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# DESPERATE MEASURES FOR DESPERATE TIMES: PUERTO RICO'S RECOVERY ACT

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## INTRODUCTION

Faced with a seemingly unending decline in its financial picture, Puerto Rico is in dire need of a way to avoid an economic catastrophe.[1] With a stagnant economy,[2] lack of industry,[3] a rapidly declining population[4] (and therefore rapidly declining taxing revenue), and a high unemployment rate,[5] Puerto Rico has been forced to take drastic measures to address its unsustainable financial situation.[6] On June 28, 2014, Puerto Rico's governor passed legislation to provide its public corporations[7] with debt adjustment, under what is essentially Chapter 9 of the United States Bankruptcy Code ("the Code").[8] Chapter 9 of the Bankruptcy Code provides a municipality the opportunity to discharge its debts.[9] "Municipality" under the Code includes a public agency or

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[1] John Burnett, *Island of Disenchantment*, U.S. NEWS & WORLD REPORT (Mar. 11, 2015, 8:00 AM), http://www.usnews.com/opinion/economic-intelligence/2015/03/11/puerto-ricos-agencies-dont-need-chapter-9-bankruptcy ("[Puerto Rico] is likely headed toward insolvency.").

[2] Steven B. Smith et al., *Floating Ashore: An Overview of Puerto Rico's Financial Crisis and Potential Restructuring Alternatives*, THE BANKRUPTCY STRATEGIST, 31 L. J. NEWSLETTER, June 1, 2014 ("Puerto Rico's economy [ ] has been in decline for several years, hurt by, among other things, the recession…").

[3] James Surowiecki, *The Financial Page: The Puerto Rican Problem*, THE NEW YORKER, Apr. 6, 2015, at 22.

[4] Burnett, *supra* note 1 (A "daily departure of more than 100 Puerto Ricans has taken thousands out of the island's productive workforce in the last few years.").

[5] *See id.* ("Puerto Rico's unemployment rate is over 14 percent."); AM. BANKR. INST., *Moody's: Puerto Rico's New Debt Law is Credit Negative for Financial Guarantors, Default Now More Likely*, (Aug. 2014) ("Puerto Rico's 13.8 percent unemployment rate is more than double the U.S. average.").

[6] Michael A. Fletcher, *Puerto Rico, With at Least $70 Billion in Debt, Confronts a Rising Economic Misery*, WASH. POST, Nov. 30, 2013, www.washingtonpost.com/business/economy/puerto-rico-with-at-least-70-billion-in-debt-confronts-a-rising-economic-misery/2013/11/30/f40a22c6-5376-11e3-9fe0-fd2ca728e67c_story.html.

[7] Zachary H. Smith, *Puerto Rico's Municipal Debt Landscape Continues To Evolve*, LAW360 (June 4, 2014, 4:47 PM), http://www.law360.com/articles/544331/puerto-rico-s-municipal-debt-landscape-continues-to-evolve ("Puerto Rico public corporations include entities such as the Puerto Rico Electric Power Authority, Puerto Rico Aqueduct and Sewer Authority, Puerto Rico Highway and Transportation Authority, and others.").

[8] *See* Leonard Weiser-Varon et al., *A Close Look at Puerto Rico's Bankruptcy-Like Legislation*, LAW360 (July 03, 2014, 9:58 AM), http://www.law360.com/articles/553454/a-close-look-at-puerto-rico-s-bankruptcy-like-legislation; *see also* Aaron Kuriloff, *Puerto Rico Power Authority Bond Prices Sink*, WALL ST. J., June 30, 2014, http://online.wsj.com/articles/puerto-rico-power-authority-bond-prices-sink-1404162222.

[9] 11 U.S.C. §901 (2006) *et seq.*

instrumentality of a state.[10]

The main problem with this legislation, claims a suit filed on behalf of Puerto Rico's bondholders, is that the bankruptcy laws, as granted by the United States Constitution, are the singular domain of Congress.[11] As a United States territory, this raises the question of the constitutionality of Puerto Rico passing legislation that essentially mirrors the United States Bankruptcy Code.[12] Puerto Rico's Act only allows Puerto Rico's public corporations the right to file bankruptcy, not Puerto Rico itself,[13] but such legislation directly conflicts with the Bankruptcy Code, which denies both Puerto Rico and its municipalities access to the Code. Furthermore, where Congress has established a uniform Bankruptcy Code, one that specifically includes Puerto Rico, Puerto Rico's creation of its own bankruptcy legislation creates an unconstitutional Supremacy Clause conflict.

Defenders of the legislation point out that Puerto Rico is not a state and therefore is not bound by the United States Code,[14] nor is it in conflict with it, since there is not a provision on point regarding Puerto Rico's public corporations.[15] However, the claim that Puerto Rico is not a state is somewhat confused by the fact that, as a territory of the United States, in many respects, the United States treats Puerto Rico no differently than

[10] 11 U.S.C. §101(40) (2006).

[11] *See* Maria Chutchian, *Puerto Rico's New Debt Law Usurps Congress, Funds Say*, LAW360 (June 30, 2014, 7:00 PM), http://www.law360.com/articles/552993/puerto-rico-s-new-debt-law-usurps-congress-funds-say?article_related_content=1.

[12] Aaron Kuriloff, *U.S. Investment Firms Challenge Puerto Rico Restructuring Law*, WALL ST. J., June 29, 2014, http://www.wsj.com/articles/u-s-investment-firms-challenge-puerto-rico-restructuring-law-1404068742 ("The act is a bankruptcy law and 'treads on the Congress's exclusive province in enacting such legislation.'").

[13] *See id.* ("The proposed bill . . . doesn't include a way for the island's general-obligation bonds and sales-tax debt to be restructured.").

[14] *See id.* ("The island's Government Development Bank said it stands behind the Public Corporations Debt Enforcement and Recovery Act and will defend it. Puerto Rico has a 'sovereign's right to pass its own debt enforcement statutes in areas not covered by federal law.'").

[15] *See generally* Stephen J. Lubben, *Puerto Rico and the Bankruptcy Clause*, 88 AM. BANKR. L. J. 553 (2014).

the states[16] and the United States Bankruptcy Code expressly includes Puerto Rico in its definition of a "state."[17] These conflicts are the backdrop of the analysis presented here.

Part I of this note presents the foundation of this conflict, briefly reviewing Puerto Rico's financial problems, its recently passed legislation, and its relationship to the United States. Part II presents an overview of the United States Bankruptcy Code and analyzes the constitutionality of Puerto Rico's legislation. Part III of this note considers the path taken by New York City during a time of extreme financial distress in the 1970's and suggests some possible directions that Puerto Rico could take to restructure its finances in an attempt to avoid use of the bankruptcy statute.

## I. BACKGROUND

### A) Puerto Rico's Financial Troubles

The worldwide recession of 2008 hit Puerto Rico especially hard.[18] Adding fuel to the fire of the greatest economic downturn since the Great Depression was the expiration of a tax subsidy in 2006 which enabled American firms doing business on the island to earn tax-free income.[19] What was already an unsteady economy turned into a downward spiral after the subprime mortgage implosion.[20] With the majority of banks curtailing lending in an effort to clean up their balance sheets, businesses were negatively impacted

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[16] *See generally* Adam D. Chandler, Note, *Puerto Rico's Eleventh Amendment Status Anxiety*, 120 YALE L.J. 2183 (2011).
[17] 11 U.S.C. §101(52).
[18] Tim Fitzsimons, *Global Recession Hits Puerto Rico Hard*, NPR (Jan. 9, 2014, 4:29 AM), http://www.npr.org/2014/01/09/260979934/global-recession-hits-puerto-rico-hard.
[19] Lizette Alvarez, *Economy and Crime Spur New Puerto Rican Exodus*, N.Y. TIMES, Feb. 8, 2014, www.nytimes.com/2014/02/09/us/economy-and-crime-spur-new-puerto-rican-exodus.html ("Tax laws that were once abundantly generous . . . came to a crash in 2006, after the 10-year phase-out of a subsidy that provided American firms operating in Puerto Rico with tax-free income.").
[20] *See id.*

by the inability to access capital.[21] This lack of capital made it difficult for businesses to run effectively, thereby creating additional problems as companies that were unable to pay their bills began laying off employees.[22] With an increase in unemployment, many people curtailed their spending, which in turn further depressed the economy.[23] With the downturn in business, Puerto Rico began to feel the pressure of less tax revenue and its increasing debt.[24] As the tax revenue was insufficient to cover the commonwealth's budget, Puerto Rico's government had no choice but to raise rates and taxes.[25] With the increase in taxes and the lack of employment, many citizens of Puerto Rico fled for the mainland of the United States.[26] Puerto Rico's financial picture grew darker as its population shrank and its tax base declined,[27] leaving the commonwealth unable to perform on the debt of its public corporations.[28]

Puerto Rico's financial structure includes three different kinds of debt: the debt of its public corporations, general obligation debt (debt that is payable on the general income of the commonwealth, not attributable to any one revenue source), and sales tax

