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Puerto Rico's New Bankruptcy Law: A Quick Fix For Its Bond Crisis?

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On June 28, 2014, Puerto Rico's Gov. Alejandro Garcia Padilla signed into law the Puerto Rico Corporations Debt Enforcement & Recovery Act (the Act), which permits certain public corporations in Puerto Rico to restructure their debt obligations. Within 24 hours, mutual funds investing in Puerto Rico's Power Revenue Bonds (the PREPA Bonds) issued by the Puerto Rico Electric Power Authority (PREPA) challenged the constitutionality of the Act, while rating agencies downgraded PREPA Bonds, sparking numerous reports of PREPA's imminent filing.

It is uncertain whether the Act will survive the constitutional challenge or how soon the Act will be invoked by Puerto Rico's public corporations. What is clear is that despite claiming to be modeled on the U.S. Bankruptcy Code (the Code), the Act lacks some of the key protections that creditors have come to expect when dealing with the U.S. system.

The Bond Crisis in Puerto Rico

The Commonwealth of Puerto Rico has been experiencing a financial crisis for at least the last six years. With its population shrinking, unemployment increasing and economy contracting, Puerto Rico has increasingly relied on the municipal bond market to fund its budget deficits. Puerto Rico's outstanding debt, including the debt of its public corporations, totals approximately $71 billion. As a result of this steady decline, rating agencies downgraded Puerto Rico bonds to non-investment grade in February 2014.

Many of Puerto Rico's public services are provided by government-owned public corporations. PREPA, for example, is the primary provider of power to the 3.6 million residents of Puerto Rico. Puerto Rico's public corporations have experienced significant operating deficits, with the combined deficit of the country's three main public corporations for fiscal year 2012-2013 reaching $800 million.[1] Like Puerto Rico itself, these public corporations have increasingly relied on the bond market to cover their recurring budget deficits, but unlike the Commonwealth, PREPA and the other public corporations have issued bonds that are secured by the revenues they generate.[2]

Statutory Gap: The Inability of Puerto Rico to File for Relief Under the Code

Before the Act, Puerto Rico and its subdivisions, agencies and instrumentalities had no statutory authority, under any body of law, to seek relief from their creditors and/or restructure their debts.

Typically, a governmental unit can rely on Chapter 9 of the Code in order to restructure

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its debt. Specifically, a governmental unit is eligible for relief under Chapter 9 as long as, among other things, it qualified as a "municipality."[3] A municipality is defined as a "political subdivision or public agency or instrumentality of a *State*."[4] However, the term "State" is defined to explicitly include Puerto Rico, *except* "for the purpose of defining who may be a debtor under Chapter 9 of this title."[5] Thus, neither Puerto Rico nor any of its subdivisions, agencies or instrumentalities is eligible to seek Chapter 9 relief.

At the same time, Puerto Rico and its subdivisions, agencies and instrumentalities are still considered "governmental units," so they are ineligible for relief under Chapters 7 or 11 of the Code,[6] and there is nothing in the Laws of Puerto Rico that permits the governmental units of Puerto Rico to restructure their debts.[7] As a result, the political subdivisions, public agencies and instrumentalities of Puerto Rico were left without any avenue under the Code or otherwise to restructure their debts or otherwise deal with their creditors.

Filling the Gap: Puerto Rico Corporations Debt Enforcement & Recovery Act

Facing mounting fiscal difficulties, the governor introduced the Act, without any prior hearings or other public proceedings, to the Puerto Rico legislature on June 25, 2014, where it was approved and signed into law within three days. The Act became effective immediately and is valid through Dec. 31, 2016 (unless otherwise extended).

Only certain public corporations in Puerto Rico are eligible for relief under the Act, and a number of entities are expressly excluded, including Puerto Rico itself (which has both GO bond debt as well as debt that it guarantees for its various public corporations and instrumentalities), its 78 municipalities and the Government Development Bank of Puerto Rico (GDB), which serves as financial adviser and fiscal agent to the Puerto Rican government. Moreover, only an eligible public corporation with GDB's express consent or GDB (at the governor's request) on behalf of an eligible public corporation can seek relief under the Act.

The Act provides two types of relief: (1) a consensual debt modification, subject to the approval of a newly-created court, under Chapter 2 of the Act, and (2) a court-supervised restructuring process under Chapter 3 of the Act.

Chapter 2: A Market-Based Consensual Debt Modification Process. Chapter 2 of the Act permits a public corporation to consensually restructure its debt with the holders of the affected debt instrument (through, among other things, interest rate adjustments, maturity extensions, debt relief, or other revisions), as long as it agrees to adopt a recovery program that includes necessary financial and operational adjustments. The stated objective of a Chapter 2 procedure is to enable the public corporation to become financially self-sufficient while "equitably" allocating the burdens of the recovery on all stakeholders, but it fails to define or provide any guidance on what would be considered "equitable." Instead, Chapter 2 seems to target and provide an avenue to restructure a particular type of debt.

