3-15-2016

A Two-Step Plan for Puerto Rico

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Introduction

As recently as Fall 2015, some observers still believed that Puerto Rico was capable of meeting all of its financial obligations and continuing to provide basic services. True, Puerto Rico had suffered from erratic politics and had been battered by economic setbacks such as the loss of a key tax deduction. But with the right correctives, the reasoning went, Puerto Rico could meet all of its obligations and begin to restore its economic health.

Almost nobody believes this anymore. Several months ago, Governor Garcia-Padilla started warning that Puerto Rico is not capable of paying all of its debts. The territory has now defaulted on some of the debts, and could default on many more when major repayment obligations come due in May and July.

Is there a way forward? We think there is. In this short article, we outline a two-part plan for correcting Puerto Rico's most urgent fiscal and financial problems.

The first step is to create an independent financial control board that has authority over Puerto Rico's budgets and related issues. Notwithstanding concerns that an externally imposed financial control board (FCB) may interfere with the decision making processes of democratically elected officials – a concern we address briefly below – properly designed FCBs can play essential roles in the rehabilitation of distressed governments. Such entities can provide expertise to officials, provide assurances to capital markets to which distressed governments typically require access, and overcome political obstacles to financial reform that elected officials might find unattractive. For those concerned that any federal intervention constitutes a "bailout," an FCB that constrains the authority of elected officials addresses the moral hazard of local overspending followed by requests for relief from centralized governments.

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In our view, the FCB needs to have significant Puerto Rico representation, but should be established and its perimeters set by Congress. The approach of having a centralized government appoint members of an FCB for one of its political subdivisions has proven effective in addressing severe financial distress in major municipalities on the U.S. mainland. In the 1970s, a pair of financial control boards—one known as the Municipal Assistance Corporation for the City of New York and the other as the Emergency Financial Control Board—played a critical role in restoring the financial health of New York City during and after its near collapse. In the 1990s, Congress created a financial control board for Washington, DC. As with New York, the control board proved highly effective. We will draw on these and other experiences in crafting the features of a potential Puerto Rico FCB.[1]

The second step is giving Puerto Rico a mechanism for adjusting its debts. By every standard measure, Puerto Rico's debts are unsustainable. In 2014, the Federal Reserve Board concluded that Puerto Rico's debt-to-income ratio exceeds 100 percent, a figure well in excess of the maximum 60 percent figure that the European Union's Stability and Growth Pact requires for its members.[2] There is no reason to believe that matters have subsequently improved. Puerto Rico's total public sector debt amounted to about $71 billion as of mid-2015, equivalent to about 103 percent of its Gross National Product.[3] The estimated present value of net unfunded pension liabilities accounts for an additional $44 billion.[4] Recent tax increases and expenditure cuts have prevented the situation from deteriorating over the past year or so, but these measures cannot easily be expanded without inducing the most productive residents and firms to exit, and one-time asset sales provide only short-term fixes to long-term problems. Puerto Rico needs to restructure its debt, but it currently does not have access to any restructuring option.

Unlike every American state, Puerto Rico is not permitted to authorize its municipalities to file for bankruptcy as Detroit, Stockton, California and other municipalities have done. The First Circuit recently held that Puerto Rico cannot even enact its own, more limited restructuring law.[5] To fix this problem, Congress could either give Puerto Rico and its municipalities access to existing bankruptcy vehicles, or it could craft an alternative restructuring framework for America's territories. We will advocate for the latter approach, as outlined below, although we believe that either approach could be used. We also propose that both a territory and its municipalities be eligible for relief, not just the municipalities.

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[1] For discussion of the various forms and roles of financial control boards, Clayton P. Gillette, Dictatorships for Democracy: Takeovers of Financially Failed Cities, 114 Colum. L. Rev. 1373 (2014).

[2] See Federal Reserve Bank of New York, An Update on the Competitiveness of Puerto Rico's Economy (July 31, 2014), available at http://newyorkfed.org/outreach-andeducation/puerto-rico/2014/Puerto-Rico-Report-2014.pdf (last visited January 20, 2016) at 5.

[3] Hunter Clark, Andrew Haughwout, and James Orr, Some Options for Addressing Puerto Rico's Fiscal Problems, http://libertystreeteconomics.newyorkfed.org/2015/11/some-options-for-addressing-puerto-ricos-fiscal-problems.html#more (last visited February 3, 2016).

[4] Id.

[5] *See* Franklin California Tax-Free Trust v. Puerto Rico, 805 F.3d 322 (1st Cir. 2015)(striking down Puerto Rico's Recovery Act). The Supreme Court agreed to review the First Circuit decision, and will hear oral arguments on March 22, 2016.

