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SECURED TRANSACTIONS

Puerto Rico Confronts a Dilemma Of Constitutional Proportions

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The typical secured creditor would not expect to confront (or be permitted to raise) constitutional issues in a financing or restructuring. But the financial crisis in Puerto Rico is notable not only for the sheer enormity of its economic scope; it has also indeed brought creditors face-to-face with issues of constitutional proportion.

The economic environment in Puerto Rico has clearly reached a critical breaking point. With over $70 billion of debt outstanding, Puerto Rico's public debt is approximately 99 percent of its gross domestic product, compared to about 6.5 percent for the typical state.[1] According to Moody's Investors Service, on a per-capita basis Puerto Rico has more than 15 times the median bond debt of the 50 states.[2] Moreover, a recently-released report commissioned by the Government of Puerto Rico states that only 40 percent of the adult population—versus 63 percent on the U.S. mainland—is employed or looking for work.[3]

Almost a third of Puerto Rico's public debt is from general obligation bonds, with the remainder concentrated in government-owned corporations (37 percent), sales tax-backed bonds (22 percent) and municipalities (6 percent).[4] The options available to Puerto Rico to restructure this debt are both limited and challenging. chapter 9 of the U.S. Bankruptcy Code governs municipal bankruptcies.[5] But states (and commonwealths) are not eligible to file for bankruptcy either under chapter 9 or any other chapter of the Bankruptcy Code. In addition, in order to receive bankruptcy relief, a municipality, defined as a "political subdivision or public agency or instrumentality of a State,"[6] must obtain authorization from that State.[7] The definition of "State" under §101(52) of the Bankruptcy Code includes Puerto Rico, "*except for the purpose of defining who may be a debtor under chapter 9 of this title.*"[8]

Puerto Rico is unable to authorize its government corporations and municipalities to file for chapter 9 relief. This restriction has now taken center stage as Puerto Rico tries to find a solution to its ever-worsening fiscal crisis.

Given this exclusion, Puerto Rico is unable to authorize its government corporations and municipalities to file for chapter 9 relief. This is not a well-kept secret. To the contrary, many creditors relied on this very fact in providing or acquiring Puerto Rico secured debt. But this restriction has now taken center stage as Puerto Rico tries to find a solution to its ever-worsening fiscal crisis.

In June 2014, the Commonwealth enacted its own municipal bankruptcy law, the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (Recovery Act). The Act is an effort to allow specifically authorized corporations, including its three largest public corporations, namely the Puerto Rico Electric Power Authority (PREPA); the Puerto Rico Highway and Transportation Authority (PRHTA); and the Puerto Rico Aqueduct and Sewer Authority (PRASA), which owe approximately $20 billion of Puerto Rico's public debt,[9] to restructure. The Recovery Act specifically excludes the territory's general obligations issuances and sales tax-backed bonds. It also provides different protections for creditors than does chapter 9.

Almost immediately following such enactment, a group of PREPA bondholders sued in federal district court in Puerto Rico challenging the Recovery Act on multiple grounds, including that the Act was preempted pursuant to federal law. On Feb. 6, 2015, the district court in that case, called *Franklin California Tax-Free Trust v. Commonwealth of Puerto Rico*,[10] upheld such challenge and issued an injunction prohibiting enforcement of the Recovery Act. On July 6, 2015, the First Circuit Court of Appeals affirmed that ruling.[11]

As evidenced by debt defaults in Greece, Argentina and Detroit, bankruptcies of sovereign entities have become less a freak of nature and more a fact of life. Today we review *Franklin*, as well as the constitutional issues that have given rise to the tension and complex interplay between federal and state laws in regard to governmental entity bankruptcies.