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[21] Eric Dash, *Puerto Rican Lenders Face Their Own Crisis*, N.Y. TIMES, Apr. 29, 2010, www.nytimes.com/2010/04/30/business/30fdic.html?_r=0 ("Loans are scarce, making life even harder for many local businesses.").
[22] *See id.* ("A lending slowdown of this kind often causes a vicious circle — slower growth, more job losses and, in turn, an even sharper pullback in lending.").
[23] Alan Gomez, *Economy's On Mend, But Puerto Ricans Still Desert Island*, USA TODAY, Aug. 11, 2014, www.usatoday.com/story/news/nation/2014/08/11/puerto-rico-population-loss/13891661/.
[24] *See* Alvarez, *supra* note 19.
[25] *See id.* ("Last year, water rates rose 60 percent in a bid to help cut the state-run water company's debt."); *see id.* ("Vowing not to lay off any more workers, he [Puerto Rico's Governor, Garcia Padilla] raised taxes sharply to provide much-needed revenue…").
[26] *See* Gomez, *supra* note 23 ("This island saw a net loss of 144,000 people from 2010 to 2013, the largest exodus since a similar period following World War II…").
[27] Danielle Kurtzleben, "Puerto Rico's Population Continues Rapid Decline," U.S. News & World Report, Jan. 2, 2014, available at http://www.usnews.com/news/blogs/data-mine/2014/01/02/puerto-ricos-population-continues-rapid-decline.
[28] Lisa Beilfuss, *Fitch Cuts Puerto Rico's Rating Deeper Into Junk*, WALL ST. J., Mar. 26, 2015, www.wsj.com/articles/fitch-cuts-puerto-ricos-rating-deeper-into-junk-1427397508 ("[T]he legislature's "willingness to pay" has become a significant concern.").

debt, (the repayment of which comes directly from sales tax revenues).[29] Puerto Rico's public corporations make up a large part of the commonwealth's economic structure.[30] For many years, Puerto Rico's main source of capital was obtained by issuing bonds on behalf of its public service corporations.[31] These public corporations, such as the Water and Gas Company and the Utility Company, because of the vital importance they played in maintaining a high standard of daily living for the citizens of Puerto Rico, were considered cash cows that would sustain the commonwealth's debt indefinitely. However, the economic downturn, the declining population, and the over abundance of public debt together created the perfect storm from which Puerto Rico now finds itself desperately trying to escape.

The most pressing of Puerto Rico's financial concerns is its interest payments on nearly $70 billion dollars of debt, 40% of which is made up of the island's corporate-like public entities.[32] By comparison, when Detroit filed for bankruptcy in July of 2014, its public debts were $18 billion.[33] However, the clouds over Puerto Rico's financial picture could lift with the recent passing of new legislation by Puerto Rico's Governor Alejandro

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[29] Aaron Kuriloff, *Credit-Rating Firms Downgrade Puerto Rico's Public Agencies*, WALL ST. J., June 27, 2014, www.wsj.com/articles/credit-rating-firms-downgrade-puerto-ricos-public-agencies-1403905253 ("The bill doesn't apply to Puerto Rico's general-obligation or sales-tax bonds, which are backed by the island's taxing authority.").

[30] BRECKINRIDGE CAP. ADVISORS, PUERTO RICO'S CHALLENGES, 3 (2012), *available at* http://www.breckinridge.com/insights/whitepapers.html?id=1238. (internal citations omitted)

> The Commonwealth's major public corporations have significant and opaque financial relationships to each other and to the Commonwealth. These intra-governmental capital flows represent a significant portion of the island's financial activities, and they are beginning to impact the island's larger issuers. Last year, almost 28% of PREPA's (Puerto Rico Electric Power Authority's) unpaid bills were owed by delinquent public sector organizations.

[31] *See* Kuriloff, *supra* note 29 ("It [Puerto Rico] has financed many of its services through a collection of semipublic and semiprivate entities, which are now loaded up with debt and have weakened prospects for increasing revenue.").

[32] *See* Fletcher, *supra* note 6; *see* Kuriloff, *supra* note 29 ("[L]arge, indebted, corporate-like public entities account for almost 40% of the island's total debt.").

[33] *See* Smith et al., *supra* note 2 (Puerto Rico's $70 billion debt obligation "dwarfs the approximately $18 billion debt owed by the City of Detroit.").

Garcia Padillo.[34]

B) The Recovery Act

The Puerto Rico Public Corporations Debt Enforcement and Recovery Act (hereafter, the "Recovery Act," or, "the Act"), signed by Governor Padilla in 2014, in effect mimics Chapter 9 of the United States Bankruptcy Code.[35] Similar to the Bankruptcy Code's requirement that a municipality be authorized to be a debtor by either state law, or by a representative of the state,[36] Chapter 2 of the Recovery Act grants debt relief to eligible public corporations which are authorized by the Government Development Bank of Puerto Rico (GDB).[37] Chapter 3 of the Recovery Act requires the public corporation debtor to submit a proposed restructuring plan[38] and a list of creditors who will be affected by the plan.[39] As also required by Chapter 9, in order to be approved under the Recovery Act, the plan must pass a vote by a majority of the votes cast, and "two-thirds of the aggregate amount of affected debt," of at least one class of affected creditors.[40] These requirements closely follow the language of Chapter 9 of the Code.[41]

## II. THE RELATIONSHIP OF PUERTO RICO TO THE UNITED STATES AND ITS LAWS

A) Federalism and the Bankruptcy Code

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[34] Leonard Weiser-Varon et al., *A Close Look at Puerto Rico's Bankruptcy-Like Legislation*, LAW360 (July 03, 2014, 9:58 AM), http://www.law360.com/articles/553454/a-close-look-at-puerto-rico-s-bankruptcy-like-legislation ("On June 28, Puerto Rico's governor, Alejandro Garcia Padilla, signed into law restructuring legislation that provides a judicial debt relief process in Puerto Rico's courts for certain public corporations…"); *see* Chutchian, *supra* note 11.

[35] *See* Recovery Act, Stmt. Of Motives, §E., ("The Recovery Act is modeled on Title 11 of the United States Code ('the federal Bankruptcy Code'), and particularly on Chapter 9 of that title."); Weiser-Varon et al., *supra* note 34 ("[T]he legislation is modeled on Chapter 9 and Chapter 11 of the U.S. Bankruptcy Code . . . and is in all practical respects a nonfederal bankruptcy statute.").

[36] 11 U.S.C. §109(c) (2006).

[37] Franklin California Tax-Free Trust v. Puerto Rico, No. 14-1518, 2015 WL 522183, at *2, *2 (D. Puerto Rico Feb. 6, 2015) citing Recovery Act §201(b).

[38] *Id.* at *2 citing Recovery Act §310.

[39] *Id.* at *2 citing Recovery Act §301(d).

[40] *Id.* at *2 citing §315(e).

[41] 11 U.S.C. §109(c) (2006).

One of the primary concerns addressed by the United States Constitution is the balance between state sovereignty and the power of the federal government. The Tenth Amendment states that all power not granted to the federal government by the Constitution is reserved to the states.[42] Under Article I of the United States Constitution, Congress alone is granted the authority to create the Bankruptcy Code.[43] However, this does not mean that the states are not allowed to create their own "collective creditor regimes"[44] based on common law concepts.

A fundamental aspect of the common law insolvency scheme is the creation of a legal structure for the assignment of an insolvent debtor's assets as an alternative to formal bankruptcy proceedings.[45] The assignment for the benefit of creditors is a voluntary transfer of property by the debtor,[46] which is inherent in the ownership of property.[47] This transfer of property is a common law right that exists independent of statute.[48] However, this insolvency framework becomes problematic when the debtor's assignment of his assets provides preferential treatment to some creditors at the expense of others.[49] "Although outside the bankruptcy context, there is nothing wrong in preferring certain creditors to others, in the bankruptcy context, preferential transfers are

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[42] U.S. CONST. amend. X.

[43] Alan J. Feld, Note, *The Limits Of Bankruptcy Code Preemption: Debt Discharge and Voidable Preference Reconsidered In Light of* Sherwood Partners, 28:3 CARDOZO L. REV., 1447, 1460-1 (2006) citing U.S. CONST. art. 1, §8, cl. 4 ("[T]he Constitution's Bankruptcy Clause sets forth Congress's power to establish 'uniform Laws on the subject of Bankruptcies throughout the United States.'").

[44] *Id.* at 1448.

[45] *Id.* at 1460-1.

[46] *Id.* at 1448.

[47] *Id.* at 1449 citing Note, *Discharge by Assignment For the Benefit of Creditors*, 36 VA. L. REV. 813, 813 (1950) ("The right of a debtor to make a voluntary assignment for the benefit of his creditors has always been recognized as a right inherent in the ownership of property. It does not depend upon statutes, as it creates an express trust partaking of the nature of a private contract.").

[48] Feld, *supra* note 43, at 1460 citing Note, *Statutory Regulation of Assignment for the Benefit of Creditors*, 47 YALE L.J. 944, 945 (1938).