The two parts of the plan we propose are closely connected. We recommend that the FCB be given authority to initiate the restructuring process. We also recommend that Puerto Rico or other territories and their municipalities be required to demonstrate that their restructuring plan will correct any obvious governance dysfunction that has substantially contributed to fiscal distress. We consider the need for restructuring governmental organization to be sufficiently important that we recommend that it be undertaken in bankruptcy if the FCB has not implemented necessary reforms.

Even the most effective restructuring would not be a complete solution to Puerto Rico's problems. Puerto Rico needs a plan for future economic growth, and it clearly would benefit from correction of harmful economic constraints such as the artificial restriction on Medicaid reimbursements for territories. We do not address those issues directly in this Essay. We focus instead on Puerto Rico's urgent need for fiscal and political restructuring.

With each step of our proposal, we summarize the key features at the outset and then describe the key features in slightly more detail. We also address the most important potential objections.

I. A Financial Control Board for Puerto Rico

Several states have imposed some form of FCB on localities that have suffered fiscal distress, and Congress created a similar board for the District of Columbia in the 1990s. While New York City's experience in the 1970s is the most salient example, financial control boards have been used in Philadelphia; Cleveland; Chelsea, Massachusetts; Yonkers, New York; Nassau County, New York; and Buffalo, New York, among others. Unlike the emergency manager structure that has been adopted in some states, an FCB augments, rather than displaces elected officials. Ideally, the FCB can play a substantial role in returning a municipality to fiscal health and avoiding recidivism by monitoring and directing the financial affairs of a municipality that has substantially failed to provide desired public goods and services to its residents, and by playing an educative role for elected officials who are charged with serving the residents' interests. While an FCB necessarily intervenes in and arguably interferes with local autonomy, a properly designed board only minimally disrupts democratic processes and withdraws once the controlled entity satisfies objective benchmarks consistent with fiscal stability. There is at least some evidence that an FCB can leave in its wake a culture of financial responsibility and structural reforms that would have been difficult for electorally accountable officials to accomplish in light of entrenched interests that frequently contribute to fiscal distress.

Basic Framework

Here, in summary form, are the key features of the financial control board we recommend:

- Appointment of Members
  - President, after consultation with congressional committee chairs

- Membership of the Board
  - Seven members overall
  - Two ex officio members: Governor of Puerto Rico; Secretary of U.S. Treasury
  - Two of five voting members from private sector
  - Three of five voting members from Puerto Rico

- Powers of the Board
  - Authority to enter into binding debt adjustment agreements
  - Approve/disapprove annual budgets and five year plan
  - Approval authority for major contracts for goods and services
  - Approve/disapprove debt issuances
  - Receive and disburse revenues
  - Impose best practices and sanction failure to follow

- Termination and Reinstatement of Board
  - Board would terminate once fiscal benchmarks were established
  - Board would reassert active role if deficits or other specified signs of crisis returned

Discussion

Appointment of the Board

We recommend following the procedure for appointment that Congress adopted with respect to the District of Columbia Financial Responsibility and Management Assistance Authority. That procedure involved presidential appointment after consultation with the chairs of various congressional committee chairs and the Delegate to the House of Representatives from the District of Columbia. We similarly recommend that the President make appointments to the Puerto Rico FCB after consultation with the Chair of the House Committee on Natural Resources, which has jurisdiction over Puerto Rico, and the Resident Commissioner for Puerto Rico in the House of Representatives. We recognize that the current political climate may be less conducive to enactment of a law that gives Congress a lesser role in naming members of the FCB. Our recommendation is based on our view that the absence of direct representation of Puerto Rico in Congress gives the legislature less of a claim on the right of appointment. Nevertheless, we do not have a strong theoretical objection to an alternative process in which each of the President, the Speaker of the House, and the Majority Leader of the Senate appoints some proportion of the FCB's membership.

Membership

We recommend a board of 7 members, large enough to ensure representation of multiple constituencies and expertise, but not so large as to be unwieldy. Two of these should be ex officio members. One should be the Governor of Puerto Rico. Inclusion of the Governor provides legitimacy to the FCB and may diminish concerns that its creation constitutes a federal takeover of the Commonwealth. Inclusion of the Governor also allows him or her to benefit from the expertise of other members. In the New York City situation in the 1970s, for example, the mayor served as a member of the Emergency Financial Control Board for the City of New York.