Constitutional Issues

The Bankruptcy Clause of the U.S. Constitution states that "Congress shall have the power to … establish … uni-

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form laws on the subject of Bankruptcies throughout the United States."[12] Pursuant to that power, Congress enacted the first municipal bankruptcy law in 1934,[13] now embodied in chapter 9 of the modern U.S. Bankruptcy Code.[14] However, that constitutional power is limited by the Tenth Amendment, which provides that "[t]he powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."[15] Accordingly, a federal bankruptcy law that impermissibly interferes with a state's control over its municipalities violates the Tenth Amendment.

chapter 9 navigates carefully through these waters. First, it requires a state's consent before its municipalities can seek bankruptcy protection under chapter 9.[16] Sections 903 and 904 of chapter 9 further recognize and delineate the limitations on federal power. Section 903, the statute at issue in *Franklin*, states that chapter 9 "does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of such municipality" with two notable exceptions set forth in subparts (1) and (2). Under those exceptions, absent the consent of a creditor, neither (1) "a state law prescribing a method of composition of" municipal debt nor (2) "a judgment entered under such" state law, may bind such creditor.[17] Section 904 states that, absent the consent of the municipality, the bankruptcy court may not interfere with (a) any political or government power of the municipality, (b) any property or revenue of the municipality, or (c) any income-producing property of the municipality.[18] Interestingly, it is the exception in subpart (1) to §903 that is at the heart of the *Franklin* decision regarding preemption.

As a result of these restrictions, municipalities in bankruptcy have fewer restrictions than a typical Chapter 11 or 7 debtor. For example, a bankruptcy court cannot appoint a trustee to operate the municipality or convert the case to a liquidation proceeding. A municipality does not need the approval of the bankruptcy court to use, sell, or lease property during its chapter 9 case. Moreover, a chapter 9 debtor may employ professionals without court approval and the only court review of fees is in the context of plan confirmation, when the court determines the reasonableness of the fees.[19]

On the other side of the equation, a state bankruptcy law faces even higher constitutional hurdles. Clause 1 of Article 1, §10 of the U.S. Constitution, commonly known as the Contract Clause, provides that "[n]o state shall … pass any … law impairing the obligation of contracts."[20] Since bankruptcy relief typically involves an adjustment of debt obligations without all creditors' consent, courts have relied on a two-prong test in determining whether a state bankruptcy law violates that clause.[21] The first test is whether the state law has substantially impaired a contract relationship. If the answer is yes, that impairment is still permitted if it is shown to be "reasonable and necessary to serve an important government purpose."[22]

> It remains to be seen how Congress will respond to this major fiscal crisis and whether it will use the authority the district court and circuit court have so carefully preserved for it.

The plaintiffs in *Franklin* asserted violations of the Bankruptcy Clause, Contract Clause and the Takings Clause.[23] The district court rejected what it called a "somewhat novel argument" that the Bankruptcy Clause by itself preempts the Recovery Act, independent of the Contract Clause.[24] It then denied a motion to dismiss claims that the Recovery Act violated the Contract Clause and (as to the Recovery Act section prohibiting appointment of a receiver) the Takings Clause, but because no party had moved for summary judgment on these issues they were not subject to appeal.[25]

However, the primary issue decided by the First Circuit (and the district court) related to preemption. Although preemption is based on the Supremacy Clause in the U.S. Constitution,[26] many litigators do not consider it a constitutional issue in the same vein as the Contract, Takings or Bankruptcy Clauses, which impose obligations irrespective of acts of Congress.

Under the Supremacy Clause, a state law is preempted if it contravenes a federal law. There are three types of preemption: express preemption, conflict preemption and field preemption. Express preemption occurs when the language of the federal statute expressly states Congress' intent to preempt state law. Conflict preemption occurs "when federal law is in 'irreconcilable conflict' with state law," or "when the state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[27] Field preemption occurs when states "regulat[e] conduct in a field that Congress, acting within its proper authority, has determined must be regulated by its exclusive governance."[28] In *Franklin*, the issue presented on appeal was whether §903(1) of the Bankruptcy Code preempted the Recovery Act. The First Circuit held that it did on the grounds of both express and conflicts preemption.