[49] *Id.* at 1449 ("Typically, statutes regulating general assignments do not permit the assignee to prefer certain creditors to others.").

usually considered inequitable because the transfer limits funds that would otherwise be shared by similarly situated creditors."[50]

A state's involvement with creditor transfers, such as assigning a trustee, or passing legislation to formalize insolvency procedures, conflicts with the Bankruptcy Code to the extent it goes beyond the common law assignments for the benefit of creditors[51] to provide for a formal structure for the discharge of debt.[52] "The presence of a discharge provision evidences a 'true' bankruptcy statute, and, since 1898, has been considered an essential feature of the bankruptcy scheme in the United States."[53] This is the central tension between the sovereign power of the states and the reach of the federal government under the Bankruptcy Code.[54]

The states themselves have never been allowed access to the Bankruptcy Code, but the Code was silent on the matter of a municipality claiming bankruptcy until 1934, when, in the aftermath of the Great Depression, many municipalities became insolvent.[55] Municipal bankruptcies were problematic for the Code from a Tenth Amendment

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[50] *Id.* at 1450 (internal citations omitted).

[51] *Id.* at 1452 ("[S]ome state statutes might be preempted [by the Bankruptcy Code] if they constitute 'complete bankruptcy legislation' and do not merely codify preexisting common law concepts underlying an assignment for the benefit of creditors.").

[52] *Id.* at 1451 (stating that the three main Supreme Court cases on which Judge Alex Kozinski in Sherwood Partners Inc. v. Lycos, Inc., 394 F.3d 1198 (9th Cir.)(2005), relied on in determining that the Bankruptcy Code preempts the preference avoidance portion of the California state creditor benefit assignment law, "stand for the proposition that discharge is the limit of preemption." (citing Stellwagon v. Clum, 245 U.S. 605 (1918); Int'l Shoe Co. v. Pinkus, 278 U.S. 261 (1929); Pobreslo v. Joseph M. Boyd Co., 287 U.S. 518 (1933))).

[53] *Id.* at 1455.

[54] Feld, *supra* note 43, at 1452 (citing Nahum L. Gordon, *The Security Interest in Inventory Under Article 9 Of The UCC And The Preference Problem*, 62 COLUM. L. REV. 49, 59 (1962) ("No invasion by a state law affording debtors a discharge will be tolerated.")("State laws will be suspended to the extent of actual conflict with the Act.").

[55] Juliet M. Moringiello, "Goals and Governance in Municipal Bankruptcy," 71 WASH. & LEE L. REV. 403, 440 (2014) ("Congress enacted the predecessor statute to today's Chapter 9 in 1934, in emergency legislation passed as the United States was recovering from the Great Depression."); John C. Philo, *Local Government Fiscal Emergencies and the Disenfranchisement of Victims of the Global Recession*, 13 J. L. SOC'Y 71, 80 (2011) (explaining that almost 5,000 cities defaulted on their debts during the Great Depression).

perspective,[56] since in order for a municipality to declare bankruptcy, the municipality was required to use federal law.[57] A municipality granted the right to declare bankruptcy by the federal government led to a constitutional conflict between the federal government and the state.[58] Congress could not grant a municipality the power to declare bankruptcy without violating the Tenth Amendment's protection of the state's sovereignty.[59] However, a state could not provide its municipalities the right to declare bankruptcy based on state statutes because a discharge from debt "could not be enforced against a creditor from another state who did not participate in the discharge proceeding"[60] under the Contracts Clause.[61] Over time, the balance of power between the two was delineated through case law, as legal challenges became more frequent.

Congress' first attempt to create a national municipal bankruptcy scheme in 1936 was struck down by the Supreme Court in the 1936.[62] Congress' intent in passing the act was to bridge the gap between the limitations imposed on the federal courts by the Tenth Amendment and limitations imposed on the states by the Contracts Clause.[63] In so doing, Congress extended the Bankruptcy Code to allow the federal government to oversee the

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[56] Moringiello, *supra* note 55, at 451 (The Supreme Court upheld the 1937 bankruptcy statute, known as Chapter X, passed by Congress at the center of the case of United States v. Bekins, 304 U.S. 27 (1938), because it recognized that the statute was "narrowly drawn so as not to interfere with state sovereignty," in deference to "the states' control over their fiscal affairs.").

[57] *Id.* at 451 (The Supreme Court in United States v. Bekins, 304 U.S. 27 (1938), "emphasized the policy of cooperation implied by the bankruptcy law, explaining that the state 'invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue…'").

[58] *Id.* at 451 (citing United States v. Bekins, 304 U.S. 27 (1938)) ("[T]hrough the state's 'cooperation with the national government the needed relief is given.").

[59] *Id.* at 451 (citing United States v. Bekins, 304 U.S. 27 (1938)) ("[T]he debtor municipality must have been authorized by state law to take all action necessary to implement the plan.").

[60] *Id.* at 444 (citing Ogden v. Saunders, 25 U.S. 213 (1827)).

[61] U.S. CONST. art. 1, §10, cl. 1.

[62] Ashton v. Cameron Cnty. Water Improvement Dist., 298 U.S. 513 (1936) (The Act of May 24, 1934, added three sections (§§ 78-80) to the Bankruptcy Code, purporting to permit State subdivisions that were unable to pay their debts to resort to the federal bankruptcy courts to readjust their obligations as they came due.).

[63] Moringiello, *supra* note 55, at 440.

financial restructuring of a state's municipalities.[64] The Supreme Court found this extension of power to be akin to the limitation imposed on the states by the Contracts Clause.[65] In essence, the Court held that the end results, requiring a creditor to take less than what he had originally contracted for, which was denied to the states by the Contracts Clause,[66] could not be achieved by an act of Congress.[67]

Congress replaced the first national municipal bankruptcy law in 1937.[68] This second attempt at a federal municipal bankruptcy structure, known as Chapter X, closely mirrored the relationship between the states and the common law insolvency scheme.[69] This approach protected the sovereignty of the states by granting the Bankruptcy Court the power to oversee the restructuring of the municipality's finances only if the debtor municipality was first granted authorization by state law.[70] Congress made the municipal bankruptcy provisions a permanent part of the Bankruptcy Code in 1946.[71]

B) Puerto Rico and United States Statehood

An important question to consider in assessing the constitutionality of Puerto Rico's Recovery Act is whether Puerto Rico should be considered no different than a state, and therefore denied the right to access the Bankruptcy Code, or whether as a sovereign entity if it is free to make its own laws regarding debt restructuring.

The United States colonized Puerto Rico after winning the Spanish-American

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[64] *See* Ashton v. Cameron Cnty., 298 U.S. 513 (1936).
[65] *See id.*
[66] Moringiello, *supra* note 55, at 410 ("The Contracts Clause [ ] prohibits the states from passing laws that would force a creditor to accept less than what it is owed on a claim without that creditor's consent.").
[67] Ashton v. Cameron Cnty., 298 U.S. 513, 531 (1936) ("The Constitution was careful to provide that 'no State shall pass any Law impairing the Obligation of Contracts.' This she may not do under the form of a bankruptcy act or otherwise. Nor do we think she can accomplish the same end by granting any permission necessary to enable Congress so to do.").
[68] U.S. v. Bekins, 304 U.S. 27 (1938).
[69] Act of August 16, 1937, 50 Stat. 653.
[70] *See* Bekins, 304 U.S. 27 (1938); *see also* Moringiello, *supra* note 55, at 452.
[71] Kenneth N. Klee, *Introduction*, 32 CAL. BANKR. J. 221, 221 (2012).

War in 1898.[72] In 1917, Puerto Rico's citizens became United States citizens[73] when Puerto Rico became a United States territory after the passage of the Jones-Shafroth Act by President Woodrow Wilson.[74] Even though citizens of the United States, the citizens of Puerto Rico do not have the same rights and responsibilities as American citizens. For example, Puerto Rico's citizens are not allowed to vote in presidential elections, nor do they pay federal taxes.[75] However, the United States Supreme Court, for the most part, treats Puerto Rico as if it were one of the states.