The other ex officio member should be the Treasury Secretary or his/her designate. This would ensure representation of federal interests in the fiscal health of a territory of the United States. FCBs imposed by the state typically include state officers or appointees of the Governor in order to ensure that the state's interests are represented.

Of the five non-ex officio members, at least three should be from Puerto Rico. With the Governor as an ex officio member, this would give the Puerto Rico members a majority of the seats on the FCB. Members of the FCB for the District of Columbia appointed under the District of Columbia Financial Responsibility and Management Assistance Act of 1995 were required to have a primary residence in the District of Columbia or a primary place of business in the District of Columbia. We believe that is an unnecessary constraint that would deprive Puerto Rico of talent that could be of great assistance in resolving issues facing Puerto Rico. We note that the emergency manager for the City of Detroit resided in Washington, D.C. at the time of his appointment and that Puerto Rico itself relied on experts outside of Puerto Rico to evaluate and make recommendations with respect to its financial condition when it commissioned what has become known as the Krueger Report.[6] Most importantly, what Puerto Rico needs at this point in time is creative, innovative thinking about government structure and finance. While we do not doubt that qualified individuals reside in Puerto Rico, there is little reason to deny the Commonwealth the benefit of expertise about public finance and institutional design that has developed elsewhere. At the same time, we believe that a membership that is largely local enhances the likelihood that necessary reforms and austerity programs will be accepted by Commonwealth residents and officials.

We recommend that at least two of the five non ex-officio members come from the private sector. We would expect that these individuals would have substantial experience in budgeting, public debt, and capital markets. One of the functions of a board is to facilitate access to the capital markets; including members who have had experience dealing with those markets can both provide comfort to potential investors in Puerto Rico and serve as effective emissaries to sources of financial assistance. It was arguably on this theory that the original members of the Municipal Assistance Corporation for the City of New York included a senior partner at an investment banking firm; a former federal judge and law firm partner; the former Secretary of the Department of Housing and Urban Development; a political science professor; the head of New York Telephone; a stock broker; an investment banker; and the head of a New York City based business. In considering the qualifications of specific members, it is important to keep in mind the nature of the crisis that Puerto Rico is addressing. The crisis in the District of Columbia was primarily a budgetary one, characterized by a series of annual deficits. That situation is exacerbated in Puerto Rico by a debt crisis, characterized by substantial numbers and variation in creditors and obligors. Individuals from the private sector may have superior experience with credit markets, restructuring, and efficient service delivery that would underlie recommendations that address the Commonwealth's current situation.

[6] *See* Anne O. Krueger, Ranjit Teja, and Andrew Wolfe, Puerto Rico – A Way Forward, available at http://www.bgfpr.com/documents/puertoricoawayforward.pdf.

Powers of Financial Control Board

- Negotiate with creditors and enter into binding debt adjustment agreements

Some creditors have indicated an unwillingness to trust the financial figures generated by Puerto Rico concerning the degree of fiscal distress. A financial control board that was perceived as being independent of electoral politics and that is charged with obtaining or confirming accurate and reliable financial information may bring a degree of transparency and credibility to portrayals of Puerto Rico's current financial situation. These would facilitate negotiations with creditors and allow adjustments of debts in light of credible figures. We are not suggesting that the figures provided to date by Puerto Rico are inaccurate. We suggest only that negotiations require credibility about the financial position of the Commonwealth that can fostered by an independent board.

- Commission and review audits of financial statements

The control board should be given authority (and funding) to commission and review audits of Puerto Rico or any of its municipalities and affiliated entities.

- Approve/disapprove annual budgets and five-year financial plan

We recommend that the Financial Control Board be given authority to approve or disapprove Puerto Rico's annual budgets. We also recommend that the FCB require the preparation of a five-year financial plan, and that it be given authority to approve or disapprove the plan. Such plans increase transparency by providing benchmarks against which actual spending can be measured and making subsequent deviations from projected expenditures more salient. The FCB would be required to convene revenue estimating conferences with Commonwealth officials and to review and approve monthly or quarterly reports of revenues and expenditures.

We do not, however, recommend that the FCB be permitted to determine spending priorities within a balanced budget. This would preserve autonomy in financial decisions for elected officials as long as the overall budget complied with requirements. The New York Emergency Financial Control Board ("EFCB"), which augmented MAC's oversight of New York City, exercised substantial powers over that city's budget. During a control period, the EFCB had authority to approve, disapprove, or modify the city's financial plan; obtain and disburse revenues that otherwise would have flowed directly to the city; review contracts for compliance with the financial plan; and approve or disapprove borrowings. The city alone, however, retained the capacity to determine the purposes for which expenditures were to be made and the amounts of such expenditures, as long as the aggregate expenditures remained within the financial plan.