'Franklin California'

In *Franklin*, the court of appeals first reviewed the language of §903(1), which, as noted above, provides that a "State" law imposing a "method of composition" of municipal debt may not bind a nonconsenting creditor. The court then analyzed the history and usage of the term "State" under the Bankruptcy Code in order to determine whether it applies to Puerto Rico.

The court noted that the defined term "State" in §101(52) specifically included Puerto Rico until 1978, when the modern Bankruptcy Code was adopted through the Bankruptcy Reform Act of 1978. Although that statute inexplicably failed to include a definition of "State," such omission was rectified in 1984 when amendments to the Bankruptcy Code were adopted adding back a definition. As indicated above, the definition now expressly includes Puerto Rico other than for purposes of being a debtor under chapter 9.[29] The controversy in *Franklin* was whether this 1984 amendment changed the preemptive effect of §903(1).

The court also reviewed the context

and history of §903(1). Legislative history confirmed that Congress' intent in enacting §903(1) was to prevent states from enacting laws that forced creditors to accept debt adjustments without their consent. In other words, Congress wanted to maintain uniform bankruptcy laws by preventing states from enacting their own versions of chapter 9. This included Puerto Rico, which, as the court held, has always fallen under the definition of "State," despite the changes to that definition, and the lack of a definition between 1978 and 1984.

In addition to holding that the Recovery Act was expressly preempted by §903(1), the court held that since the Recovery Act "frustrates Congress' undeniable purpose in enacting §903(1)," it was further preempted under conflict preemption principles.[30]

The defendants, among other arguments, asserted that if the court found the Recovery Act preempted, it should then determine whether §903(1) violated the Tenth Amendment by impermissibly interfering with Puerto Rico's control over its municipalities. The court flatly rejected that exercise, noting that the Tenth Amendment does not apply to Puerto Rico given its constitutional status as a territory.[31]

Finally, the court invoked Puerto Rico's constitutional status in observing that the limitations on Congress' ability to address municipal insolvency do not apply to Puerto Rico. As the court noted, in creating chapter 9 relief for states Congress was constrained by the federal structure and the Tenth Amendment. It is not so constrained in addressing Puerto Rico's municipal insolvency, and has retained for itself the ability to create better solutions.[32] In the court's view, Puerto Rico's enactment of its own municipal bankruptcy act undermines Congress' ability to choose an appropriate response to municipal insolvency in Puerto Rico.[33]

Conclusion

Franklin shows the uncertainty that non-state territories of the United States can face when applying federal bankruptcy law, and the limited recourse they have absent congressional action. Puerto Rico is seeking relief from Congress through the Puerto Rico chapter 9 Uniformity Act of 2015.[34] The bill was introduced in the House in February, and an identical bill was introduced in the Senate on July 15. The Justice Secretary of Puerto Rico has stated that the defendants intend to appeal the decision to the Supreme Court.[35] It remains to be seen whether the Supreme Court will grant certiorari, and, if so, what issues it will address. It further remains to be seen how Congress will respond to this major fiscal crisis and whether it will use the authority the district court and circuit court have so carefully preserved for it.

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1. Robert Rosenkranz, "Eight Percent Tax Free with a Government Guarantee," Huffington Post Business, The Blog (April 14, 2015), http://www.huffingtonpost.com/robert-rosenkranz/eight-percent-tax-free-wi-wi-b_b_7061214.html.

2. Mary Williams Walsh, "The Bonds that Broke Puerto Rico," N.Y. Times Deal Book, June 30, 2015.

3. See Anne O. Krueger, et al., "Puerto Rico—A Way Forward" (2015), http://www.gdbpr.com/documents/puertoricoawayforward.pdf.

4. Commonwealth of Puerto Rico Financial Information and Operating Data Report (2013), http://www.gdb-pur.com/spa/documents/commonwealthreport.pdf.

5. 11 U.S.C. §§901, 946.

6. 11 U.S.C. §101(40). Although not defined in the Bankruptcy Code, "public agencies or instrumentalities of a State" refers, in general, to cities, counties, townships, school districts and public improvement districts, as well as revenue-producing bodies that provide services paid by users rather than general taxes. Chapter 9—Bankruptcy Basics, United States Courts, http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-9-bankruptcy-basics (last visited July 31, 2015) (hereinafter U.S. Courts website—Bankruptcy Basics).