In the case of Examining Board of Engineers, Architects & Surveyors v. Flores de Otero,[76] the Supreme Court observed that Puerto Rico could conceivably be considered a state and noted its uniqueness: "We readily concede that Puerto Rico occupies a relationship to the United States that has no parallel in our history… ."[77] More pointedly, in the case of Calero-Toledo v. Pearson Yacht Leasing Co.,[78] the Court approvingly quoted an observation from the First Circuit that "Puerto Rico has … not become a State in the federal Union like the 48 States, but it would seem to have become a State within a common and accepted meaning of the word."[79] In the Supreme Court case of Rodriguez v. Popular Democratic Party,[80] the Court expressly stated that "[i]t is not disputed that the fundamental protections of the United States Constitution extend to the inhabitants of

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[72] Mireya Navarro, *A New Debate on the Fate (And State) of Puerto Rico*, N.Y. TIMES, Mar. 30, 1989, http://www.nytimes.com/1998/03/30/us/a-new-debate-on-the-fate-and-state-of-puerto-rico.html?pagewanted=all.
[73] 8 U.S.C. §1402 (2006) ("All persons born in Puerto Rico on or after January 13, 1941, and subject to the jurisdiction of the United States, are citizens of the United States at birth.").
[74] Andrew Glass, *Puerto Ricans granted U.S. citizenship March 2, 1917*, POLITICO (Mar. 2, 2008, 7:42 AM), http://www.politico.com/story/2008/03/puerto-ricans-granted-us-citizenship-march-2-1917-008771#ixzz3nWobwqkI.
[75] *Id.*
[76] 426 U.S. 572.
[77] *Id.* at 596.
[78] 416 U.S. 663 (1974).
[79] *Id.* at 672 (1974) quoting Mora v. Mejias, 206 F.2d 377, 387 (1st Cir. 1953).
[80] 457 U.S. 1 (1982).

Puerto Rico."[81] The Court even went so far as to say, "[i]n particular, we have held that Puerto Rico is subject to the constitutional guarantees of due process and equal protection of the laws."[82]

Of greater concern is whether Puerto Rico's public corporations qualify as municipalities under the Code. The Code defines a municipality as a "political subdivision" or "public agency" or "instrumentality of a state."[83] One of the more problematic aspects of Puerto Rico's financial situation is the lack of distinction between Puerto Rico and its public corporations, or as *The Washington Post* referred to them, Puerto Rico's "state-run" corporations.[84]

For example,

> [Puerto Rico Electric Power Authority] PREPA is governed by a nine member board comprised of the Secretary of DTPW, and six members appointed by the Governor with the advice and consent of the Senate, and two members [who] represent the consumers' interest elected in a referendum carried out by the Puerto Rico Consumer Affairs Department. … The Commonwealth provides financial support to PREPA through legislative appropriations.[85]

Furthermore, according to one report, "successive administrations turned to the bond market to plug gaping budget deficits."[86] If there is no distinction between Puerto Rico and its state-run corporations, then how can it be argued that Puerto Rico's utility companies should be allowed to declare bankruptcy under the Bankruptcy Code, where

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[81] *Id.* at 7.
[82] *Id.* at 7 (emphasis added).
[83] 11 U.S.C. §101(40) (2006).
[84] Michael A. Fletcher, *Can Bankruptcy Save Puerto Rico's State-Run Corporations?*, WASH. POST, Feb. 26, 2015, www.washingtonpost.com/blogs/wonkblog/wp/2015/02/26/can-bankruptcy-save-puerto-ricos-state-run-corporations/.
[85] JESÚS F. MÉNDEZ RODRÍGUEZ ET AL., P.R. TREASURY DEP'T, COMPREHENSIVE ANNUAL FINANCIAL REPORT 73 (2011).
[86] Fletcher, *supra* note 6.

Puerto Rico is prohibited from using the Code, when in effect they are mere extensions of the sovereign itself?[87] Municipalities like Detroit and New York City were separate entities with politically appointed governing bodies, separate and apart from the state. The same cannot be said for the Puerto Rico Electric Power Authority (PREPA).[88]

Although the Bankruptcy Code provides for an instrumentality of the state to declare bankruptcy under its definition of a municipality, similar to its treatment of Puerto Rico, the Code flat-out denies Puerto Rico's municipalities from seeking debt adjustment pursuant to Chapter 9.[89] No matter how Puerto Rico's financial structure is analyzed, Puerto Rico[90] and its municipalities[91] are denied reorganization protection under Chapter 9 of the United States Bankruptcy Code.

C) The Recovery Act and The Supremacy Clause

Another important issue to consider in determining the constitutionality of the Recovery Act is whether the Bankruptcy Code preempts Puerto Rico's legislation. Article 4, Section 2 of the United States Constitution, known as The Supremacy Clause, states that the Constitution is the Supreme Law of the land.[92] As such, where Congress has written a law under authority of the Constitution, a state may not write a law to the

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[87] *See* Lubben, *supra* note 15.
[88] *Puerto Rico Power Authority Restructuring Plan To Aim At Consensus-Donahue*, REUTERS (Sept. 17, 2014), *available at* http://www.reuters.com/article/2014/09/18/usa-puertorico-prepa-donahue-idUSL1N0RJ03N20140918 ("Donahue's [a newly hired restructuring expert] actions are subject to approval by PREPA's board, which is dominated by government appointees.").
[89] Franklin Cal. Tax-Free Trust v. P.R., No. 14-1518, 2015 WL 522183, at *2, *2 (D. Puerto Rico Feb. 6, 2015).
[90] 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 of this title.").
[91] Franklin Cal. at *2 (citing 11 U.S.C. §101 (52)) ("Puerto Rico municipalities are expressly prohibited from seeking debt adjustment pursuant to Chapter 9.").
[92] U.S. CONST., art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land…").

contrary.[93] Federal law may preempt state law 1) expressly, 2) by implied occupation of a field, or 3) by implied exclusion of conflicting state regulation.[94]

> When Congress acts within constitutional limits, it may expressly preempt state law. Field preemption occurs when the federal regulatory scheme is so 'pervasive' that it would be a reasonable inference that Congress left no room for the States to supplement it. Finally, as for conflict preemption, where the federal government, in the exercise of its superior authority in a field, has enacted a complete scheme of regulation and has therein provided a standard . . . states cannot, inconsistent with the purpose of Congress, conflict or interfere with, curtail or complement, the federal law, or enforce additional or auxiliary regulations.[95]

Although Congress' jurisdiction to create the Bankruptcy Code is directly delegated to it by the United States Constitution, set forth in Article I, Section 8, Clause 4,[96] it is widely recognized that it was not Congress' intent to preempt the field.[97] On the contrary, it is critical for an effective national bankruptcy scheme that the Code work in conjunction with state sovereignty.[98] The limit of state power in the realm of municipal bankruptcy is the establishment of the priority of the municipality's creditors. State sovereignty, with regards to the enactment of insolvency statutes, does not permit states to determine whether a creditor in a bankruptcy proceeding will be repaid. The power to discharge debt belongs solely to Congress.[99] The Act however, ignores such state

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[93] U.S. CONST., art. VI, cl. 2 ("…and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."); Int'l Shoe Co. v. Pinkus, 278 U.S. 261, 265 (1929) ("States may not pass or enforce laws to interfere with or compliment the Bankruptcy Act or to provide additional or auxiliary regulations.").
[94] Feld, *supra* note 43, at 1462 (quoting Pac. Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n, 461 U.S. 190, 203-4 (1983)).
[95] Feld, *supra* note 43, at 1462 (internal citations omitted).
[96] U.S. CONST., art I, § 8, cl. 4.
[97] *See* Moringiello, *supra* note 55.
[98] Moringiello, *supra* note 55, at 452 ("The Court emphasized the policy of cooperation implied by the bankruptcy law, explaining that the state 'invites the intervention of the bankruptcy power to save its agency which the State itself is powerless to rescue,' adding that through the state's 'cooperation with the national government the needed relief is given.'") (citing U.S. v. Bekins, 304 U.S. 27 (1938)) .
[99] Feld, *supra* note 43, at 1462.

restrictions by going beyond a common law bankruptcy scheme to provide a debtor with a way to fully discharge its debts.

The District Court case of Franklin California Tax-Free Trust v. Puerto Rico[100] addressed the legality of Puerto Rico's Recovery Act based on the consolidated complaints of Puerto Rico's public corporation bondholders.[101] The plaintiffs in Franklin California made a Supremacy Clause claim, as well as a Contracts Clause claim and a Takings Clause claim.[102] Regarding the plaintiff's Supremacy Clause claim, the Court held that in its passage of the Bankruptcy Code, Congress expressly preempted state law to the extent that it binds non-consenting creditors.[103]

The plaintiff's Contracts Clause claim stems from Article I, Section 10, Clause 1 of the United States Constitution, which prohibits states from interfering in the contractual agreements between private parties. The bondholders in Franklin California claimed that the Recovery Act violates the Contracts Clause by impairing the contractual obligations imposed by the Authority Act and the Trust Agreement, contractual obligations entered into by the public corporations with its debt holders.[104] The court held that Section 903(1) of the Bankruptcy Code prohibits states from passing laws that adjust or discharge financial agreements between private parties which require a creditor to accept an amount less than is owed under his agreement with the debtor.[105]

Under the Fifth Amendment of the United States Constitution, The Takings Clause forbids the federal government from taking private property for public use without

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[100] No. 14-1518, 2015 WL 522183 (D. Puerto Rico Feb. 6, 2015).
[101] *Id.* at *3.
[102] *Id.* at *3.
[103] *Id.* at *12.
[104] *Id.* at *3.
[105] Franklin Cal. Tax-Free Trust v. P.R., No. 14-1518, 2015 WL 522183, at *13 (D. Puerto Rico Feb. 6, 2015).

just compensation to the owner.[106] This same provision is applied to state and local governments by the Fourteenth Amendment under the Due Process Clause.[107] In Franklin California, the plaintiffs claimed that the Recovery Act allows Puerto Rico to take the plaintiff-bondholder's contractual right to seek the appointment of a receiver and their right to liens on Puerto Rico Electric Power Authority's revenues without just compensation in violation of the Takings Clause.[108]

Although its ruling is certain to be appealed, the District Court ultimately found the Recovery Act to be unconstitutional as a violation of both the United States Constitution's Supremacy and Contracts Clauses.[109] As for the right of Puerto Rico's public corporations to claim bankruptcy protection, the Court devoted exactly one sentence to this concern, stating flatly, "Puerto Rico municipalities are expressly prohibited from seeking debt adjustment pursuant to Chapter 9."[110]

## III. ALTERNATIVE SOLUTIONS FOR PUERTO RICO'S FISCAL PROBLEMS

Regardless of whether the Recovery Act is ultimately held to be unconstitutional, the commonwealth will still need to address its financial problems. This section explores the ways other municipalities have addressed similar fiscal crises and considers which options might provide a workable solution for Puerto Rico.