- Exercise approval authority for contracts for goods or services

Board approval should be required for all substantial contracts. This would include collective bargaining agreements with public service unions. Municipalities that have experienced fiscal distress have frequently been criticized as providing generous compensation to organized employees, as officials attempt to solidify political support.[7] An appointed FCB has the benefit of being able to evaluate the propriety of proposed collective bargaining agreements independent of the political pressures that elected officials face.

- Approve/disapprove debt issues

The board should have authority to approve or disapprove any new debt issues.

- Receive and disburse all Puerto Rico revenues

While we do not recommend that the FCB replace elected officials, as was done in Detroit, we do recommend that revenues (taxes, bond proceeds, and federal funds) that would otherwise flow to the Commonwealth should instead be received and disbursed by the FCB during a control period. This procedure, again followed in New York City, allows the FCB to withhold funds in the event that there is substantial deviation from agreed-on expenditures or cost reductions. With the FCB for the District of Columbia, each time the mayor requisitioned funds from U.S. Treasury, the U.S. Treasury deposited the funds in an escrow account controlled by the FCB. The FCB then released the funds when and as it deemed appropriate, consistent with the financial plan and budget for the year. With Puerto Rico, a similar procedure of disbursements through the FCB would assure the credit markets that the Commonwealth has incentives to act in a fiscally responsible manner, and create the strongest inducement for creation of and compliance with a financial plan.

We understand that requiring that disbursements of revenues occur through the FCB might be politically infeasible, even if fiscally prudent. Even if the FCB does not capture revenues otherwise payable to the Commonwealth, it should retain the lesser, but still effective

[7] See, e.g., In re City of Stockton, California, 542 B.R. 261 (Bankr. App. 9th Cir. 2015).

capacity to approve disbursements of Commonwealth revenues. Withholding funds from the municipality essentially becomes a "nuclear" option. If withholding funds is the only sanction available to the FCB, it may not be used because its deployment will cause the Commonwealth to default on obligations. It may be useful, therefore, to combine the option with less harsh alternatives, such as heightened review or the ability of the FCB to take direct control of municipal functions prior to or in place of withholding funds.

- Impose best practices and sanction failure to follow

The control board should have authority to impose on the Commonwealth a series of "best practices" for budgeting and accounting, both to educate municipal officials and to facilitate monitoring of fiscal performance.

This authority is has been a common feature of financial control boards in other contexts. The Ohio statute concerning financial control of distressed municipalities requires a city in a control period to adopt specified financial accounting and reporting systems. Both MAC and the EFCB had the authority to advise New York City on its management practices and budgetary practices. The EFCB required implementation of a financial management system that integrated information across financial functions and across agencies; reconciled differences in accounting methods used by different offices; and, by incorporating generally accepted accounting principles, improved monitoring of city finances.

The control board should be able to impose sanctions, including removal, against officials who violate its orders or policies.

Termination and reinstatement of board

The control board would withdraw from an active role in the management of the Commonwealth when specified fiscal benchmarks were satisfied.

But the control board should reassert an active role whenever the Commonwealth suffered one of the following events: (1) failure to adopt a balanced budget; (2) failure to pay principal of or interest on any bonds or notes when due; (3) existence of a non-minimal operating deficit in any major fund of the Commonwealth; (4) failure of the chief fiscal officer of the Commonwealth to certify that securities are saleable in amounts that will satisfy substantially all of the capital and cash flow requirements of the Commonwealth during a specified period in accordance with the financial plan discussed below.

Democratic concerns

We discuss below the need to allow governmental reorganization, either through the FCB or through the bankruptcy process. Although financial control boards are sometimes criticized as undermining democracy, if successfully implemented they can have the opposite effect, restructuring democratic processes that have failed to provide services desired by constituents at a tax price that induces residents and firms to remain in Puerto Rico. It is difficult to maintain that Puerto Rico, which has suffered an exodus of residents, a debt structure that is not sustainable, and a dwindling economy, has been acting in a manner consistent with the interests of residents, as would occur in a well-functioning democracy. If federal funds or guarantees are made available to Puerto Rico, democratic principles also suggest that federal involvement is appropriate to ensure that the Commonwealth's economy recovers sufficiently to permit repayment and that federal funds are spent in a manner consistent with expectations.

