

2015

Lights Out for Puerto Rico's Restructuring Law?: Puerto Rico's Municipal Bankruptcy Dilemma

Michael K. Piacentini

Follow this and additional works at: <https://brooklynworks.brooklaw.edu/blr>

Recommended Citation

Michael K. Piacentini, *Lights Out for Puerto Rico's Restructuring Law?: Puerto Rico's Municipal Bankruptcy Dilemma*, 80 Brook. L. Rev. (2015).

Available at: <https://brooklynworks.brooklaw.edu/blr/vol80/iss4/11>

This Note is brought to you for free and open access by the Law Journals at BrooklynWorks. It has been accepted for inclusion in Brooklyn Law Review by an authorized editor of BrooklynWorks.

Lights Out for Puerto Rico's Restructuring Law?

PUERTO RICO'S MUNICIPAL BANKRUPTCY DILEMMA¹

INTRODUCTION

Detroit's record-breaking municipal bankruptcy has captured the attention of American media recently, while the potentially more catastrophic bankruptcy looming in Puerto Rico has been underreported.² Even in the Caribbean, the focus of news reports has been on the potential normalization of U.S.-Cuba relations and not on the storm brewing in Puerto Rico.³ The Commonwealth of Puerto Rico's official debt estimate is approximately \$73.5 billion, not including an additional \$38 billion in unfunded healthcare and pension liabilities.⁴ Much of this debt is on the verge of default and, if mishandled, could have a significant negative effect on the world economy just as it is recovering from the global financial crisis.⁵

¹ On the eve of the publication of this note, the United States Court of Appeals for the First Circuit decided *Franklin Cal. Tax-Free Trust v. Puerto Rico*, Case Nos. 15-1218, 15-1221, 15-1271, 15-1272, slip. op. (1st Cir. July 6, 2015), holding that the Puerto Rico Debt Enforcement and Recovery Act is unconstitutional. I believe that the First Circuit came to the correct conclusion, for reasons that will be discussed later in the note in the context of a discussion of the district court's decision. As of the date of publication, Puerto Rico is still considering an appeal to the Supreme Court. Alan Crosby & Megan Davies, *Puerto Rico's Governor Considering Appeal Over Recovery Act Decision*, REUTERS (July 7, 2015), <http://www.reuters.com/article/2015/07/07/usa-puertorico-appeal-idUSL1N0ZN2D920150707>.

² Editorial, *Congress Can Help Ease Puerto Rico's Debt Crisis*, WASH. POST (Feb. 26, 2015), http://www.washingtonpost.com/opinions/congress-can-ease-puerto-ricos-debt-crisis/2015/02/26/535f2aee-b877-11e4-a200-c008a01a6692_story.html.

³ William M. LeoGrande, *5 Things Cuba Can Do to Speed the Normalization of Relations with the United States*, HUFFINGTON POST (Mar. 3, 2015), http://www.huffingtonpost.com/william-m-leogrande/five-things-cuba-can-do-t_b_6809824.html.

⁴ Richard Finger, *Puerto Rico: Paradise Lost*, HUFFINGTON POST (Mar. 2, 2015), http://www.huffingtonpost.com/richard-finger/puerto-rico-paradise-lost_b_6769950.html.

⁵ Belen Marty, *Surprise! Puerto Rico's Public Debt Is Far Larger Than Stated*, PANAM POST (July 16, 2014, 12:25 PM), <http://panampost.com/belen-marty/2014/07/16/surprise-puerto-ricos-public-debt-is-far-larger-than-stated/>.

The Commonwealth's government-owned public utilities, particularly the Puerto Rico Electric Power Authority (PREPA), are unable to pay their staggering debts and are nearing a fiscal catastrophe.⁶ The situation is exacerbated by the tenuous legality of a Puerto Rican municipal bankruptcy, a safety valve afforded to states but withheld from Puerto Rico under the U.S. Bankruptcy Code.⁷ Investors fear that a Puerto Rican debt crisis could negatively impact the global economy similar to the effect of the Greek debt crisis that began several years ago and continues to destabilize the global economy.⁸ At that time, people feared that if Greece defaulted it would destroy "people's faith in the ability of other countries to pay their debts . . . creating a domino effect that could cripple global markets."⁹

PREPA is one of the main culprits behind Puerto Rico's burgeoning debt. PREPA is the largest municipal power system in the U.S., in terms of customers (1.47 million) and revenues (\$4.4 billion), and is the sole electric utility on the island.¹⁰ PREPA comprises nearly \$9 billion, or 12%, of Puerto Rico's debt.¹¹ PREPA has been able to amass such a massive amount of debt because Puerto Rico's debt is widely held as a result "of its generous tax benefits, with almost two-thirds of [American] municipal-bond funds holding the commonwealth's debt."¹² This only heightens fears about the magnitude of damage that a PREPA default could cause.¹³

PREPA is currently on the verge of insolvency, and due to U.S. bankruptcy law, is unable to file for bankruptcy.¹⁴ To rectify

⁶ Tom Tzitzouris, *Why Would a Puerto Rico Debt Crisis Matter?*, FORBES (Oct. 16, 2013, 8:00 AM), <http://www.forbes.com/sites/realspin/2013/10/16/why-would-a-puerto-rico-debt-crisis-matter/>.

⁷ Editorial, *supra* note 2.

⁸ Natalie Kitroeff & Joe Weisenthal, *Why You Should Care About Greece Again*, BLOOMBERG BUS. WEEK (Jan. 2, 2015), <http://www.businessweek.com/articles/2015-01-02/why-you-should-care-about-greece-again>.

⁹ *Id.*

¹⁰ FITCH RATINGS, FITCH RATES PUERTO RICO POWER AUTH'S \$453.8M POWER REV BNDS 'BBB+'; OUTLK TO NEGATIVE (Mar. 28, 2012), *available at* <http://www.aepr.com/investors/docs/financial%20information/rating%20report/fitch%27s%20media%20release%20-%20march%202012.pdf>.

¹¹ *Puerto Rico to Pay \$9.7 mn to Restructuring Consultant*, FOX NEWS LATINO (Sept. 16, 2014), <http://latino.foxnews.com/latino/news/2014/09/16/puerto-rico-to-pay-7-mn-to-restructuring-consultant/>.

¹² Aaron Kuriloff, *Puerto Rico Moves to Restructure Debt*, WALL ST. J. (June 26, 2014, 11:54 AM), <http://online.wsj.com/articles/puerto-rico-governor-proposes-law-to-restructure-public-entities-1403724012?mg=id-wsj>.