Beyond the question of the constitutionality of the Act, the problem with the solution put forth by Puerto Rico lies in the fact that Puerto Rico itself is an interested

[106] U.S. CONST. amend. V.
[107] U.S. CONST. amend. XIV, § 1.
[108] Franklin Cal. at *2, *3.
[109] *Id.* at *3.
[110] *Id.* at *3.

party.[111] Being an interested party to a reform plan is not necessarily an indication of a failure to create a workable plan,[112] but the lack of oversight is troubling.[113] Since Puerto Rico has a vested interest in eliminating its public corporations' debts without being required to make any changes, Puerto Rico's passage of the Recovery Act provides a solution which lacks hope for any significant reform.[114] By contrast, when New York City faced a substantial financial crisis in the 1970's,[115] even though Chapter 9 had been amended specifically to make it easier for a municipality of New York's size to enter into bankruptcy, New York City declined to use it.[116] Instead, the state legislature established the Municipal Assistance Corporation, which placed the city's finances under the supervision of a control board, which included state officials.[117]

In all likelihood, the debts of Puerto Rico's public entities will become the burden of Puerto Rico, and from a creditor perspective it might be difficult to distinguish between Puerto Rico and its public corporations going forward. As it currently stands, the

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[111] In re City of Detroit, Mich., 504 B.R. 97, 172-3 (2013) (Congress added a requirement to chapter 9 – 11 U.S.C. §109(c)(5) – that a debtor must have attempted a pre-bankruptcy good-faith negotiation with its creditors before it is eligible to use chapter 9.); Moringiello, *supra* note 55, at 419 ("The Moral Hazard" argument).

[112] Mario H. Lopez, *Republicans Abandoning Principles in Bailout for Puerto Rico*, THE DAILY CALLER, (Mar. 30, 2015), http://dailycaller.com/2015/03/30/republicans-abandoning-principles-in-bailout-for-puerto-rico/ ("Puerto Rico has a mind-boggling $73 billion in debt that has no chance of being repaid because there is no political will to undertake the budget cuts, pension reform, and tax policy overhaul that is necessary.").

[113] Matt Wirz et al., *Puerto Rico, Investors Enlist Ex-IMF Officials*, WALL ST. J., Apr. 12, 2015, www.wsj.com/articles/puerto-rico-investors-enlist-ex-imf-officials-1428878228 ("The Commonwealth needs to commit to developing a comprehensive plan that balances the budget with timely and transparent financial reporting.").

[114] *See* Moringiello, *supra* note 55, at 415 (Unlike Chapter 9, under which only the debtor may propose a plan of adjustment.).

[115] Adam Lisberg et al., *Fiscal Crisis in 1975 Taught New York Hard Lessons of Chopping, Freezing That Are Handy Now*, NY DAILY NEWS, Feb. 3, 2009, www.nydailynews.com/news/money/fiscal-crisis-1975-taught-new-york-hard-lessons-chopping-freezing-handy-article-1.388460.

[116] Moringiello, *supra* note 55, at 418 (quoting Michael W. McConnell et al., *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 472 (1993)) ("Both New York and Cleveland experienced significant difficulties 'due in large part to municipal mismanagement,' and neither one resorted to Chapter 9 to resolve its problems.").

[117] *Id.* at 38.

credit rating of some of Puerto Rico's public corporation's bonds have already been reduced to junk status by the credit rating agencies.[118] From an investor's perspective, it is not an unnatural conclusion to think that the inability of Puerto Rico's public corporations to honor its financial obligations would extend to Puerto Rico itself.[119] Even if the Recovery Act is ultimately struck down as being unconstitutional, rebuilding Puerto Rico's credit rating will not be easy.[120]

The following scenarios represent possible approaches Puerto Rico could use to restructure its finances without resorting to the use of the Bankruptcy Code.

<u>Approach 1: United States Bailout</u>

In the wake of the 2008 financial crisis, the United States government bailed out 947 companies totaling $613 billion in disbursements.[121] It is clear from the size of this list that the idea of the United States government bailing out failing institutions after the economic meltdown is not out of the realm of possibility. Entities on this list of recipients include Chrysler, GM and Citibank, to name just a few.[122] One positive aspect of a government bailout, in addition to the immediate financial relief, is that in providing significant financial backing, Congress often makes demands that changes be

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[118] *See* Kuriloff, *supra* note 29 ("Moody's Investors Service this week dropped its rating on about $8.8 billion in bonds from the Puerto Rico Electric Power Authority to Ba3 from Ba2, both junk grades…").

[119] Michael Corkery, *Puerto Rico's Indebted Power Utility Adds to Island's Problems*, DEALBOOK, N.Y. TIMES, July 1, 2014, http://dealbook.nytimes.com/2014/07/01/puerto-ricos-indebted-power-utility-adds-to-islands-problems/?_r=0 ("While Puerto Rico officials insist the government's debt remains sacrosanct, Moody's Investors Service downgraded the commonwealth's general obligation rating further into junk status on Tuesday, saying the Recovery Act "marks the end of the commonwealth's long history of taking actions needed to support its debt. It signals a depleted capacity for revenue increases and austerity measures, and a new preference for shifting fiscal pressures to creditors.").

[120] Larry McDonald, *Could a Puerto Rico Default Hammer the $3.7 Trillion U.S. Muni Bond Market in 2014?*, FORBES (Jan. 3, 2014), http://www.forbes.com/sites/larrymcdonald/2014/01/03/puerto-rico-default-to-re-price-the-3-7-trillion-municipal-bond-market-in-2014/2/ ("Once investor confidence is lost, it's like losing personal trust, and becomes almost impossible to get back.").

[121] Bailout Tracker: *Bailout Recipients (Detailed View)*, PROPUBLICA, *available at* http://projects.propublica.org/bailout/list/simple (last visited Apr. 28, 2015).

[122] *See id.*

implemented to help safeguard its investment.[123] These demands for changes take the difficult – and often politically unpopular – decisions necessary for the restructuring process out of the hands of, in the case of a municipality, elected officials who need voter approval to stay in office.[124] This approach allows those in charge to make the changes necessary to restructure without fear of losing their jobs. Unfortunately, this method denies voters the opportunity to have a say in the process, at least until the next election.

In the aftermath of the 2008 downturn, a great deal has been written about the government bailout of private and semi-private companies at the expense of taxpayers.[125] Another interpretation of the government bailouts is that they were shrewd investments in companies when their shares were trading at historically low prices.[126] One such example was the government bailout of Fannie and Freddie Mac. Created by the United States government to help provide home mortgages to the middle class,[127] Fannie and Freddie Mac were largely considered by investors to be backed by the full faith and credit of the

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[123] *See* David Goldman, *Congress Demands Answers On Bailout*, CNN-MONEY (Dec. 10, 2008), http://money.cnn.com/2008/12/10/news/economy/bailout_oversight_hearing/index.htm ("Rep. Maxine Waters, D-Calif., demanded to know why Treasury has not adopted a plan put forth by the Federal Deposit Insurance Corp. to use bailout funds to directly help mortgage holders. 'You don't have a comprehensive plan to deal with foreclosures [and] until you do, please don't come here and ask for another penny - I will work 24 hours a day to make sure you don't get another dime.'").

[124] *See* Martin Sullivan, *The Obama Administration's Backdoor Bailout of Puerto Rico*, FORBES (Jan. 28, 2014), http://www.forbes.com/sites/taxanalysts/2014/01/28/the-obama-administrations-backdoor-bailout-of-puerto-rico/ (alluding to the fact that actions have consequences, especially for politicians)("Without committing itself to a legal position, Treasury has provided certainty that has enabled Puerto Rico to raise taxes in the most politically painless way imaginable.").