Some have claimed that a strong federally appointed FCB would amount to an assumption by the United States of sovereign authority over Puerto Rico, and would expose the United States Treasury to liability for Puerto Rico indebtedness. We conclude that these statements, certainly insofar as they relate to existing debt of Puerto Rico, are not correct. Puerto Rico debt, by its own terms, is limited to payment from stated sources, typically tax revenues or revenues generated by the operation of facilities operated by Puerto Rico instrumentalities. The U.S. has not guaranteed these debts or pledged revenues for their repayment.. The claim that creation of a federal FCB would make the United States a successor in interest and thus responsible for the debt of the Puerto Rico rests on scenarios far removed from anything that we contemplate herein. Case law recognizes that liability for pre-existing debts may attach to a new entity where a state dissolves an existing debtor municipality and replaces it with a proposed new one that contains essentially the same boundaries, tax base, or population as the dissolved entity. In those cases, the U.S. Supreme Court concluded that the "new" municipality was responsible for the debts of the "old" municipality.[8] But that is a far cry from the framework we advocate in which the debtor municipality is not dissolved at all, but is augmented by a temporary control board that exercises substantial discretion over a limited number of fiscal powers of a distressed locality.

II. A Restructuring Law for the Territories

Although an effective financial control board could bring crucial discipline to Puerto Rico's budgets and reassure credit markets, we do not believe that discipline alone is sufficient to alleviate Puerto Rico's financial distress. By every realistic yardstick, Puerto Rico's debtload is unsustainable. Because Puerto Rico does not currently have access to a formal restructuring mechanism, we recommend that Congress create such a structure.

[8] See, e.g., Mobile v. Watson, 116 U.S. 289 (1886); Meriwether v. Garrett, 102 U.S. 472 (1880).

Either of two approaches would work. Congress could give Puerto Rico access to the existing municipal bankruptcy laws in Chapter 9 of the Bankruptcy Code. Alternatively, Congress could create a new restructuring framework for Puerto Rico and the other territories, borrowing some features of Chapter 9 but including other provisions tailored more directly to the territorial context. As discussed more fully below, we recommend the latter approach, a new territorial restructuring law. If Congress were to extend Chapter 9 instead, we would recommend amending Chapter 9 to address the specific issues discussed below.

Basic Framework

Here, in summary form, are the key features of the restructuring law we recommend:

- Enact a territorial restructuring law
    - Authority: U.S. Const., Article IV Territorial Clause, and U.S. Const., Article I Bankruptcy Clause
    - Separate from current municipal bankruptcy law (Chapter 9)

- Scope: Both the territory and its municipalities may file

- Treatment of separate entities
    - Separate entities may file if the territory itself files
    - Insolvency not required for separate entities
    - Cases consolidated administratively, not substantively
        - Entities must be treated separately; but
        - Single reorganization plan permitted

- Initiation
    - Either Governor or Financial Control Board can invoke the restructuring law

- Key provisions
    - Automatic stay on litigation
    - Majority vote binds each class of creditors
    - Right to assume or reject contracts
    - Financing may be provided by public or private entities
    - Creditors protected by definitions of "unfair discrimination" and "best interests"
    - "Feasibility" includes governance reform

Discussion

A territorial restructuring law

Under current law, Puerto Rico has no formal mechanism for restructuring its debts. In 1984, Congress excluded Puerto Rico's municipalities from Chapter 9, the municipal bankruptcy laws.[9] Ordinarily, a state or territory could craft its own, more limited restructuring law even in the absence of access to federal bankruptcy law. Puerto Rico pursued this option in 2014, enacting a law known as the Recovery Act. Federal trial and appellate courts have struck down this law, however, concluding that it was preempted by a provision in Chapter 9 that restricts the right of a state to enact its own restructuring laws.[10] Although the Supreme Court has agreed to review the case, the case is not likely to be decided until summer 2016.

The most obvious solution to this predicament, in which every state has access to a restructuring option for its municipalities but Puerto Rico does not, would be to reverse Puerto Rico's exclusion from Chapter 9. Legislation that would have this effect is pending in Congress. Access to Chapter 9 is clearly preferable to the current no-man's land in which Puerto Rico finds itself; we ourselves have advocated precisely this step elsewhere.