A Chapter 2 proceeding is commenced by posting on the public corporation's website a notice of the commencement of a "suspension period," which identifies the debt instruments that are subject to restructuring—the so-called "affected debt instruments." There is no court filing associated with the commencement of a Chapter 2 proceeding. Once the suspension period is announced, the holders of an affected debt instrument are stayed from exercising their remedies for up to 270 days (which period may be extended). During this period, the public corporation negotiates a consensual restructuring with the holders of the affected debt instruments and formulates a recovery plan. The proposed restructuring must be approved by at least 75 percent of the creditors voting, and at least 50 percent of the debt entitled to vote must participate. Thereafter, the public corporation must seek court approval of both the restructuring proposal and the recovery plan. Upon approval by the court, the amendments become effective immediately and bind all holders of the affected debt instrument, and the public corporation's recovery program is monitored by an oversight commission comprised of three independent experts appointed by the governor.

Chapter 3: A Judicial Restructuring. Chapter 3 of the Act allows a public corporation to commence a court-supervised restructuring process to formulate an orderly debt enforcement plan. A Chapter 3 case is commenced by the filing of a petition for relief with the court, which must list the claims that the petitioner intends to affect under its debt enforcement plan and which automatically stays any actions which could otherwise be taken to enforce such claims.

During the case, the petitioner remains in control of its assets and operations, with any post-filing expenses treated as administrative claims to be paid in the ordinary course. The petitioner can obtain unsecured credit or incur debt in the ordinary course, but can also seek authority for further protections for lenders willing to extend credit, if necessary. Under the Act, the court will appoint a creditors' committee to represent the interests of the affected creditors, but limits the issues on which it can be heard and bars the committee from commencing any actions.

Chapter 3 of the Act is intended to permit the petitioner to modify certain of its debt obligations. Specifically, trade debt can be reduced when necessary and the petitioner can assign or reject contracts to which it is a party. Collective bargaining agreements are subject to rejection or modification under certain circumstances, including that reasonable efforts to negotiate a voluntary modification have failed. Secured claims can be modified if the plan provides that holders of such claims will retain the liens securing their claims. In this way, Chapter 3 of the Act closely resembles the Code. Certain claims, however, cannot be modified, including obligations for employee wages and salaries, amounts owed for certain goods and services, claims owed to another public corporation, and debts owing to the United States will all be paid in full. These seemingly broad protection for certain types of creditors is a significant departure from the priorities outlined in the Code.

Only the petitioner and GDB can propose a debt enforcement plan. The plan must provide that every affected creditor will receive at least the value it would receive if all creditors holding claims against the petitioner were allowed to enforce them on the filing date (similar to a liquidation analysis for cases commenced under the Code), plus a note providing for the possibility of additional consideration based on future performance. To be confirmed, "at least one class of affected debt [will have] voted to accept the plan by a majority of all votes cast in such class [so long as] two-thirds of the aggregate amount of affected debt in such class [has] voted."[8] Accordingly, Chapter 3 permits a public corporation to "cram-down" the plan on non-consenting creditors (similar to the Code) and can be used by a Puerto Rican public corporation to restructure its debt where it is unable to do so consensually under Chapter 2.

Future of the Act: Constitutional Challenges

Within 24 hours of the Act's passage, on June 29, 2014, a suit challenging the constitutionality of the Act was commenced by funds managed by Franklin Templeton and OppenheimerFunds holding approximately $1.56 billion of PREPA

Bonds (the Funds).[9] Another challenge was filed on July 22, 2014 by BlueMountain Capital Management, which manages funds holding more than $400 million in PREPA Bonds.[10]

Both of these suits seek a declaratory judgment that the Act violates the U.S. Constitution, including the Bankruptcy Clause, the Takings Clause and the Contracts Clause. Puerto Rico and PREPA moved to dismiss, and the Funds responded on August 11th by filing a second amended complaint and a cross-motion for summary judgment. The focus of these recent filings is whether the Constitutionality of the Act is even ripe for adjudication.

How the Act Stacks Up: Comparison With the U.S. Bankruptcy Code

In enacting the Act, the Puerto Rico legislature made it clear that it was "designed in many respects to mirror certain key provisions of [the Code], and courts and stakeholders are encouraged to review and consider existing precedent under [the Code] … when interpreting and applying this Act."[11] Despite its intent, however, the Act differs from the Code in several very critical respects, some of which are outlined below.

No Complete Discharge of Prepetition Debts. Under both Chapters 9 and 11 of the Code, a debtor receives a discharge of its pre-petition debts upon, among other things, the confirmation of its plan. In contrast, under Chapter 3 of the Act, a petitioner's pre-filing claims are not entirely discharged upon the confirmation of a plan. In addition to the debts that cannot be modified at all (described above), creditors who are not paid in full under the plan are entitled to their pro rata share of 50 percent of the petitioner's positive free cash flow, if any, after the payment of certain operating and other expenses, for 10 years following the effective date of the plan, until paid in full. While this does not necessarily mean that creditors will be made whole and does not permit creditors to pursue their remedies on pre-petition claims, it does provide a mechanism for creditors to continue to hold claims against a petitioner even after a plan has been consummated.