[125] *See* Hester Pierce, *The Real Cost of the 2008 Bailouts*, U.S. NEWS & WORLD REPORT (Mar. 14, 2012, 12:15 PM), http://www.usnews.com/opinion/blogs/economic-intelligence/2012/03/14/the-real-cost-of-the-2008-bailouts; Mark Gongloff, *Bailout Costing Taxpayers Billions, TARP Watchdog Reports*, HUFFINGTON POST (Jan. 30, 2013, 12:01 AM), http://www.huffingtonpost.com/2013/01/30/bailout-cost-taxpayers_n_2576057.html; Martin Karnitschnig et al., *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, http://www.wsj.com/articles/SB122156561931242905.

**126** Joe Light, *Treasury Department: Fannie, Freddie Bailout Wasn't a Loan*, WALL ST. J., Apr. 21, 2015, http://blogs.wsj.com/developments/2015/04/21/treasury-department-fannie-freddie-bailout-wasn't-a-loan/ ("The bailout wasn't a loan, but an investment on which taxpayers are now being compensated.").

[127] Binyamin Appelbaum, *Without Loan Giants, 30-Year Mortgage May Fade Away*, N.Y. TIMES, Mar. 3, 2011, *at* http://www.nytimes.com/2011/03/04/business/04housing.html

United States.[128] On the verge of bankruptcy in 2008, the federal government took both companies under receivership.[129] The government helped keep the companies afloat by offering a $187.5 billion loan.[130] Today, that entire loan has been paid back and Fannie and Freddie are on their way to being profitable again.[131] The same can also be said of the federal bailout of both GM and Chrysler.[132] Similarly, with regards to Puerto Rico's public corporations, if the federal government provided the capital necessary to help restructure their outstanding debts, it could be another opportunity to buy a company's debt at rock-bottom prices with the potential for future profits.

Although the government was willing to bailout once-great companies like Chrysler and GM, it has rarely shown the same willingness to do so for a municipality,[133] even for three of the nation's largest – Detroit, Washington, D.C., and New York City.

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[128] MARK JICKLING, CONG. RESEARCH SERVICE, RS22950, FANNIE MAE AND FREDDIE MAC IN CONSERVATORSHIP (2008) ("the market has long believed that Fannie and Freddie debt was 'implicitly' guaranteed by the government…").

[129] Matthew Frankel, *The Government Might Leave Fannie Mae and Freddie Mac Alone*, THE MOTLEY FOOL (Apr. 17, 2015), http://www.fool.com/investing/general/2015/04/17/fannie-mae-and-freddie-mac-might-stay-in-conservat.aspx ("Fannie Mae and Freddie Mac are both under government conservatorship as a result of the bailouts given during the financial crisis.").

[130] *See* Light, *supra* note 127 ("After getting taken over by the U.S. government, mortgage-finance companies Fannie Mae and Freddie Mac took a bailout of about $187.5 billion.").

[131] *See id.* ("To date, the companies [Fannie and Freddie] have paid the government more than $228 billion, $40 billion more than they took in the bailout.").

[132] Damon Lowney, *GM, Chrysler Bailouts Saved 2.6 Million Jobs*, AUTOBLOG.COM (Dec. 10, 2013, 1:01 PM), http://www.autoblog.com/2013/12/10/gm-chrysler-bailouts-saved-money-jobs/ ("[T]he US Treasury has officially sold off the rest of its stake in GM (and Chrysler has already paid back its loan)."); Jerry Hirsch, *GM, Chrysler Federal Bailouts Were Net Economic Gain, Report Argues*, L.A. TIMES, Dec. 9, 2013, www.latimes.com/business/autos/la-fi-hy-gm-bailout-cost-20131209-story.html ("As the federal government gets ready to sell the last of its shares in General Motors Co., a research institute has calculated the final bill on the auto industry bailout and says that taxpayers were net winners," when looked at from the perspective of the effect of the bailout on the overall economy.); *but see* Eric Beech, *U.S. Government Says It Lost $11.2 Billion on GM Bailout*, REUTERS (Apr. 30, 2014), *available at* http://www.reuters.com/article/2014/04/30/us-autos-gm-treasury-idUSBREA3T0MR20140430 ("The U.S. government lost $11.2 billion on its bailout of General Motors Co (GM.N), more than the $10.3 billion the Treasury Department estimated when it sold its remaining GM shares in December . . . The $11.2 billion loss includes a write-off in March of the government's remaining $826 million investment in "old" GM, the quarterly report by a Treasury watchdog said.").

[133] *See* Fletcher, *supra* note 6 ("Officials in San Juan and Washington are adamant that a federal bailout is not on the table, but the situation is being closely monitored by the White House, which recently named an advisory team to help Puerto Rican officials navigate the crisis.").

Detroit, Michigan, once famous for being the home of the Big Three auto manufacturers, had been on a steady decline for decades as a change in consumer preference for foreign made cars accelerated during the mid-1980s.[134] Unable to stem the tide against it after the 2008 recession, Detroit found itself unable to pay its bills after its residential and business entities were largely abandoned.[135] Nowhere in the public discourse about how to turn around the finances of this once great city was the suggestion of a government bailout;[136] and none was ever provided. In 2012, Detroit was allowed to declare bankruptcy and is the largest United States city to ever do so.[137]

In the early-nineties, Washington D.C. faced its own fiscal crisis.[138] In attempting to help get Washington back on its feet, Congress passed the District of Columbia Financial Responsibility and Management Assistance Act of 1995.[139] "The Act created a financial control board to oversee the finances of the District of Columbia and granted the board the power to override decisions made by the District of Columbia's mayor and city council."[140] It is important to note that D.C., similar to Puerto Rico, is not a state, nor is it a municipality.[141] Chapter 9 of the Bankruptcy Code requires a state to authorize a municipality to access the Code.[142] Because Washington D.C. is not a municipality or a

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[134] *See Anatomy of Detroit's Decline*, N.Y. TIMES, Dec. 8, 2013, *at* http://www.nytimes.com/interactive/2013/08/17/us/detroit-decline.html?_r=0

[135] *See* Mark Niquette, *Detroit Bankruptcy Underscores Rift Between City, Suburbs*, BLOOMBERG (July 29, 2013), *at* http://www.bloomberg.com/news/articles/2013-07-29/detroit-bankruptcy-underscores-rift-between-city-and-its-suburbs

[136] *See* Mark Steyn, *The Downfall of Detroit*, NAT'L REV., July 19, 2013, *at* http://www.nationalreview.com/article/353959/downfall-detroit-mark-steyn

[137] *See* Nathan Bomey et al., *Detroit Becomes Largest U.S. City to Enter Bankruptcy*, USA TODAY, Dec. 3, 2013, *at* http://www.usatoday.com/story/news/nation/2013/12/03/detroit-bankruptcy-eligibility/3849833/

[138] *See* Smith et al., *supra* note 2.

[139] *See id.*

[140] *See id.*

[141] *See* PROFESSOR G. RAY WARNER, SORRY D.C., YOU'RE NOT A MUNICIPALITY, GREENBERG TRAURIG RESTRUCTURING REVIEW (2014).

[142] Michael W. McConnell et al., *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 457 (1993) ("Section 109(c)(2) [of the Bankruptcy Code] preserves

State, Congress was able to create the control board to oversee the restructuring of its finances.[143] Significantly though, although Congress was instrumental in helping to establish a financial restructuring plan for D.C., it did not provide a bailout.

As for New York City, a headline from 1975 referring to President Ford's resistance to helping New York City with its fiscal crisis of that time seems to sum up the government's perspective on municipal bailouts. The headline read, "Ford to City: Drop Dead."[144] With this history in mind, it is highly unlikely that the Congress will provide such assistance to Puerto Rico,[145] but never say never.[146]

Approach 2: Creditor Negotiations

From the most basic perspective, Puerto Rico's use of its Recovery Act could be seen as "the nuclear option."[147] That is to say that its use would completely wipe away all of the debt of its public corporations, but it would also completely wipe away all of the equity of its bondholders. This is a very drastic move that would have far reaching effects.[148] Although much more difficult, negotiating with creditors in an attempt to find

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the power of the states to determine the extent to which their political subdivisions have access to the powers of the bankruptcy court.").

[143] *See* Smith et al., *supra* note 2.

[144] Lisberg et al., *supra* note 116.

[145] *See* Sullivan, *supra* note 124 ("[J]ust last week a White House spokesperson said, 'There is no deep federal assistance being contemplated at this time.'").

[146] *See id.* ("The Obama administration has already provided a multibillion-dollar bailout to Puerto Rico.").

[147] In re City of Detroit, Mich., 504 B.R. 97, 173 (2013) (Section 11 U.S.C. §109(c)(5) of the Bankruptcy Code, which required a debtor-municipality to negotiate with its creditors prior to entering Chapter 9, was enacted "because Congress recognized that municipal bankruptcy is a drastic step and should only be taken as a last resort.").