For several reasons, however, we believe that Congress should enact a separate restructuring law for Puerto Rico and the other territories, either as a standalone restructuring law

[9] Congress adopted a definition of "State" that treats Puerto Rico as a state for other purposes under the bankruptcy laws, but not for the purposes of a filing for Chapter 9. Because only a state can authorize municipalities to file for Chapter 9 under 11 U.S.C. § 109(c), Puerto Rico and its municipalities are excluded.
[10] *See* Franklin California Tax-Free Trust v. Puerto Rico, 805 F.3d 322 (1st Cir. 2015)(striking down Puerto Rico's Recovery Act).

or as a new chapter of the Bankruptcy Code.[11] First, the territories have features that distinguish them from the states. Territories are more independent than states in some respects (e.g., they function somewhat like countries) and less independent in others (e.g., Congress has direct control over them). Second, several of Chapter 9's key requirements are an awkward fit for Puerto Rico. Chapter 9 applies only to "municipalities," a term that does not apply to Puerto Rico itself and may not apply to some of the other entities that have issued debt. In addition, some of the relevant entities might not meet Chapter 9's insolvency requirement. Third, crafting a unique restructuring law for territories will underscore that Congress's treatment of Puerto Rico has no bearing on the absence of a bankruptcy law for the states; they are separate issues.

Congress's authority to enact a restructuring law would come from the Territories Clause in Article IV of the U.S. Constitution, which gives Congress broad authority over the territories; together with the Bankruptcy Clause in Article I of the Constitution. Including all territories, rather than just Puerto Rico, would assuage any concerns that the law is not "uniform," as required by the Bankruptcy Clause.

Scope: either the territory or its municipalities may file

A key initial question is whether to give Puerto Rico (or another territory) itself access to the restructuring law, or solely Puerto Rico's municipalities. Of Puerto Rico's roughly $70 billion of debt, nearly $50 billion is owed directly or indirectly by Puerto Rico itself. Unless these obligations are restructured, Puerto Rico is unlikely to achieve enough debt reduction to adequately address its crisis. We therefore recommend that both the territory itself and its municipalities and other entities be permitted to restructure.

Treatment of separate entities

In Puerto Rico, at least eighteen different entities have issued debt. These include the Government Development Bank, which serves as Puerto Rico's fiscal agent; Prepa, the public electricity company; and Cofina, which has issued bonds secured by sales taxes. Some of these entities are not traditional municipalities—they are primarily conduits for the issuance of debt—and some may not technically be insolvent.

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[11] As noted earlier, if Congress does extend Chapter 9 to Puerto Rico instead, it will need to address most of the issues we discuss in the text that follows. Chapter 9 already includes the "key provisions" we discuss, but it does not address the other issues flagged in this part of the Article.

We recommend that the restructuring law provide that, if the FCB initiates the restructuring law (and meets its entrance requirements) for the Commonwealth, it should also be permitted to initiate proceedings for any of its municipalities or affiliated entities as well. The affiliated entities should not be subject to an insolvency requirement. Requiring every entity to demonstrate insolvency could create costly and time-consuming disputes as to whether each individual entity is insolvent, even if the territory itself and most of its entities are clearly insolvent.

If multiple entities invoke the restructuring law, we recommend that the cases be administered jointly, but that the entity boundaries be respected. Creditors of a particular entity should have first claim to the assets of that entity unless they consent to different treatment. This is roughly the approach used in the Chapter 11 reorganizations of complex private corporations.[12]

Initiation

We recommend that the governor (or principal executive) of the territory and the FCB each be given independent authority to invoke the restructuring framework. Since the governor is an ex officio member of the control board, the governor will have major input into any decision by the FCB to initiate a restructuring.

Key provisions

- Automatic stay on litigation

In an ordinary bankruptcy, the "automatic stay" prohibits creditors from suing the debtor or taking any other steps to collect what they are owed.[13] The objective is to prevent a "race to the courthouse" that could jeopardize the debtor's restructuring effort. The stay is not quite as essential for a territory or country, since it is more difficult for creditors to successfully sue a public entity. Lawsuits can nevertheless pose serious problems for a territory such as Puerto Rico. Puerto Rico already faces a growing number of lawsuits that will be costly to defend.

[12] In technical terms, courts ordinarily do not allow "substantive consolidation"—the merging of the assets and liabilities of different entities—unless the creditors that would be affected agree to the consolidation. See In re Owens Corning, 419 F.3d 195 (3d Cir. 2005).
[13] 11 U.S.C. § 362(a).

Given these realities, we believe that the restructuring law should include a stay on litigation or other efforts to collect debts or realize on collateral pledged for debts. The stay should begin as soon as the statutory restructuring process is initiated.

- Majority vote binds each class of creditors

Puerto Rico theoretically could restructure its bond debt through an exchange offer or other private arrangement outside of any formal restructuring law. Indeed, Puerto Rico entities been trying to do this with some of their debt—most notably, the debt of Prepa. The difficulty is that, even if a significant majority of bondholders favor a restructuring, the restructuring is not binding on bondholders who do not consent. This gives bondholders an incentive to hold out, since they are likely to be paid in full if most other bondholders agree to a restructuring.

