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Law and Corporate Finance: Credit Markets and Corporate Reorganization

Panel 4: Puerto Rico (or Restructuring without Bankruptcy Precedent)

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I. Introduction

- A. Puerto Rico and its various instrumentalities have debt of over \$70 billion. In addition, Puerto Rico’s pension liabilities exceed \$50 billion, and its pension fund is essentially depleted. Puerto Rico has defaulted on its general obligation debt, and it has lost access to the credit markets.
- B. Instrumentalities of Puerto Rico are not eligible for relief under Chapter 9. Puerto Rico also lacks the ability to enact its own insolvency regime. *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, 136 S. Ct. 1938 (2016).

- C. Congress passed PROMESA in the summer of 2016. This legislation puts in place a seven-person Oversight Board and a mechanism for restructuring the debt of both Puerto Rico and its instrumentalities.

II. Municipalities Are Not Businesses

- A. Municipalities exist primarily to provide local public goods that otherwise would be undersupplied by the market.
- B. Municipal residents, unlike shareholders or customers of firm, do not have easy access to alternative sources of similar services if municipality fails to provide them.
 - 1. Some courts have recognized “service delivery insolvency” that embraces this concept. See *In re City of Stockton*, 493 Bankr. 772 (Bankr. E.D. Cal. 2013).
 - 2. The consequence for governmental insolvency regimes is that they are not necessarily only collection devices.
- C. The fact that municipal bankruptcy does not allow for “liquidation” of the municipality also recognizes the distinction between distressed governmental units and distressed private entities. When private entities fail, customers and employees can migrate to other firms. Such migration is much harder in the case of a financially distressed municipality.
- D. The most mobile residents of distressed governmental units are likely those who provide net tax value to the insolvent municipality.
 - 1. They are likely to exit when they cease to receive municipal services with a value in excess of the taxes they pay.
 - 2. When they exit from governmental units, the remaining residents have less capacity to fund services.
 - 3. Some courts have recognized the “death spiral” that occurs when mobile residents exit leaving behind only less mobile residents.
 - 4. Puerto Rico, for example, has faced high rates of exit followed by high taxes and fees for those who remain, leaving residents with a total tax burden in excess of that borne by residents of virtually all states.
- E. It might seem sensible to allocate losses to those best able to monitor the debtor. Such an allocation would seem to reduce the chance of fiscal distress arising in the first instance.

1. While shareholders of a firm have a common objective of maximizing firm value, and thus may be viewed as appropriate monitors of firm financial decisions, residents of a locality may be in a relatively poor position to monitor their government.
 2. Governments do not have a single objective function. Different groups will monitor for different and conflicting objectives, with the result that collective action problems prevent any group from monitoring overall performance. In the absence of effective monitoring of overall performance of the government, groups that have distinct interests may have an advantage in inducing governments to act in a manner inconsistent with overall financial interests.
- F. Creditors may have an advantage over residents in monitoring fiscal behavior of governments. To what extent does this ability make it appropriate to favor residents and perhaps pensioners over creditors in the allocation of losses when the government cannot meet all its obligations?

III. Puerto Rico's Economic Condition

- A. The Commonwealth has experienced negative real GNP growth in every year but one since 2006. This has led to stagnating incomes, increasing outmigration to the mainland, and a staggering increase in total public sector debt.
1. In the United States, 16% of the population lives below the poverty line. In Puerto Rico, 46% does.
 2. The population of the United States has grown by 7.7% over the last decade. In Puerto Rico, it has declined by 8.7%.
 3. At the same time, total public sector debt has risen by 65%.
- B. The Commonwealth has taken significant austerity measures to strengthen its finances.
1. A number of new taxes have been put in place, including a sales-and-use tax of 11.5%.
 2. There has been a reduction of nonsalary benefits, elimination of subsidies to PRASA, school consolidations, payroll reductions, and additional reductions in General Fund expenditures.
- C. Many Commonwealth entities rely, directly or indirectly, on the Commonwealth's already hampered taxing authority to make debt service

payments. Certain entities that have issued debt backed by allocated tax revenues have revenues that are either explicitly “available revenues” that may be diverted to pay Commonwealth general obligations (HTA, PRCCDA, AMA, PRIFA) or have been alleged in litigation by general obligation debt holders to be an “available revenue” (COFINA)

IV. Puerto Rico’s Path to Recovery

- A. Even after implementing significant austerity measures, Puerto Rico’s debt load is unsustainable.
- B. The March 13, 2017 Fiscal Plan submitted by Governor Rossello and certified by the Oversight Board shows that even with significant contributions in the form of expense and revenue measures as well as structural reforms, a substantial debt restructuring is necessary to put the Commonwealth on a path toward long-term sustainability.
 - 1. Before any debt service, the Fiscal Plan projects a cumulative fiscal deficit of approximately \$31.7 billion over the next ten years, based on the Commonwealth’s current fiscal policies.
 - 2. To address this deficit, Governor Rossello has proposed a number of revenue and expense measures to produce a small surplus of approximately \$7.9 billion, before payment of any debt service.
 - a. Revenue measures include the extension of Act 154 and increased tax compliance efforts.
 - b. Expense measures include central government employee attrition, reduction in central government subsidies, improved operational efficiencies, a “new healthcare model” and pension reform.
- C. With approximately \$35.2 billion of contractual principal and interest payments due over the ten-year projection period, Governor Rossello’s Fiscal Plan suggests that a substantial restructuring is required.

