the wake of the Recovery Act's passage, by which demanding repayment "could hasten [PREPA's] path to restructuring and increase the likelihood of losses for the banks").

[64] WILLIAM SHAKESPEARE, MACBETH act 5, sc. 5, l. 27 (Nicholas Brooke ed., Oxford Univ. Press 1990) (1623).

[65] *See, e.g.*, Wilson, *supra* note 5.