To counteract this problem, the restructuring law should include a voting provision that binds all of the creditors in a class if a specified majority of the class agrees to the restructuring. Voting rules are standard in bankruptcy; this was the central feature of the earliest municipal bankruptcy laws in the 1930s. We recommend that a class of creditors be bound if two-thirds in amount of the allowed claims of the class that votes on the plan vote to accept the plan. This is similar to the voting rule that applies in corporate and municipal bankruptcy cases.[14]

- Right to assume or reject contracts

Outside of bankruptcy, it is often very difficult to terminate some kinds of contracts that are problematic for the debtor or undesirable for other reasons; and the debtor may lose its rights under a contract that <u>is</u> desirable if the debtor defaults. Bankruptcy's treatment of so-called executory contracts is designed to counteract these problems. It permits a debtor to terminate undesirable contracts and assume desirable contracts. We recommend that the restructuring law include these powers.

- Financing may be provided by public or private entities

Current bankruptcy law gives the bankruptcy court broad authority to authorize new financing for a bankruptcy debtor. The financing provision does not distinguish between private and government financers.

[14] 11 U.S.C. § 1126(c). The main difference is that § 1126(c) also includes a majority-in-number requirement. This requirement would not be likely to have a significant effect in a territorial bankruptcy.

We recommend that the restructuring law include similar financing authority. We do not recommend that the law provide a designated source of public funding, as the Dodd-Frank Act of 2010 does for systemically important financial institutions. Although the liquidity needs of a territory or its affiliated entities may be pressing in the event of financial distress, a territory is less fragile than a financial institution. We believe that the ordinary bankruptcy options for arranging financing are likely to be sufficient for a territory (as they are for municipalities under Chapter 9).

- Creditors protected by definitions of "unfair discrimination" and "best interests of the creditors"

Key issues for creditors include their concerns that their treatment be as predictable as possible, that classes of general creditors be given roughly comparable treatment, and that creditors' payout not be reduced more than is necessary. Chapter 9 attempts to address these concerns with a variety of provisions. Two of the most important are the requirements that a proposed plan not "discriminate unfairly" against any class of creditors, and that the plan be in the "best interests of creditors." Both requirements are subject to uncertainty in cases involving public entities.

With the "no unfair discrimination requirement," one of us believes that the requirement should be defined to prohibit approval of a restructuring plan in which recoveries among classes of unsecured creditors deviate more than 20%. The other believes that the specific characteristics of different debts and different creditors make limits on variations inadvisable. We both recommend that the restructuring law include a "no unfair discrimination" requirement.

Under current Chapter 9, "best interests" of the creditors has sometimes been defined to suggest that nearly any proposal is acceptable, since creditors' prospects for recovery outside of bankruptcy would be dim. The definition of "best interests" outside of Chapter 9 is frequently tied to what creditors would have received in a liquidation. Since governmental entities are not liquidated in Chapter 9, that definition requires modification. We recommend that "best interests" be included in the restructuring law, but defined to require that the proposed plan give creditors as much as "reasonably possible," consistent with the public entity's obligation to provide services to its constituents. Public entities are created to provide public goods that may not otherwise be available. As a result, we consider the maintenance of at least a baseline level of service delivery to be the primary objective of restructuring. This is consistent with the perspective of courts and commentators that have analyzed the "best interests" test in Chapter 9 proceedings.[15]

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[15] See, e.g., In re City of Stockton, California, 542 B.R. 261 (Bankr. App. 9th Cir. 2015); 6 *Collier on Bankruptcy* ¶ 943.03[7][a] (Alan N. Resnick & Henry J. Sommer eds., 16th ed.).

- Governance Reform

Under current Chapter 9, a court can only approve a proposed restructuring plan if it is "feasible"—which is generally interpreted to mean likely to succeed. Most courts focus primarily on the extent to which the plan will restructure the debtor's financial obligations, and do not consider whether governance dysfunction may have been an underlying cause of the distress. We have argued in our scholarly work that courts should decline to approve a restructuring plan as feasible if the plan does not address obvious governance dysfunction.[16] We are led to that conclusion by a view that government structure is frequently a primary cause of fiscal distress. Fragmented governmental decision making often increases the size of government as multiple actors make budgetary claims, entrenched interest groups resist reforms that reduce their share of government budgets, and lack of competition for services allows providers to ignore efficiencies.