¹³ *Id.*

¹⁴ COMMONWEALTH OF P.R., GOV'T DEVELOPMENT BANK FOR PUERTO RICO, THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT (2014), <http://www.gdb-pur.com/documents/FactsAboutDebtEnforcementAndRecoveryAct.pdf>.

the situation, Puerto Rico recently passed the Puerto Rico Public Corporations Debt Enforcement and Recovery Act (Recovery Act), which would allow PREPA and other Puerto Rican municipal entities to enter bankruptcy and modify or discharge their debts.¹⁵

PREPA bondholders fear that the passage of the Recovery Act is a prelude to a municipal bankruptcy that will greatly dilute the value of their investments.¹⁶ Several PREPA investors have banded together to challenge the constitutionality of the Recovery Act, alleging that Congress expressly excluded Puerto Rico from the municipal bankruptcy laws and that the Recovery Act's attempt to extend bankruptcy law is unconstitutional.¹⁷ Recently, in *Franklin California Tax-Free Trust v. Puerto Rico (Franklin)*, the United States District Court for the District of Puerto Rico ruled that the Recovery Act was unconstitutional.¹⁸ Specifically, the court held that it was preempted by the Federal Bankruptcy Code. However, the ruling failed to address whether there was an unconstitutional taking or if the Recovery Act violated the contracts clause.¹⁹ Puerto Rico has already filed for an appeal in the First Circuit Court of Appeals in Boston, asking for an expedited decision and claiming that the Recovery Act was an "emergency response to the most profound fiscal crisis in [the] Commonwealth[s] history."²⁰

This note argues that the District of Puerto Rico made the correct decision in deeming the Recovery Act unconstitutional, and that the Puerto Rican Legislature did not have the legislative authority to fill the municipal bankruptcy "gap" left by Congress.²¹ Part I of this note will introduce the Recovery Act, as well as the economic problems that led to its passage. Part II will discuss the potential negative economic effects that a PREPA bankruptcy could have on global, American, and Puerto Rican financial markets. A PREPA bankruptcy has the potential to shock the global economy into a recession and could have lasting negative effects on Puerto Rico, ranging from a humanitarian crisis to a lasting reputation for default, impairing

¹⁵ *Id.*

¹⁶ Andrew Scurria, *Bankruptcy Cases to Watch in 2015*, LAW360 (Jan. 2, 2015, 3:25 PM), <http://www.law360.com/articles/604190/bankruptcy-cases-to-watch-in-2015>.

¹⁷ *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518 (FAB), slip op. at 1, 7 (D.P.R. Feb. 6, 2015).

¹⁸ As mentioned earlier, the First Circuit has affirmed the ruling, and Puerto is still considering whether to appeal to the Supreme Court. *See supra* note 1.

¹⁹ *Franklin Cal. Tax-Free Trust*, slip op. at 75.

²⁰ *Update 1-Puerto Rico Asks for Quick Decision in Bankruptcy Ruling Appeal*, REUTERS (Feb. 20, 2015, 12:33 PM), <http://www.reuters.com/article/2015/02/20/us-puertorico-bankruptcy-idUSL1NOVU1MA20150220>.

²¹ COMMONWEALTH OF P.R., *supra* note 14.

the Commonwealth's ability to raise money in the future. Part III will explore the constitutional arguments against the adoption of the Recovery Act in the context of Puerto Rico's unique status as a U.S. Commonwealth. The constitutional deficiencies in the Recovery Act are numerous; the Recovery Act has been preempted by federal bankruptcy law, it attempts to impose an impermissible stay of federal litigation, and it violates both the Takings and Contract Clauses of the Constitution. Part IV will propose alternatives to the unconstitutional Recovery Act. Any realistic solution to PREPA's problems will likely need to begin with Puerto Rico's willing repeal of the Recovery Act. From there, a number of options are left to the Commonwealth; PREPA could try and revise operations to turn around the company or attempt to secure a workout with creditors. Puerto Rico's journey will not be an easy one, but the Recovery Act is not the answer to the island's problems.

I. BACKGROUND ON PREPA AND THE RECOVERY ACT

Puerto Rico (the Commonwealth) has been having economic troubles for years.²² As an American Commonwealth, Puerto Rico is subject to U.S. federal minimum wage laws and uses the American dollar as its currency.²³ These factors make it difficult for Puerto Rico to export goods internationally and effectively compete in the global market.²⁴ From 1976 until 2006, the Commonwealth was exempt from federal taxes on local profits—an exemption that helped the country stay afloat.²⁵ But once that exemption expired in 2006, it contributed to the Commonwealth's steady and continuing recession.²⁶ Moreover, Puerto Rico's available workforce has been rapidly dissipating. "From April 2010 through July 2014 Puerto Rico's population declined by over 177 thousand people and by the end of 2015 is expected to reach 3.45 million, the lowest in a century."²⁷ Even with this continuing exodus decreasing the number of eligible workers, the Commonwealth's unemployment still sits at over

²² *Puerto Rico's Debt Crisis: Neither a State nor Independent*, ECONOMIST (July 5, 2014), <http://www.economist.com/news/united-states/21606319-how-territory-falls-between-bankruptcy-regimes-neither-state-nor-independent>.

²³ *Puerto Rico Basic Facts*, COMMONWEALTH OF PUERTO RICO, GOV'T DEVELOPMENT BANK FOR PUERTO RICO, <http://www.gdb-pur.com/economy/puerto-rico-facts.html> (last visited Apr. 8, 2015); *Minimum Wage Laws in the States*, U.S. DEP'T OF LABOR (Feb. 24, 2015), <http://www.dol.gov/whd/minwage/america.htm#PuertoRico>.

²⁴ *Puerto Rico's Debt Crisis: Neither a State nor Independent*, *supra* note 22.

²⁵ *Id.*

²⁶ *Id.*

²⁷ Finger, *supra* note 4.

14%.²⁸ All of these factors contribute to the Commonwealth's economic downturn, which in turn has taken a toll on its municipal corporations.²⁹

A. *PREPA's Slide Towards Insolvency*

Puerto Rico's economic struggles have negatively impacted investors' views of the island's debt as a viable investment opportunity.³⁰ Concurrently, credit rating agencies have continuously lowered Puerto Rico and its municipal corporations' credit ratings, making it harder for the Commonwealth to secure financing.³¹ To date, PREPA's bonds are rated as "junk", indicating that they are close to defaulting.³² PREPA's bonds are rated as Caa3 by Moody's,³³ CCC³⁴ by Standard & Poor's, and CC³⁵ by Fitch.³⁶ In 2012, the bonds held a BBB+ rating from Fitch, showing just how quickly the economic situation has deteriorated.³⁷ After Detroit's bankruptcy, investors became wary

²⁸ John Burnett, *Island of Disenchantment*, U.S. NEWS (Mar. 11, 2015, 8:00 AM), <http://www.usnews.com/opinion/economic-intelligence/2015/03/11/puerto-ricos-agencies-dont-need-chapter-9-bankruptcy>.