7. 11 U.S.C. §109(c)(2).

8. 11 U.S.C. §101(52) (emphasis added).

9. *Franklin Cal. Tax-Free Trust v. Commonwealth*, —F.3d—, No. 15-1218, 2015WL 4079422, at *18 (1st Cir. July 6, 2015) (hereinafter Cir. Ct. Op.) (citing the Statement of Motives, §A of the Preamble to the Recovery Act).

10. —F. Supp. 3d—, No. CIV. 14-1518 FAB, 2015 WL 522183 (D.P.R. Feb. 6, 2015) (hereinafter Dist. Ct. Op.), aff'd by Cir. Ct. Op.

11. Cir. Ct. Op. at *15.

12. U.S. Const. art. I, §8, cl. 4

13. See U.S. Courts website—Bankruptcy Basics. This statute was held unconstitutional as an improper interference with the sovereign rights of states pursuant to *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936). Congress enacted a revised Municipal Bankruptcy Act in 1937, Pub. L. No. 302, 50 Stat. 653 (1937), which was upheld by the Supreme Court. *United States v. Bekins*, 304 U.S. 27, 54 (1938).

14. 11 U.S.C. §§901-946.

15. U.S. Const. amend. X.

16. States have taken various approaches to allowing municipalities to seek chapter 9 relief. California, for example, has given municipalities almost blanket authority to file. Other states condition the right to file on various consents, such as from the governor. Some do not permit municipalities to file at all without prior authorization from the state legislature.

17. 11 U.S.C. §903.

18. 11 U.S.C. §904.

19. U.S. Courts website—Bankruptcy Basics.

20. U.S. Const. art. I, §10, cl. 1.

21. See, e.g., *United Auto., Aerospace, Agric. Implement Workers of Am. Int'l Union v. Fortuño*, 633 F.3d 37, 41 (1st Cir. 2011).

22. Id. (internal quotation marks omitted).

23. U.S. Const. amend. V, cl. 5 provides that "private property [shall not] be taken for public use, without just compensation."

24. Dist. Ct. Op. at *17.

25. See Br. for Defs.-Appellants Melba Acosta-Febo in 15-1271 & John Doe in 15-1272, 2015 WL 1395513, at *14 n.4 (March 16, 2015)..

26. U.S. Const. art. VI states as follows: "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; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding."

27. *Telecomms. Regulatory Bd. of P.R. v. CTIA-Wireless Ass'n*, 752 F.3d 60, 64 (1st Cir. 2014); see also *Barnett Bank of Marion Cnty., N.A. v. Nelson*, 517 U.S. 25, 31 (1996).

28. Dist. Ct. Op. at *17 (quoting *Ariz. v. United States*, 132 S. Ct. 2492, 2501 (2012)).

29. The District of Columbia was also excluded for this purpose. See 11 U.S.C. §101(52).

30. Cir Ct. Op. at *13.

31. Id. at *14.

32. Id. at *15.

33. In his concurring opinion, Judge Juan R. Torruella agreed with the majority that §903(1) preempts the Recovery Act, but opined that the 1984 Amendments, which added the current definition of "State" (including the exception precluding Puerto Rico from authorizing its municipalities to file for bankruptcy under chapter 9), are unconstitutional because they violate the uniformity requirement of the Bankruptcy Clause and no rational basis or clear policy reasons exist for their adoption. Id. at *15-24.

34. H.R. 870, 114th Cong. (1st Sess. 2015).

35. "P.R. Justice Department turns to U.S. Supreme Court to claim Recovery Act's constitutionality," Caribbean Bus., July 10, 2015, http://www.caribbeanbusinesspr.com/news/p.r.-justice-department-turns-to-u.s.-supreme-court-to-claim-recovery-acts-constitutionality-113374.html.