Puerto Rico appears to exhibit many of these characteristics. Taxes and fees are not collected. A plethora of government agencies (approximately 120) provide services with insufficient centralization to avoid overlap and coordination among public services. Public sector employment has historically constituted a more substantial portion of the workforce as a share of population than is typical on the mainland. That proportion has been reduced, but the paucity of private sector employment is likely to constrain the ability to impose additional cuts in the public sector. Because these structures can contribute to inefficiencies in the delivery of public goods and services, and entrenched interests frustrate efforts at reform, we believe it is necessary that some external body be authorized to eliminate or consolidate government agencies, and to implement structural economic, labor or tax measures that promise to deliver goods and services at prices that will attract the residents and businesses necessary to economic development in the Commonwealth.

While we believe that current Chapter 9, properly understood, permits governance reform to be included in the debtor's plan of adjustment, we are sensitive to questions of statutory construction and constitutional limitations on the ability of federal bankruptcy judges to induce structural reform of municipalities. Territories, however, stand in a very different relationship to Congress than States, and thus present fewer constitutional difficulties. We recommend that any bankruptcy statute for Puerto Rico or its municipalities explicitly permit governmental restructuring as part of a "feasible" plan for a governmental debtor. Indeed, Congress explicitly became involved with governance restructuring in the District of Columbia when it required the appointment of a chief financial officer for the District and conferred on that office many of the budgetary powers previously residing in the mayor.

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[16] Clayton P. Gillette & David A. Skeel, Jr., Governance Reform and the Judicial Role in Municipal Bankruptcy, Yale L.J. (forthcoming 2016).

In the case of Puerto Rico, such restructuring might include the creation of a nonpartisan budget office along the lines of the New York City Independent Budget Office that was created after that city's brush with bankruptcy in the 1970s. It may also involve centralized authority over budgets and functions to avoid duplication of resources. At the very least, restructuring would entail modernization of budget and management to align with principles adopted for government accounting in municipalities on the mainland.

As we have noted above, an FCB could also be charged with governance reform. We are somewhat agnostic as to whether structural reforms occur as a function of FCB intervention or bankruptcy court intervention. We would authorize each to take the necessary steps as we are more concerned with the substance and implementation of structural change than with its source.

In our view, it is not necessary to explicitly define the "feasibility" requirement to require governance reform; but lawmakers may wish to include such a requirement.

A risk of contagion?

The most important concern with giving Puerto Rico access to a restructuring option is that introducing the possibility of restructuring could have damaging effects on the municipal bond market as a whole. Critics worry that confidence in the municipal bond market might decline, and that this could lead to higher interest rates and possibly a decline in market access throughout the country.

In our view, adopting a restructuring regime would not create a meaningful risk of contagion. First, although municipal defaults sometimes have effects beyond the municipality itself, these effects are usually short-term in nature and confined to the other municipalities within the same state as a municipality that has defaulted.[17] Municipal markets may not be as robust as those for securities of private companies; nevertheless, the increased requirements of disclosure and reporting with respect to municipal securities suggests that markets would be able to distinguish between distressed and nondistressed entities. Second, if the existence of a restructuring option had adverse effects on credit markets, we would expect to find bond insurers charging higher rates or credit rating agencies issuing lower ratings for bonds issued by municipalities in states that permit bankruptcy. But this does not appear to be the case. Moreover, the existing evidence suggests that interest rates may actually be lower, not higher, in states that permit bankruptcy when other factors are controlled for.[18] Finally, it is important to recognize that Puerto Rico is already unable to pay its debts. The choice is not between a restructuring option, on the one hand, and full payment, on the other. The choice is between an

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[17] See, e.g., Mardi Dungey, et al, Contagion in International Bond Markets During the Russian and the LTCM Crises, 2 J Fin Stability 1, 19 (2006); John M. Halstead, Shantaram Hegde, and Linda Schmid Klein, Orange County Bankruptcy: Financial Contagion in the Municipal Bond and Bank Equity Markets, 39 Fin. Rev. 293, 295–99, 313 (2004).

[18] See, e.g, Samir D. Parikh & Zhaochen He, The Paralysis Justification and a Unifying Approach to Municipal Restructuring (Jan 26, 2016), available at www.ssrn.com.

orderly restructuring framework and a disorderly default. From this perspective, a restructuring option seems likely to be better for the municipal bond market as a whole, not worse.

Conclusion

Puerto Rico's financial crisis is so deep that no approach is guaranteed to provide relief. But we belief that the two-step strategy we have outlined provides a realistic path forward. The proposed control board and restructuring law draw extensively on the experience of other major financial crises, ranging from New York City to Detroit. The strategies incorporated into our two-step proposal have helped to alleviate severe crises in these other contexts. We believe they offer hope for Puerto Rico.