²⁹ *Puerto Rico's Debt Crisis: Neither a State nor Independent*, *supra* note 22.

³⁰ Danielle Kurtzleben, *Puerto Rico's Population Continues Rapid Decline*, U.S. NEWS (Jan. 2, 2014, 5:48 PM), <http://www.usnews.com/news/blogs/data-mine/2014/01/02/puerto-ricos-population-continues-rapid-decline>.

³¹ *See id.*

³² *PREPA Credit Ratings*, GOV'T DEVELOPMENT BANK FOR PUERTO RICO, http://www.gdb-pur.com/investors_resources/prepa.html (last visited May 4, 2015).

³³ Bonds with a Moody's Rating of Caa "are judged to be speculative of poor standing and are subject to very high credit risk"; the "3" modifier indicates that it is the lowest possible rating within this class. A Caa rating is two steps above a C rating, which typically indicates default. MOODY'S INVESTOR SERVS., RATING SYMBOLS AND DEFINITIONS (Mar. 2015), *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

³⁴ A Standard & Poor's Rating of "CCC" means that the credit rating is "[c]urrently vulnerable and dependent on favorable business, financial and economic conditions to meet financial commitments." This is the best rating that the PREPA bonds received from the three main ratings agencies, but it is still only three levels above default and is not a positive indicator of future health. *Credit Ratings Definitions & FAQs*, STANDARD & POOR'S, <http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us> (last visited Jan. 16, 2015).

³⁵ A Fitch Rating of "CC" Denotes that a "[d]efault of some kind appears probable." It is only two steps above default. *Fitch Ratings Definitions*, FITCH RATINGS, https://www.fitchratings.com/creditdesk/public/ratings_definitions/index.cfm?rd_file=ltr#LTR (last visited Jan. 16, 2015).

³⁶ *PREPA Credit Ratings*, *supra* note 32.

³⁷ A Fitch rating of BBB+ signifies that the investment is of investment grade quality (much higher than junk bond status), and it "indicat[es] that expectations of default risk are currently low. The capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity." *Fitch Ratings Definitions*, *supra* note 35.

of municipal defaults, further impacting PREPA's ability to sell bonds to raise capital.³⁸

For a number of reasons, PREPA, the sole electricity provider in Puerto Rico, has been operating at a loss since 2011.³⁹ From 2011 through 2013, PREPA's net financial position decreased by \$272.4 million, \$346.2 million, and \$275.7 million per year, respectively.⁴⁰ This accounts for a total of nearly \$900 million in losses over the span of just three years.⁴¹ One of the reasons for PREPA's chronic underperformance is its reliance on outdated and uneconomical methods of producing electricity.⁴² PREPA still uses fuel oil to generate nearly 65% of its power, an operating process which has largely been left behind in other countries.⁴³ This technique is not only inefficient, but expensive as well. It costs PREPA nearly twice as much to produce energy as compared to other U.S. energy companies.⁴⁴ PREPA has only been able to continue making these oil purchases by taking on new debt.⁴⁵ Although the recent drop in oil prices has helped PREPA lower its costs in the short term, the lower price does not obviate PREPA's need for structural changes.⁴⁶ PREPA not only faces internal structural challenges, but faces pressure from the Puerto Rican government, which forces PREPA to grant subsidies to other government utilities—by 2017, the cost of these subsidies could account for over 17% of PREPA's income.⁴⁷ Fear for the future of the utility is justified and was one of the catalysts for the passage of the Recovery Act.⁴⁸

³⁸ Nick Reeve, *Detroit's Bankruptcy and its Impact on Your Bond Portfolio*, CHIEF INVESTMENT OFFICER (Aug. 20, 2014), http://www.ai-cio.com/channel/risk_management/detroit_s_bankruptcy_and_its_impact_on_your_bond_portfolio.html.

³⁹ PUERTO RICO POWER AUTH., FINANCIAL STATEMENTS, REQUIRED SUPPLEMENTARY INFORMATION AND SUPPLEMENTAL SCHEDULES (Jan. 16, 2014), http://www.gdb-pur.com/investors_resources/documents/PREPAFSwithIndependentAuditorsReport6-30-13.pdf.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Daniel Gross, *Why is Puerto Rico Burning Oil to Generate Electricity?*, SLATE (May 30, 2014, 11:25 AM), http://www.slate.com/articles/business/the_juice/2014/05/puerto_rico_is_burning_oil_to_generate_electricity_it_s_completely_insane.html.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ Daniel Irvin, *Low Oil Prices Could Accelerate Puerto Rico's Recovery*, SEEKING ALPHA (Jan. 9, 2015, 12:53 PM), <http://seekingalpha.com/article/2809835-low-oil-prices-could-accelerate-puerto-ricos-recovery>.

⁴⁷ Suneet Chandvani & Simone Baribeau, *Puerto Rico's Utility Siblings Prep for Subsidy Fight*, FORBES (Oct. 10, 2014, 3:46 PM), <http://www.forbes.com/sites/debtwire/2014/10/28/puerto-ricos-utility-siblings-prep-for-subsidy-fight/>.

⁴⁸ THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, *supra* note 14.

B. History of the Municipal Bankruptcy and its Application to PREPA

Municipal bankruptcies were first deemed constitutional by the Supreme Court in 1938, and since then, less than 700 cases have been filed.⁴⁹ Many of the filed cases were not actually filed by municipalities, but rather by special subsets of the municipalities, such as public utility corporations.⁵⁰ Municipalities and their subsets are banned from filing bankruptcies under all chapters of the Bankruptcy Code except for Chapter 9, which is specific to municipal bankruptcies.⁵¹ A Chapter 9 bankruptcy has unique rules that differentiate it from the processes and procedures that are followed under the other bankruptcy chapters, providing special protections to the municipalities.⁵² Many of these protections are concerned with upholding federalism principles and protecting the states' sovereignty from outside influences.⁵³ Before filing for a Chapter 9 bankruptcy, the filing municipality must first ask the state for permission and cannot file without state approval.⁵⁴ In the United States, 23 states have specified that they have not authorized their municipalities to file, leaving them unable to seek a municipal bankruptcy, and two states have expressly forbidden their municipalities from filing a Chapter 9 bankruptcy petition.⁵⁵

Municipal bankruptcies were first implemented during the Great Depression and were created by an amendment to the Federal Bankruptcy Code.⁵⁶ However, soon after their introduction, the Supreme Court struck down the new municipal bankruptcy laws over concerns that Congress was abrogating the states' sovereignty.⁵⁷ In 1937, Congress again tried to amend the bankruptcy laws to allow for municipal bankruptcies, and this

⁴⁹ Juliet M. Moringiello, *Goals and Governance in Municipal Bankruptcy*, 71 WASH. & LEE L. REV. 403, 406 (2014) (providing background on the history of the municipal bankruptcy).