[148] *See* Burnett, *supra* note 1 ("In testimony before Congress, Thomas Moers Mayer, a bankruptcy expert, pointed out that if Congress grants Chapter 9 protection to Puerto Rico, it could materially impact the ability for the island's public corporations to raise money from bond sales in the near future – funds it desperately needs to keep the water running and the highways open."); Kuriloff, *supra* note 29 ("Standard & Poor's Ratings Services last week downgraded its $8.6 billion of bonds to triple-B-minus, the lowest investment grade, following a similar cut by Fitch Ratings this month, saying it may not be able to renew lines of credit it has used to purchase oil for its generating plants."); *see* Smith et al., *supra* note 2 ("[T]he downgrade could have substantial ripple effects on the entire U.S. municipal bond market, by: 1) potentially forcing mutual funds to sell their Puerto Rico bonds because by mandate or convention, such

a solution that takes the needs of both sides into account is the smartest approach. As helpful as it may appear to immediately eliminate the financial pressure the commonwealth currently faces, the after shock would be so great that the repercussions would be felt for years to come, in ways that could prove equally painful. A compromise obtained via a dialogue with its creditors on the other hand will not provide immediate and absolute relief, but neither will the after-effect be quite so painful either.[149] A good example of this approach comes from New York City's financial crisis of 1975.

In the fall of 1975, New York City's finances were on the brink of collapse.[150] After years of more affluent city-dwellers relocating to the suburbs, New York City found itself in precisely the same predicament Puerto Rico is currently facing. The defections of high-income earners to the suburbs left New York City with a diminished tax base, a seemingly insurmountable amount of debt due to a changing economy, and a commitment to a large number of social programs for a city that could no longer afford them.[151] When reviewing news reports from that time, what is most striking, and most glaringly absent from the reports regarding Puerto Rico's current situation, is the struggle between New York City and its creditors to find a workable solution.[152] Significantly, the Bankruptcy Code requires debtors seeking Chapter 9 protection to negotiate for a "good

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funds cannot hold non-investment grade bonds . . . ; and 2) triggering upwards of a billion dollars of debt acceleration.").

[149] *See* Wirz et al., *supra* note 114 ("'Puerto Rico's government has relatively low levels of debt by international standards, and tackling the deficit is manageable,' said Charles Blitzer, a former assistant director of the IMF's monetary and capital-markets department and now principal at Blitzer Consulting. 'This is doable without great pain,' he said. 'In fact, countries that have adjusted have found growth rates actually increase.'").

[150] Kim Phillips-Fein, *Lessons From the Great Default Crisis of 1975*, THE NATION (Oct. 16, 2013), *available at* www.thenation.com/article/176707/lessons-great-default-crisis-1975#.

[151] *See* Donna E. Shalala et al., *A State Saves a City: The New York Case*, 1976 DUKE L. J. 1119 (1977).

[152] *See* Daniel Hertzberg, *New York City Given 6-Month Schedule By State Court to Pay $1 Billion of Notes*, WALL ST. J., Feb. 9, 1977, at A33; *see* Shalala et al., *supra* note 151; *see* Lisberg et al., *supra* note 116; *see* Phillips-Fein, *supra* note 150.

faith" settlement with its creditors as a prerequisite for declaring bankruptcy.[153] Yet, in the articles written about Puerto Rico's financial troubles, little has been mentioned about the efforts Puerto Rico has taken to renegotiate with its creditors.[154]

Although New York City's brush with bankruptcy was difficult for those who lived through it, the approach used to rescue the city's finances without claiming bankruptcy,[155] or receiving a government bailout,[156] provides a still relevant blueprint for today's fiscal crises. Among the approaches that Puerto Rico might consider in renegotiating its debts without claiming bankruptcy is to alter the terms of the repayment. If the debt that comes to maturity this year could be restructured so that the payments are reduced to close to zero now, but then gradually increase over the life of the debt, it would give Puerto Rico some space to breathe by providing it more time to turn its financial situation around, while also making sure its creditors are still made whole. On the interest payment side, when an interest payment comes due, instead of requiring the interest payment to be paid now, if the interest is added to the principal amount due on an on-going basis, again, this would provide enough breathing room to help Puerto Rico get back on its feet, but does not allow it to completely escape its financial obligations.

Another option might be to split each share into two. The first new share having

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153 §109(c)(5)(B); In re City of Detroit, Mich., 504 B.R. 97, 172 (2013) (citing In re Sullivan Cnty. Reg'l Refuse Disposal Dist., 165 B.R. 60, 78 (Bankr.D.N.H.1994) referencing §109(c)(5)(B)) ("This section was enacted because Congress recognized that municipal bankruptcy is a drastic step and should only be taken as a last resort."); *Id.* at 176 (even though city's efforts before filing for Chapter 9 did not demonstrate "good faith" effort, "City was unable to negotiate with creditors because such negotiation was impracticable."); *but see* ROGER DUNSTAN, OVERVIEW OF NEW YORK CITY'S FISCAL CRISIS, CALIFORNIA RESEARCH BUREAU NOTE, VOL. 3, NO. 1, 1 (1995) ("New York City faced a significant fiscal crisis and almost defaulted in 1975. It was a true crisis because the nation's largest city had literally run out of money and could not pay for normal operating expenses. Timely state and federal action saved the city from defaulting on its obligations and possible bankruptcy.").

154 *See* Kuriloff, *supra* note 29 ("The year-old administration of Gov. Padilla has been trying to jump-start the economy, eliminate budget deficits and reassure investors that the U.S. commonwealth's fiscal position is improving.").

155 *See* Shalala et al., *supra* note 151.

156 Lisberg et al., *supra* note 116.

the original coupon and maturity date, the second newly created share having the original coupon, but not being payable until after the first round of shares are completely paid off, thereby reducing the amount of interest due immediately. This is not ideal, but it is far better than having the obligation being wiped away completely. Another option could be a compromise between the parties that would reduce the amount of debt, without altering share amount or the maturity of the debt. Obviously, this is the least attractive option for creditors, but it might be the best option to replace a worse-case scenario where otherwise all shareholder equity would be eliminated.

In some sovereign debt situations, there have on occasion been bondholders who refuse to go along with the negotiated compromise, suing for specific performance instead.[157] In the case of Elliot Assocs. v. Banco de la Nacion,[158] a holdout bondholder sued Peru, during its 1983 financial crisis, in order to enforce the judgment of an earlier case, Pravin Banker v. Banco Popular del Peru,[159] against the sovereign for not honoring the terms of its debt issuance.[160] In Pravin, Peru tried to restructure its debt by eliminating its bondholder-creditors and then tried to raise new capital by issuing more bonds.[161] The holdout debt holder, hedge fund Elliot Associates, sued Peru for its attempt to restructure its finances at the expense of its creditors. The court found in favor of the Elliot Associates, who then sued Peru to enforce the Pravin ruling in the United States, as well as many other jurisdictions.[162] The United States court issued an attachment order against

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[157] *See* Mitu Gulati et al., *The Market Reaction to Legal Shocks And Their Antidotes: Lessons From the Sovereign Debt Market*, 39 J. LEGAL STUD. 289 (2010).
[158] 12 F. Supp. 2d 328, 332 [S.D.N.Y. 1998].
[159] 895 F. Supp. 660, 668 [S.D.N.Y. 1995]
[160] Gulati et al., *supra* note 157, at 291.
[161] *Id.* at 291.
[162] *Id.* at 291.

payments on Peru's new debt offering in the amount of $55 million.[163]

> To bypass the risk of attachment in New York, Peru sought to use Euroclear, in Brussels, to make the planned payments. But Elliot had filed an attachment order there as well. And although the initial request for the ex parte injunction in Brussels was denied, the Court of Appeals reversed and granted the injunction. At this point, Peru faced the risk of defaulting on its Brady bonds [the new issuance], which in turn would have triggered cross-default provisions and accelerations in its other bonds. To avoid this sequence of events, Peru paid Elliot $56.3 million in an out-of-court settlement.[164]

Two important lessons can be gleaned from Peru's financial crisis. The first is that, from the United States to Brussels, contractual obligations are not to be taken lightly. Secondly, as attractive as it may seem to a struggling entity, claiming bankruptcy is neither an easy solution, nor a sure thing.[165]

## IV. THE COST OF BANKRUPTCY

Significantly, the legislation passed by Governor Padillo stops short of allowing Puerto Rico itself from using the statute to restructure its general obligation bonds.[166] However, it would be in Puerto Rico's best interest for long-term growth to avoid use of this law.[167] The most prudent path that Puerto Rico can take is to restructure the finances

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[163] *Id.* at 290.
[164] *Id.* at 292-3 (internal citations omitted).
[165] Ken Parks, *Holdout Creditors Ask Judge to Deny Argentina More Time on Defaulted Bonds*, WALL ST. J., June 24, 2014, http://www.wsj.com/articles/holdout-creditors-ask-judge-to-deny-argentina-more-time-on-defaulted-bonds-1403631222.
[166] *See* Kuriloff, *supra* note 29 (The Recovery Act "is limited to the island's public entities such as the Puerto Rico Electric Power Authority and the Highway and Transportation Authority."); *See* Cutchian, *supra* note 11 ("Puerto Rico Gov. Alejandro Garcia Padilla proposed legislation . . . passed Wednesday night by Puerto Rico's House and Senate [ ] doesn't include a way for the island's general-obligation bonds and sales-tax debt to be restructured.").
[167] *See* Burnett, *supra* note 1 ("Rather than dispensing with Puerto Rico's current debt through Chapter 9 bankruptcy protection . . . [it would] be better to find a solution that does not undermine investor confidence in the island at a time when investment is a big part of what will help lift the island's fortunes.").