No Limits on Ability to Reject and Assign Contracts. Under the Code, a debtor can reject the contracts to which it is a party only if they are "executory." While the Code does not define "executory," courts generally follow the so-called "Countryman Test," which defines an executory contracts as "[a] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other."[12] In contrast, a petitioner in a Chapter 3 proceeding can reject or assign any contract, not just those that are executory. The result of this seemingly purposeful omission is that all types of contracts can be rejected, including ones where a counterparty has fully performed and where the only thing left is for the petitioner to pay.

Ability to Borrow Money and Prime Liens Without Adequate Protection. The Code requires a debtor to provide adequate protection to its secured creditors as a condition to using its cash collateral or obtaining credit with a lien equal or senior to such creditor's existing lien. While the Act also requires a petitioner to provide adequate protection in these circumstances, it also provides that "[n]otwithstanding any section of this Act conditioning the eligible obligor's or the petitioner's use or transfer of its property on adequate protection of an entity's interest in the property, if and when the police power justifies and authorizes the temporary or permanent use or transfer of property without adequate protection, the *Court may approve such use or transfer without adequate protection.*"[13] Moreover, a petitioner can prime liens solely if the proceeds are needed to perform public functions. Thus, the Act provides an explicit means for a petitioner to use cash collateral or prime a lien without providing adequate protection, stripping away one of the important protections provided to secured creditors under the Code.

No Special Protections for Derivative Contracts or Special Revenue Bonds. Finally, the Code provides special protections to non-debtor counterparties to derivative contracts, including the ability to liquidate, terminate or accelerate a derivative contract upon a debtor's bankruptcy filing despite the automatic stay and the general unenforceability of so-called ipso facto clauses, i.e., clauses that permit the termination of a contract because of the financial condition of a debtor. Such safe harbor provisions do not exist in the Act.

Similarly, Chapter 9 of the Code contains special protections for creditors holding liens on the debtor's special revenues, such that any special revenues acquired post-petition would remain subject to the pre-existing, pre-petition lien notwithstanding the application of the automatic stay. Again, the Act does not contain any such protections.

Impact of the Act

In these early stages, the Act is untested and its future is uncertain. It is unclear whether the Act will survive the current constitutional challenge, or the future challenges that are sure to follow, or whether it will ever be utilized by Puerto Rico's public corporations. What is clear is that Puerto Rico's public corporations are in a dire financial situation, and that, absent the Act, there is no statutory basis for restructuring their debts. It is also clear that the Act is almost unapologetically targeting the Commonwealth's special revenue bond holders—the strict eligibility criteria that exclude the Commonwealth and GDB (thus placing their bonds outside the Act's purview) and the notable departures from the Code's protections for special revenue bonds demonstrate that the Act is willing to impair the Commonwealth's special revenue bonds, which were previously considered to be immune from impairment, to an extent not contemplated by the Code. The focus on special revenue bonds may fix Puerto Rico's current financial crisis, but, as already evidenced by the municipal bond market's reaction, it may also have the long-term effect of destroying an important source of funding for Puerto Rico's future. In fact, with its two-year term, the Act seems purposefully designed to be a quick fix and not a permanent solution to the inability of Puerto Rico and its subdivisions, agencies and instrumentalities to restructure their debts under the Code.

1. In addition to PREPA, these include the Puerto Rico Aqueduct and Sewer Authority (PRASA) and the Puerto Rico Highways and Transportation Authority (PRHTA).
2. For example, the PREPA Bonds are secured by a pledge of all or substantially all of the present and future revenues of PREPA. A GO bond, on the other hand, is generally paid from tax revenues and is backed by the full faith and credit of the issuing municipality.
3. 11 U.S.C. §109(c).
4. 11 U.S.C. §101(40) (emphasis added).
5. 11 U.S.C. §101(52).
6. See 11 U.S.C. §§101(27) (defining "governmental unit" to include departments, agencies and instrumentalities of a state), 101(41) (defining "person" to exclude governmental units), 109(b) and (d) (providing, among other things, that only a "person" can file for Chapter 7 and Chapter 11 relief).
7. See Act, Stmt. of Motives at §B.
8. Act at §315(e).
9. See *Franklin California Tax-Free Trust v. The Commonwealth of Puerto Rico*, Case No. 14-1518 (D.P.R. June 29, 2014).
10. See *BlueMountain Capital Management v. Garcia-Padilla*, Case No. 14-01569 (D.P.R. July 22, 2014).
11. Act, Stmt. of Motives at §E. In particular, the stated purpose of Chapter 3 of the Act is to be similar to Chapter 9 of the Code "in order to provide all stakeholders with much needed familiarity in a process wrought with uncertainty." Id.
12. V. Countryman, "Executory Contracts in Bankruptcy," 57 Minn. L. Rev. 439, 446 (1973).
13. Act at §129 (emphasis added).