⁵⁰ *Id.*

⁵¹ Seena Foster, *Eligibility for Chapter 9 Bankruptcy Relief, Applicable to Municipalities, Pursuant to 11 U.S.C.A. § 109(c)*, 57 A.L.R. Fed. 2d 121, 133 (2011).

⁵² Hannah Heck, *Solving Insolvent Public Pensions: The Limitations of the Current Bankruptcy Option*, 28 EMORY BANKR. DEV. J. 89, 97 (2011).

⁵³ *Id.*

⁵⁴ *Puerto Rico Chapter 9 Uniformity Act of 2015: Hearing on H.R. 870 Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. 3-4 (2015) [hereinafter *Hearing on H.R. 870*] (testimony of Thomas Mayer, Partner, Kramer Levin Naftalis & Frankel LLP).

⁵⁵ *Id.*

⁵⁶ Pub. L. No. 251, 48 Stat. 798 (1934).

⁵⁷ *Ashton v. Cameron Cnty. Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936).

time they were more careful concerning limitations placed on the states.⁵⁸ In particular, there was a concern that state functions would be put into the hands of the bankruptcy court or creditors.⁵⁹ State sovereignty is one of the central concerns in municipal bankruptcies. In fact, the preface to Chapter 9 explicitly states that the chapter “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, including expenditures for such exercise.”⁶⁰

These limitations affect what a municipal bankruptcy can accomplish—the municipality cannot just liquidate and walk away as a corporation can.⁶¹ Similarly, there are limitations on the effects that bankruptcy can have on other entities, such as the municipality’s constituents.⁶² “Chapter 9 was never intended to serve as a comprehensive scheme to solve municipal financial problems; it was designed to complement state efforts to solve those problems.”⁶³ Furthermore, municipal bankruptcies raise a host of difficult questions; for example, in the Detroit bankruptcy there was concern over how much recovery would go to the bondholders based on their legal contracts and how much would go to the municipal workers’ pension plans.⁶⁴ Municipal bankruptcies are much more circumscribed than other bankruptcies, and in many cases the protections are necessary, but these limitations can also create more problems than they solve.

C. *PREPA and its Potential Municipal Bankruptcy*

An understanding of the history of Chapter 9 municipal bankruptcy is essential to understanding how Puerto Rico’s unique situation interacts with the purposes and intentions of Chapter 9. The tensions of federalism have played an important role in the creation and application of Chapter 9 bankruptcy law, and Puerto Rico occupies a unique niche in this area. Additionally, many of the processes surrounding Chapter 9 remain unsettled due to a

⁵⁸ Pub. L. No. 302, 50 Stat. 653 (1937).

⁵⁹ *Id.*

⁶⁰ 11 U.S.C. § 903 (2012).

⁶¹ Cory Eucalitto et al., *Municipal Bankruptcy: An Overview for Local Officials*, STATE BUDGET SOLUTIONS (Feb. 26, 2013), <http://www.statebudgetsolutions.org/publications/detail/municipal-bankruptcy-an-overview-for-local-officials>.

⁶² *Id.*

⁶³ Moringiello, *supra* note 49, at 485.

⁶⁴ Danielle Kurtzleben, *Detroit Bankruptcy Could Affect City Workers Nationwide*, U.S. NEWS (Dec. 3, 2013, 5:15 PM), <http://www.usnews.com/news/articles/2013/12/03/detroit-bankruptcy-could-affect-city-workers-nationwide>.

relative lack of case law.⁶⁵ Puerto Rico's status as a commonwealth makes it even harder to draw on this limited pool of precedent.

Puerto Rico's commonwealth status both grants it unique advantages and creates certain obstacles.⁶⁶ In 1900, the Foraker Act established Puerto Rico as an unincorporated territory and introduced the position of the Puerto Rican non-voting delegate to Congress.⁶⁷ In 1952, Puerto Rico became a commonwealth, a status which it continues to hold today.⁶⁸ Legally, while Puerto Rican citizens are U.S. citizens, Puerto Rico is subject to U.S. federal laws that do not always provide the same benefits to Puerto Ricans as they do to state citizens.⁶⁹ Today, Puerto Rico still has one non-voting representative in Congress, Representative Pedro Pierluisi.⁷⁰

Under the current construction of the Federal Bankruptcy Code, PREPA has no bankruptcy outlet.⁷¹ As a municipal corporation, PREPA is excluded from either liquidating under Chapter 7, or filing for reorganization under Chapter 11.⁷² Additionally, Chapter 9 of the U.S. Bankruptcy code explicitly excludes Puerto Rican municipal entities from being able to file for municipal bankruptcy.⁷³ Per the Bankruptcy Code, "[t]he term 'State' includes . . . Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title."⁷⁴

In response to PREPA's economic degradation, Puerto Rico passed the Recovery Act, which would allow Puerto Rican municipal entities to enter bankruptcy.⁷⁵ According to the Puerto Rican government, one of the main reasons for the implementation of the Act was "to fill the gap in restructuring law and ensure that no critical services are jeopardized."⁷⁶ The Commonwealth

⁶⁵ Rachel E. Schwartz, *This Way To The Egress: Should Bridgeport's Chapter 9 Filing Have Been Dismissed?*, 66 AM. BANKR. L.J. 103, 104 (1992).

⁶⁶ See generally Lani E. Medina, *An Unsatisfactory Case of Self-Determination: Resolving Puerto Rico's Political Status*, 33 FORD. INT'L L.J. 1048 (2010) (an article exploring Puerto Rico's history in relation to the United States, the current status of the Commonwealth, and how this confusing and unresolved situation can be resolved with finality).

⁶⁷ The Foraker Act, Pub. L. No. 56-191, 31 Stat. 77 (1900).

⁶⁸ Medina, *supra* note 66, at 1048-49.

⁶⁹ *Id.* at 1049-50.

⁷⁰ Kyle Glazier, *Pierluisi Offers Bill to Include Puerto Rico under Muni Bankruptcy Law*, BOND BUYER (July 31, 2014, 4:08 PM), <http://www.bondbuyer.com/news/washington-budget-finance/pierluisi-offers-bill-to-include-puerto-rico-under-muni-bankruptcy-law-1064876-1.html>.