V. PROMESA Oversight Board

- A. PROMESA establishes an Independent Fiscal Oversight Board for Puerto Rico

1. PROMESA provides that the Oversight Board is an entity within the territorial government that is not be considered to be a department, agency, establishment, or instrumentality of the Federal Government.
2. The seven members of the Oversight Board are appointed by the President. Six of its members are selected from lists submitted by leaders of Congress. They serve without pay and include two investment bankers, a law professor, a retired bankruptcy judge, and an economist.
3. The estimated \$370 million cost of the Oversight Board is to be paid by Puerto Rico.

B. Functions of the Oversight Board

1. The Oversight Board works with the governor and legislature of Puerto Rico to create a fiscal plan and ensure that the annual budgets comply with it.
2. The Oversight Board must approve any in-court or voluntary restructuring of the territory's debt. Puerto Rico may not issue debt, nor guarantee, exchange, modify, repurchase, nor redeem its debt without Oversight Board approval.
3. The Oversight Board may advise the territorial government to implement remedial action if it falls out of step with the annual budget and Fiscal Plan. If the government cannot stay on course, the Board can take appropriate steps, including making reductions in nondebt expenditures and overseeing entry into contracts.

VI. Title III Restructuring Plan

- A. The Oversight Board has the sole power to authorize Puerto Rico or one of its instrumentalities to commence a Title III Proceeding. A court enters an order for relief upon filing of petition. §304(c).

1. Oversight Board remains in control of the Title III Proceeding, including the terms of any restructuring plan. §315.
 2. Unlike Chapter 9, where the chief judge of the circuit appoints a bankruptcy judge, Article III judges will preside in cases under PROMESA. §308.
 - a. If any instrumentality of Puerto Rico seeks to restructuring debt under Title III, the Chief Judge of the First Circuit appoints a district judge.
 - b. In the case Puerto Rico itself, the Chief Justice makes the appointment.
 3. If the Oversight Board so determines, “venue shall be proper in the district court for the jurisdiction in which the Oversight Board maintains an office that is located outside the territory.” §307(b)(1).
- B. “Fair and Equitable” Test
1. Like Chapter 9, PROMESA incorporates §1126(c) by reference. §301(a). Hence, creditors are put into classes. Approval requires two-thirds in amount and a majority in number.
 2. PROMESA also incorporates §1129(b)(1) by reference. Hence, a court may confirm the plan over the objection of a class, but only if the plan is “fair and equitable.”
 3. “Fair and equitable” is a term of art in Chapter 9 and it may have a different meaning in Chapter 9 than it does in Chapter 11. See *Kelley v. Everglades Drainage Dist.*, 319 U.S. 415, 419–20 (1943); *In re Mount Carbon Metropolitan District*, 242 Bankr. 18 (Bankr. Colo. 1999).
 4. Some courts have suggested that a “fair and equitable” Chapter 9 plan is one where “the payments provided for in the plan of composition are all that the [municipality] is reasonably able to pay in the circumstances.” See *Lorber v. Vista Irrigation District*, 127 F.2d 628 (9th Cir. 1942). A court may fashion a similar interpretation of “fair and equitable” under PROMESA rather than the hard-edged absolute priority rule of Chapter 11.
- C. “Best Interests” Test

1. Title III, like Chapters 9 and 11, has a “best interests” test.
 2. Section §1129(a)(7) requires that each individual creditor who objects to a plan receive under the plan at least as much as it would receive in a Chapter 7 liquidation
 3. By contrast, §943(b)(7) requires that a plan be in the “best interests of the creditors.” Courts have held that this creates a collective, rather than an individual right. Courts look to how creditors as a group fare, not at how each individual creditor would fare inside of bankruptcy and out. Some courts have held that “best interests” in Chapter 9 requires only “that a proposed plan provide a better alternative for creditors [as a group] than what they already have.” *In re City of Detroit*, 524 Bankr. 147, 213 (Bankr. E.D. Mich. 2014).
 4. The “best interests” test under PROMESA includes language not found in §943(b). To decide whether a plan is in the best interests of creditors the court must “consider whether available remedies under the non-bankruptcy laws and constitution of the territory would result in a greater recovery for the creditors than is provided by such plan.” §314(b)(6). This may provide creditors with more protection than they would enjoy under Chapter 9.
- D. PROMESA also requires that the plan be consistent with the Fiscal Plan, and under §201, a Fiscal Plan must “respect the relative lawful priorities or lawful liens . . . in effect prior to the date of enactment of this Act” §201(b)(1)(N). This may also provide greater protection for creditors than Chapter 9.

VII. Title VI and Creditor Collective Action

- A. Title VI of PROMESA allows voluntary “Qualifying Modifications” or “QMs” of bond debt of Puerto Rico or its instrumentalities, outside of a Title III Proceeding.
1. QMs may be proposed by the territorial issuer or its bondholders, with supervision of the Oversight Board. §601(i).
 2. To be effective, a QM must be approved by at least two-thirds of the principal amount of the bonds voting in each “Pool” of the issuer, and in no event less than a majority of the total outstanding bonds in each Pool. §601(j).
 3. Bonds will be classified in Pools based upon whether they are (i) general obligations subject to issuer’s “full faith and credit,” (ii)

secured, (iii) senior or junior in priority, (iv) senior or subordinated, and (v) guaranteed by the territory. §601(d)(3).

4. Bonds of identical security or priority cannot be placed into separate Pools. §601(d)(3)(E).

B. Oversight Board must certify the QM meetings a number of conditions:

1. The QM must provide for a sustainable level of debt and conform with the Fiscal Plan. §601(g)(1)(A); §104(i)(1).
2. The QM must ensure that all similarly situated bondholders will receive the same treatment. §601(g)(1)(B).
3. The QM must be in the “best interests of creditors and is feasible.” §601(g)(1)(C). Title VI, however, does not include the language requiring consideration of nonbankruptcy remedies that is included as part of the best interests test in Title III. Hence, modifications may be possible under Title VI that are not possible under Title III.