of its public corporations so as to not destroy its investors' equity, thereby protecting its good will.[168] The issuance of debt has been a significant source of capital for the sovereign.[169] Many investors who purchased Puerto Rico's public corporation's debt did so for its triple-tax exempt status,[170] but also because municipal bonds were thought to be less risky than other investments.[171] Traditionally, such investors were retirees seeking to gain income from their investments,[172] rather than growth.[173] Many retirees purchase municipal bonds for the payment of dividends as a form of income replacement.[174] As it currently stands, mutual funds are the biggest holders of Puerto Rico's triple tax-free bonds.[175] For Puerto Rico to eliminate its income payment on its debt, or to eliminate its debt altogether would be devastating to these investors, which would greatly damage investor confidence in Puerto Rico. Once investor trust in Puerto Rico is destroyed, that faith will not be easily regained and the cost of raising capital will increase

168 *See id.* ("Giving Puerto Rican agencies access to Chapter 9 bankruptcy would undermine investors' faith forever.").

169 *See* Fletcher, *supra* note 6 ("…successive administrations turned to the bond market to plug gaping budget deficits.").

170 *See* Kuriloff, *supra* note 29 ("Puerto Rico debt is widely held because of its generous tax benefits.").

171 *The Safety of Municipal Bonds*, MUNICIPALBONDS.COM, http://www.municipalbonds.com/education/read/72/the-safety-of-municipal-bonds/ (last visited Apr. 28, 2015) ("Next to US treasury bonds and instruments guaranteed by the US government (this includes CDs and bank obligations guaranteed by the federal government), it could be argued that municipal bonds are the next safest category of investment.").

172 Suze Orman, *Why Municipal Bonds Might Be A Good Investment For You*, HUFFINGTON POST (Mar. 3, 2014, 11:59 AM), http://www.huffingtonpost.com/2014/02/28/why-municipal-bonds-might_n_4876116.html ("For senior citizens looking to bring in supplemental income, Suze thinks municipal bonds are the way to go.").

173 Miranda Marquit, *Income Investing vs. Growth Investing*, EVERYTHING FINANCE, http://everythingfinanceblog.com/849/income-investing-vs-growth-investing.html (last visited Apr. 28, 2015).

174 Gerald Prante, *The Importance of Dividend Income for Low-Income Seniors*, TAX FOUNDATION (Feb. 8, 2006), http://taxfoundation.org/article/importance-dividend-income-low-income-seniors.

175 Smith et al., *supra* note 2 ("Seventy-five percent of the municipal bond market own[s] Puerto Rico bonds…"); Tim McLaughlin, *Redemptions Force U.S. Mutual Funds To Unload Puerto Rico Debt*, REUTERS (Feb. 7, 2014), *available at* http://www.reuters.com/article/2014/02/07/funds-puertorico-bonds-idUSL2N0LC0SD20140207 ("Puerto Rico and its agencies have about $70 billion in debt outstanding, and much of it is held by U.S. mutual funds.").

dramatically.[176] It cannot be overstated how drastic a measure it is for a municipality to claim bankruptcy.[177]

Although the main focus of a bankruptcy claim will, by its nature, be centered on the numbers, there is also the "moral hazard" component to consider as well.[178] The moral hazard in bankruptcy is the tendency of debtors to neglect their repayment of debts to devote resources to their own interests,[179] resulting in not only the destruction of its shareholder's equity, but their trust as well. Damaging investor confidence is not only harmful to the debtor,[180] but also affects the larger economy. When investors' equity is destroyed, the ill will left in its wake creates a destabilizing force, not just for the debtor

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[176] *See* Richard Levin et al., *How To Raise Capital For A Financially Troubled Company*, *in* THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE 2008/2009 70, 70; Moringiello, *supra* note 55, at 440 (early bankruptcy commentators were concerned that State oversight of a financially burdened municipality could be problematic for lack of familiarity with the local finances, but ultimately of greater concern was the possibility of the negative fallout on the credit ratings of the state's other municipalities from the bankruptcy of a municipality without state restructuring assistance) (referencing Harold Gill Reuschlein, *Municipal Debt Readjustment: Present Relief and Future Policy*, 23 CORNELL L. Q. 365, 365 (1938)).

[177] Richard Levin et al., *supra* note 176, at 70 ("In general, a financially troubled company might raise much-needed capital through various types of debt or equity financing. The cost of each of these types of capital depends primarily on the perceived risk of repayment…"); *see* Smith et al., *supra* note 2 ("[A]ny additional financing provided to Puerto Rico might come with a [debt] yield as high as 10%. Such a yield would be over twice the yield currently being paid on highly rated municipal bonds."); *see id.* ("Reportedly, bankers at Morgan Stanley have been trying to cobble together [a financial bailout of Puerto Rico] through the sale of municipal bonds totaling $2 billion."); *see id.* ("[A] failure to attract buyers after Puerto Rico starts selling the bonds could send a signal to the U.S. municipal bond market regarding investor's lack of faith in Puerto Rico meeting its debt obligations.").

[178] Michael W. McConnell et al., *supra* note 142, at 456; *see* Fletcher, *supra* note 6 ("'I can assure you that Puerto Rico will not default,' [Puerto Rico's Governor] Padilla said. 'Puerto Rico will pay our [sic] debts. It is a constitutional obligation. But for me it is also a moral obligation.'"); *see also* McDonald, *supra* note 120 ("If there was a picture of moral hazard in the dictionary, Puerto Rico's image would be right there…"); Anna Gelpern, *A Skeptic's Case for Sovereign Bankruptcy*, 50 HOUS. L. REV. 1095, 1113 (2013) (see "Bailouts and Moral Hazard" for a discussion of politically accountable bankruptcy outcomes); McConnell et al., *supra* note 142, at 426 (suggesting there is a moral hazard in easy debt relief, where the debtor absolved of its obligations is allowed to provide its resources to its own interests instead of paying off its debts); *See* Moringiello, *supra* note 55, at 424 (noting that too much discretion afforded municipal debtors provides an easy way out without the requirement of substantial change necessary to prevent further fiscal failings); *see* Burnett, *supra* note 1 ("[The Recovery Act] abruptly and unfairly changes the rules on creditors who invested in the island in good faith.").

[179] Michael W. McConnell et al, *supra* note 142, at 456.

[180] *See* Burnett, *supra* note 1 ("In testimony before Congress, Thomas Moers Mayer, a bankruptcy expert, pointed out that if Congress grants Chapter 9 protection to Puerto Rico, it could materially impact the ability for the island's public corporations to raise money from bond sales in the near future – funds it desperately needs to keep the water running and the highways open.").

in the capital markets, but for the flow of capital in general.[181] The good will of investors is critical to an efficient market, which in turn is a vital component to a productive economy. Investor confidence is as critical to the financial structure of both a business and society as a balanced asset sheet.[182] Bankruptcy should be seen a last resort.

## CONCLUSION

Puerto Rico's Recovery Act represents the usurpation of Congress' singular authority to allow for the discharge of debt under the Bankruptcy Code, in violation of the Supremacy Clause. Regardless, there is a strong chance that Puerto Rico will be able to relieve itself of the burden of its debt, simultaneously destroying its creditors' equity.[183] However, doing so is not in Puerto Rico's best interests. The most prudent approach would be to find a way to be pay back the debt that is owed, without completely eliminating it. This article has illustrated a number of approaches that could be used to address Puerto Rico's fiscal crisis. No matter which approach Puerto Rico ultimately chooses, it is clear it will not be without pain for all parties involved.

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[181] *See* Lynn A. Stout, *The Investor Confidence Game*, 68 BROOK. L. REV. 407 (2002).
[182] Burnett, *supra* note 1 ("[Puerto Rico's creditors] will be more likely to help in the island's recovery if they do not feel shortchanged.").
[183] Andrew Scurria, *House Bill Would Open Up Ch. 9 To Puerto Rico Public Cos.*, LAW 360 (Aug. 01, 2014), http://www.law360.com/articles/563298/house-bill-would-open-up-ch-9-to-puerto-rico-public-cos (Even if the Recovery Act is found unconstitutional, Puerto Rico's representatives are working hard to find other methods of relief for Puerto Rico. A non-voting member of the U.S. House of Representatives, Pedro Pierluisi, introduced legislation to allow Puerto Rico to access Chapter 9 of the U.S. Bankruptcy Code, similar to Detroit and San Bernardino, California.); *see id.* ("Municipal debt experts told Law360 that the law might well pass…").