⁷¹ 11 U.S.C. § 101(52) (2014).

⁷² Moringiello, *supra* note 49, at 406 n.7.

⁷³ 11 U.S.C. § 101(52).

⁷⁴ *Id.*

⁷⁵ THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, *supra* note 14.

⁷⁶ *Id.*

recognizes that the federal government left Puerto Rico out of the municipal bankruptcy equation, stating that Puerto Rican municipalities “fall into an unintended gap in the legal system.”⁷⁷

The Commonwealth expressly excluded itself from being able to utilize the Recovery Act and limited the Recovery Act’s applicability to a few select municipal corporations, including PREPA.⁷⁸ Many speculate that the Recovery Act was actually drafted solely for use by PREPA.⁷⁹ The Recovery Act presumes to allow municipal bankruptcies under either Chapter 2 or Chapter 3, both of which present different ways for the public corporations to restructure their debts.⁸⁰

Under a Chapter 2 proceeding, the municipal corporation is seeking consensual debt relief with its creditors.⁸¹ The statute presupposes that debtors will attempt to utilize this route before commencing a nonconsensual Chapter 3 proceeding; however, the statute does not put any restrictions in place to assure this result.⁸² Fundamentally, in a Chapter 2 proceeding, the municipal debtor agrees to make structural and operating changes in return for refinancing its debts with creditors, similar to a workout.⁸³ “A workout is a negotiated process by which a financially troubled debtor and its creditors agree to modify certain terms of the claims against the debtor in order to permit it to stay in business.”⁸⁴

Chapter 2 cases may only be initiated by the municipal corporation, and once commenced by the filing of a notice, an automatic stay comes into effect for at least 270 days.⁸⁵ The automatic stay is a principal feature of U.S. bankruptcy law.⁸⁶ The stay prohibits creditors from attempting to hunt down and levy on the debtor’s assets and allows for a systematic and orderly distribution or reorganization of the debtor’s estate.⁸⁷ Generally, under U.S. bankruptcy law, the automatic stay protects the

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ Kevin Mead, *Financial Restructuring in Duties of PREPA’s New CRO Post*, CARIBBEAN BUS. (Aug. 19, 2014, 1:35 PM), <http://caribbeanbusinesspr.com/news/financial-restructuring-part-of-duties-of-prepas-new-cro-post-99796.html>.

⁸⁰ THE FACTS ABOUT PUERTO RICO’S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, *supra* note 14.

⁸¹ The Puerto Rico Corporation Debt Enforcement and Recovery Act, Act 71-2014 (2014). English translation available at <http://www.lexjuris.com/lexlex/Leyes2014/lexl2014071d.htm> [hereinafter The Recovery Act].

⁸² *Id.*

⁸³ *Id.*

⁸⁴ Richard E. Mendales, *We Can Work It Out: The Interaction of Bankruptcy and Securities Regulation in the Workout Context*, 46 RUTGERS L. REV. 1211, 1220 (1994).

⁸⁵ The Recovery Act, *supra* note 81.

⁸⁶ 11 U.S.C. § 362 (2012).

⁸⁷ *Id.*

debtor for the duration of the bankruptcy case.⁸⁸ But this is not the case under the Recovery Act, which gives the debtor protection for the first 270 days of the case, but requires 20% of a creditor class to approve 90-day extensions beyond that.⁸⁹ For a final municipal restructuring plan to be approved, creditors holding at least 50% of the debt need to vote on the plan, and of that amount, holders of at least 75% of the total debt value need to approve the transaction.⁹⁰ However, as with U.S. bankruptcy cases, once the plan has been approved, it is binding on all creditors.⁹¹ The Recovery Act characterizes this path as “designed to be efficient and expedient in light of the consensual nature of the transaction.”⁹²

Alternatively, a public corporation may choose to follow the more structured and court-intensive Chapter 3 path, which requires the approval of the Government Development Bank (GDB) for a proceeding to commence.⁹³ The law places several constraints on who can utilize this path, in addition to the general requirements mentioned above. The municipal corporation needs to be insolvent, and it needs to fall within the “gap” that Puerto Rico aims to fill with the passage of the Recovery Act.⁹⁴ To fit in this “gap,” the corporation must be ineligible to file under the Federal Bankruptcy Code, because it is ineligible for a Chapter 7 or Chapter 11 bankruptcy and is not a “municipality” for the purposes of filing for Chapter 9.⁹⁵ Beyond this, Chapter 3 resembles Chapter 11 of the current U.S. Bankruptcy Code, in that it allows a restructuring of debt which the court can force on creditors.⁹⁶

While both of the Recovery Act’s chapters draw on current U.S. bankruptcy law, there are some key differences that could cause problems. First, by creating a new municipal bankruptcy law, Puerto Rico has rendered it harder to draw on the already limited pool of municipal bankruptcy precedent.⁹⁷

⁸⁸ *Id.*

⁸⁹ The Recovery Act, *supra* note 81.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.*

⁹³ *Id.*; The GDB serves “as bank, fiscal agent and financial advisor for the Commonwealth of Puerto Rico, and its instrumentalities.” And its mission is “[t]o safeguard the fiscal stability of Puerto Rico and promote its competitiveness in order to transform our economy into one of the most developed economies in the world, hence, fostering the social and economic enhancement” of Puerto Rico. *Mission*, GOV’T DEV. BANK FOR PUERTO RICO, <http://www.gdb-pur.com/about-gdb/mission.html> (last visited Mar. 22, 2015).

⁹⁴ The Recovery Act, *supra* note 81.

⁹⁵ *Id.*

⁹⁶ *Id.*

⁹⁷ Moringiello, *supra* note 49, at 406.

This will only make it more difficult for a court to wade through the convoluted rules of a municipal bankruptcy. More troubling still are the changes made to the automatic stay. The automatic stay and its ability to prevent a mad dash to consume the debtor's assets at the expense of other creditors is one of the core values of the bankruptcy system.⁹⁸ The changes made to the automatic stay in Chapter 2 of the Recovery Act contravenes one of the essential purposes of bankruptcy laws by limiting the duration of the stay and subsequently putting its renewal in the hands of creditors.

II. EFFECTS OF ALLOWING THE RECOVERY ACT TO STAND

The passage of the Recovery Act has already had economic effects that will only worsen as the situation continues to unfold. Investors have been spooked by the Act's passage, making it harder for Puerto Rico to borrow the money that it needs to survive. If this continues to worsen, it could lead to a default, leaving investors with billions of dollars of near-worthless debt.⁹⁹ Legally, the Recovery Act sets a dangerous precedent in bankruptcy and constitutional law. If PREPA's situation worsens and it is forced to default or to utilize the Recovery Act, there could be unintended humanitarian effects as well.

Allowing the Recovery Act to stand would exacerbate the negative economic effects that followed its passage.¹⁰⁰ PREPA's bond ratings dropped precipitously following the Recovery Act's passage.¹⁰¹ PREPA and Puerto Rico's ability to raise capital by selling bonds was limited to begin with, but the ratings drop has lowered investor confidence, making it even harder for them to

98

The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that.

S. Rep. No. 95-989, at 49 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5835.

⁹⁹ Finger, *supra* note 4; Michelle Kaske, *Puerto Rico Facing Debt Risk Beyond Power Utility: Muni Credit*, BLOOMBERG (Jan. 13, 2015, 8:00 PM), <http://www.bloomberg.com/news/2015-01-14/puerto-rico-facing-debt-risk-beyond-power-utility-muni-credit.html>.

¹⁰⁰ Marty, *supra* note 5.

¹⁰¹ *PREPA Credit Ratings*, *supra* note 32.

borrow.¹⁰² When Moody's downgraded Puerto Rico's credit rating, Puerto Rico's Governor Padilla said, "[t]hat credit agency, and any other entity acting alike, will have to answer for this offense," and threatened a lawsuit.¹⁰³ Recently, while the rest of the municipal bond market has had a bit of a rally, Puerto Rico and PREPA's bonds have continued to backslide, signifying decreased consumer confidence in the Commonwealth's bonds.¹⁰⁴ News agencies are reporting that "[t]he market action suggests that sophisticated investors are beginning to realize that Puerto Rico's economic and fiscal situation is unlikely to turn around anytime soon," and that "[g]iven the current morass, it is hard to recall the happy decades during which Puerto Rico was the belle of the municipal bond market."¹⁰⁵

This ratings drop not only hurts the value of the current Puerto Rican bonds in the market, but also affects Puerto Rico's ability to successfully raise capital in the future. This is a problem not only for PREPA, which needs to continue to incur debt to continue producing power, but also for the island as a whole, which needs to raise capital from bonds to maintain a stable economy.¹⁰⁶ Since passing the Recovery Act, the Commonwealth of Puerto Rico has only raised money on the market once, selling approximately \$1.2 billion of short-term notes to large banks in October 2014 at a high yield.¹⁰⁷ The notes contained an uncommon covenant that required the purchasing banks to agree not to resell the debt.¹⁰⁸ Investors speculate that "[t]he commonwealth . . . may have wanted to keep the bonds from trading immediately to avoid the risk that falling prices might undermine investor confidence."¹⁰⁹ The note covenants show that the market recognizes the uncertainty that the Recovery Act represents, and this fear manifests itself in Puerto

¹⁰² Arturo C. Porzecanski, *Puerto Rico Needs a Financial Control Board*, HILL (Oct. 24, 2014, 2:00 PM), <http://thehill.com/blogs/congress-blog/economy-budget/221593-puerto-rico-needs-a-financial-control-board>.

¹⁰³ Simone Baribeau, *Puerto Rico's Public Relations Headache*, FORBES (July 28, 2014, 12:13 PM), <http://www.forbes.com/sites/mergermarket/2014/07/28/puerto-ricos-public-relations-headache/>.

¹⁰⁴ Porzecanski, *supra* note 102.

¹⁰⁵ *Id.*

¹⁰⁶ Kaske, *supra* note 99.

¹⁰⁷ Matt Wirz & Aaron Kuriloff, *Puerto Rico to Sell \$1.2 Billion in Notes on Unusual Terms*, WALL ST. J. (Oct. 7, 2014, 6:12 PM), <http://online.wsj.com/articles/puerto-rico-to-sell-1-2-billion-in-notes-on-unusual-terms-1412715249>.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

Rico paying additional interest and imposing special restrictions for the ability to raise capital.¹¹⁰

Further, the Recovery Act not only has economic effects, but changes how the world perceives Puerto Rico as a sovereign entity, impacting the Commonwealth's "dignity."¹¹¹ "Cities, states, and countries are considered to be sovereign in some respects, and bankruptcy seems un-seemly—an assault on the dignity of a sovereign."¹¹² A recent example of the effect this can have on a sovereign entity is Argentina, which unilaterally decided to restructure its debts without investor consent. Due to this, the government "risks leaving deep structural problems for any subsequent administration, not only in the Argentine economy but in the legal and financial relationship with the developed world, all of which may take years to repair."¹¹³ Puerto Rico's Governor Alejandro Garcia Padilla "proposed the new rules and the legislature passed them in a single day," without comments or hearings, leading many to believe that it was "a statement of unwillingness to stand by the legal commitments of the commonwealth."¹¹⁴ Puerto Rico risks further endangering its economic relationships and potentially burning bridges that the Commonwealth will need in the future if it is unable to balance its finances.

PREPA is the sole provider of power for the Commonwealth, and if forced to restructure, it would likely need to shut off power to customers, presenting a humanitarian issue.¹¹⁵ PREPA's economic troubles have become so severe that they are considering cutting a subsidy to the Puerto Rico Aqueduct and Sewer Authority (PRASA), which provides water services for the island.¹¹⁶ The discount currently stands at approximately \$40 million a year, and if removed could push the already financially

¹¹⁰ *Id.*

¹¹¹ Nick Brown et al., *Puerto Rico Debt Crisis Headed for U.S.-Style Bankruptcy Resolution*, REUTERS (July 23, 2014, 2:22 PM), <http://www.reuters.com/article/2014/07/23/us-puertorico-debt-analysis-idUSKBN0FS0A420140723>.

¹¹² David A. Skeel, Jr., *When Should Bankruptcy Be an Option (for People, Places or Things)?*, 55 WM. & MARY L. REV. 2217, 2226 (2014).

¹¹³ Hans Humes, *Who to Blame for Argentina's Disastrous Default? Its Lawyers, of Course*, GUARDIAN (Aug. 20, 2014, 8:00 AM), <http://www.theguardian.com/world/2014/aug/20/argentina-debt-default-lawyers-court-pay-clause>.

¹¹⁴ Reid Wilson, *Looming Puerto Rico Debt Deadlines Have Investors Nervous*, WASH. POST (July 24, 2014), <http://www.washingtonpost.com/blogs/govbeat/wp/2014/07/24/looming-puerto-rico-debt-deadlines-have-investors-nervous/>; see also Brown et al., *supra* note 111.

¹¹⁵ Luciana Lopez, *Puerto Rico Keeps the Lights On, But Debt Crisis Far From Over*, REUTERS (Aug. 15, 2014, 6:07 AM), <http://www.reuters.com/article/2014/08/15/usa-puertorico-utility-insight-idUSKBN0GF0C320140815>.

¹¹⁶ Chandvani & Baribeau, *supra* note 47.

troubled water authority further along its own path towards insolvency.¹¹⁷ If either of these utilities were forced to cease operations, it could present a situation similar to when Detroit shut off water to constituents as part of its own municipal bankruptcy.¹¹⁸ The Detroit water shutoff was decried worldwide as a humanitarian crisis, with the U.N. stating that “[d]isconnection of water services because of failure to pay due to lack of means constitutes a violation of the human right to water and other international human rights.”¹¹⁹ Not only did this affect the reputation of Detroit as a sovereign entity, but it had effects on the city’s people as well.¹²⁰ Puerto Rico potentially faces both of these negative effects.

A PREPA bankruptcy could also shock global financial markets. The Puerto Rico debt situation has been compared to the Greek debt crisis, which rocked the world economy and triggered a global recession.¹²¹ Upon closer inspection, the two situations closely mirror one another. Both countries were downgraded to junk bond status and afflicted with heavy debts and a lack of economic growth.¹²² “Like Greece, Puerto Rico is a chronically uncompetitive place locked in a currency union with a richer, more productive neighbor,” in this case the United States.¹²³ “And, as with Greece, there are fears that a chaotic default could precipitate a far bigger crisis by driving away investors, and pushing up borrowing costs in America’s near-\$4-trillion market for state and local bonds.”¹²⁴ Aside from the financial impact that Greece’s financial crisis had, it also impacted citizens on a personal level, leaving vast swathes of the population unemployed and unable to heat their homes.¹²⁵ Puerto Rico and PREPA are in

¹¹⁷ *Id.*

¹¹⁸ Laura Gottesdiener, *UN Officials ‘Shocked’ by Detroit’s Mass Water Shutoffs*, AL JAZEERA AM. (Oct. 20, 2014, 3:00 PM), <http://america.aljazeera.com/articles/2014/10/20/detroit-water-un.html>.

¹¹⁹ *Id.* (internal quotation marks omitted).

¹²⁰ See Michelle Miller, *Detroit Water Shut-Offs Bring U.N. Scrutiny*, CBS NEWS (Oct. 20, 2014, 7:05 PM), <http://www.cbsnews.com/news/detroit-water-shut-offs-brings-u-n-scrutiny/>.

¹²¹ Timothy Alexander Guzman, *Puerto Rico’s Debt Bomb. Could Puerto Rico become “The New Greece” in the Caribbean?*, GLOBAL RESEARCH (Jan. 30, 2014), <http://www.globalresearch.ca/puerto-ricos-debt-bomb-could-puerto-rico-become-the-new-greece-in-the-caribbean/5366756>.

¹²² *Greece in the Caribbean*, ECONOMIST (Oct. 26, 2013), <http://www.economist.com/news/leaders/21588374-stuck-real-debt-crisis-its-back-yard-america-can-learn-europes-aegean>.

¹²³ *Id.*

¹²⁴ *Id.*

¹²⁵ See Derek Gatopoulos, *Suicides in Greece Spike During Financial Crisis*, HUFFINGTON POST (Nov. 10, 2013, 5:12 AM), http://www.huffingtonpost.com/2013/09/10/greece-suicides_n_3900906.html; see also Maria Paravantes, *A Greek Christmas Carol*,

a precarious position, burdened by structural deficiencies and facing wide ranging consequences if they default on their debt or enter bankruptcy.

III. CONSTITUTIONAL ARGUMENTS AGAINST THE RECOVERY ACT

As dire as Puerto Rico's situation may seem, the Recovery Act was not the correct response. It has been met with fervent opposition, in large part because so many entities have invested massive sums of money in the Commonwealth.¹²⁶ PREPA bondholders worry that the passage of the Recovery Act is a prelude to the Commonwealth restructuring its debts at heavy losses to investors.¹²⁷ In response, several bondholders successfully challenged the constitutionality of the Recovery Act in *Franklin*, although this decision is currently in the midst of an appeal.¹²⁸ The District Court ruled in *Franklin* that the Recovery Act was federally preempted, but in doing so did not reach several arguments, which will be addressed below.¹²⁹

There are a number of issues with the Recovery Act, including issues of federal preemption due to Congress's heavy legislation in the area, issues with the automatic stay, impairment of contracts under Article I, Section 10 of the Constitution, and unconstitutional takings claims under the Fifth Amendment. These arguments will be addressed in turn to expand upon why the First Circuit Court of Appeals should affirm the United States District Court for the District of Puerto Rico's ruling that the Recovery Act is unconstitutional.

A. *The Recovery Act is Federally Preempted*

The Recovery Act is federally preempted by the abundance of federal bankruptcy legislation and Congress' purposeful exclusion of Puerto Rico from Chapter 9 of the Bankruptcy

HUFFINGTON POST, (Feb. 24, 2014, 5:59 AM), http://www.huffingtonpost.com/maria-paravantes/a-greek-christmas-carol_b_4501117.html.

¹²⁶ See Hunter, *Legal Fault Lines Over Puerto Rico Restructuring Law Come Into Focus*, DISTRESSED DEBT INVESTING (July 29, 2014), <http://www.distressed-debt-investing.com/2014/07/legal-fault-lines-over-puerto-rico.html>.

¹²⁷ Aaron Kuriloff, *U.S. Investment Firms Challenge Puerto Rico Restructuring Law*, WALL ST. J. (June 29, 2014, 7:09 PM), <http://online.wsj.com/articles/u-s-investment-firms-challenge-puerto-rico-restructuring-law-1404068742>.

¹²⁸ *Update 1-Puerto Rico Asks for Quick Decision in Bankruptcy Ruling Appeal*, *supra* note 20.

¹²⁹ As mentioned earlier, the First Circuit has affirmed the ruling, and Puerto Rico is still considering whether to appeal to the Supreme Court. See *supra* note 1.

Code.¹³⁰ In *Franklin*, the District Court for the District of Puerto Rico held that “[b]ecause the Recovery Act is preempted by the federal Bankruptcy Code, it is void pursuant to the Supremacy Clause of the United States Constitution” and thus is unconstitutional.¹³¹ The court found express preemption, stating that although proving federal preemption has a “high bar, this is not a close case.” However, the court did not address arguments about other types of preemption.¹³²

“Federal preemption of state law can occur in three circumstances: (1) express preemption where Congress explicitly preempts state law; (2) implied preemption where Congress has occupied the entire field (field preemption); and (3) implied preemption where there is an actual conflict between federal and state law (conflict preemption).”¹³³ The U.S. Constitution provides that “[t]he Congress shall have Power To . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States.”¹³⁴ “Congress has broad authority to preempt state laws, but whether Congress has done so in a particular instance is a matter of congressional intent.”¹³⁵ Preemption can be found not only when a statute expressly preempts conflicting statutes, but also when the circumstances evince intent by Congress to wholly occupy a field and to bar the states from legislating in it.¹³⁶

The Bankruptcy Code’s exclusion of Puerto Rico from Chapter 9 is an express preemption and was drafted intentionally by Congress to exclude Puerto Rico from pursuing a municipal bankruptcy. Because of this, there is no inadvertent “gap” as asserted by Puerto Rico.¹³⁷ The Commonwealth would have a much stronger argument if the Bankruptcy Code did not explicitly list Puerto Rico as one of only two entities that are not eligible for Chapter 9 bankruptcies.¹³⁸ While drafting the Bankruptcy Code, Congress consciously chose to limit the applicability of Chapter 9

¹³⁰ As shown by the terms of 11 U.S.C. 101(52), which states “[t]he 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 [11 USCS §§ 901 et seq.]”

¹³¹ *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518 (FAB), slip op. at 1, 2 (D.P.R. Feb. 6, 2015).

¹³² *Id.* at 42.

¹³³ *Gracia v. Volvo Europa Truck, N.V.*, 112 F.3d 291, 294 (7th Cir. 1997) (citing *English v. Gen. Elec. Co.*, 496 U.S. 72, 78-79 (1990)).

¹³⁴ U.S. CONST. art. I, § 8.

¹³⁵ *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1200 (9th Cir. 2005).

¹³⁶ *Id.*

¹³⁷ THE FACTS ABOUT PUERTO RICO’S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, *supra* note 14.

¹³⁸ 11 U.S.C. § 101(52) excludes both Puerto Rico and the District of Columbia from utilizing Ch. 9 of the Bankruptcy Code.

of the Bankruptcy Code.¹³⁹ This intention is clear from the legislative history of the Code. Prior to 1984, there was no language banning Puerto Rico from utilizing Chapter 9.¹⁴⁰ After the amendments to the Bankruptcy Code in 1984, the ban was added, meaning that during the deliberations, it was purposefully added to the Code.¹⁴¹ Whether or not the ban was added during the course of negotiations and forgotten or was the result of a scrivener's error, the wording of the statute is precise.¹⁴² Thus, this issue should not be resolved by Puerto Rico; it should be left for Congress to decide and clarify the exact meaning of Puerto Rico's exclusion from Chapter 9 of the Bankruptcy Code.

There are several reasons why Congress could have intended to exclude the Commonwealth from Chapter 9, including the special protections afforded to Puerto Rican municipal bonds.¹⁴³ Puerto Rican bonds are "Triple Tax Exempt," and "[u]nder current acts of the U.S. Congress, the interest on most bonds issue[d] by the Commonwealth of Puerto Rico, its political subdivisions and public corporations, is not includable in gross income for federal income tax purposes or subject to income tax by state and local municipalities."¹⁴⁴ The Puerto Rican tax exemptions are a huge draw to investors and are part of the reason why so many American investors own Puerto Rican municipal bonds.¹⁴⁵ "Congress chose to give Puerto Rican bonds a nationwide tax exemption, enjoyed by no state, and Congress chose to exclude Puerto Rico from Chapter 9 . . . [t]he benefit and the restriction go together."¹⁴⁶ The wording of the Bankruptcy Code, together with the circumstantial evidence of Congressional intent, is sufficient to establish that Congress explicitly meant to bar Puerto Rico from municipal bankruptcy, and as such, the court in *Franklin* correctly found that the Recovery Act is expressly preempted.

¹³⁹ 11 U.S.C. § 101(52).

¹⁴⁰ In the prior iteration of the Bankruptcy Code, there was no definition of "State" as it appears in the current version which now bans Puerto Rico from filing municipal bankruptcies. Pub. L. No. 95, § 101, 92 Stat. 2549 (1978).

¹⁴¹ Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 421(j), 98 Stat. 333, 369 (1984).

¹⁴² Cf. *Hearing on H.R. 870*, *supra* note 54, at 2-3 (testimony of John Pottow, Univ. of Mich. Professor of Law).

¹⁴³ *Investor Resources, Introduction*, COMMONWEALTH OF PUERTO RICO, GOV'T DEV. BANK FOR PUERTO RICO, http://www.gdb-pur.com/investors_resources/introduction.html (last visited April 9, 2015).

¹⁴⁴ *Id.*

¹⁴⁵ Kuriloff, *supra* note 12.

¹⁴⁶ *Hearing on H.R. 870*, *supra* note 54, at 6 (testimony of Thomas Mayer, Partner, Kramer Levin Naftalis & Frankel LLP).

In *Franklin*, the court did not reach the question of whether the Recovery Act was barred by either field or conflict preemption, as it had already deemed the Recovery Act unconstitutional under express preemption.¹⁴⁷ “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.’”¹⁴⁸ Given the long-held concern about state sovereignty and the prevalence of Congressional legislation in the area of municipal bankruptcy, it would be reasonable to assume that even if express preemption were not found, the Recovery Act would be field preempted. Congress has a vested interest in maintaining a stable bankruptcy system for the country, and allowing states to unilaterally decide how they should be able to restructure their debts by developing individual municipal bankruptcy systems state-by-state runs against this interest. Additionally, Congress specifically limited Puerto Rico’s ability to pursue a municipal bankruptcy, which the Recovery Act presumes to grant to the Commonwealth. This would put the two laws into conflict, establishing conflict preemption. Thus, although the *Franklin* court may not have reached an analysis of these two types of preemption, it would be safe to assume that the Recovery Act would be preempted under either of these premises as well.

Puerto Rico also tries to rely upon section 903 of the Bankruptcy Code to overcome the preemption bar.¹⁴⁹ Section 903 states, “[t]his chapter . . . 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, including expenditures for such exercise.”¹⁵⁰ Chapter 9 of the bankruptcy code “both reserves to the state the power to control a municipality in the exercise of its political and governmental powers . . . and prohibits the court from interfering with the property, revenues, and political and governmental powers of the debtor unless the debtor consents.”¹⁵¹ Puerto Rico attempts to argue that it is unfair “to read the federal Bankruptcy

¹⁴⁷ *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518 (FAB), slip op. at 1, 2 (D.P.R. Feb. 6, 2015).

¹⁴⁸ Alan J. Feld, *The Limits of Bankruptcy Code Preemption: Debt Discharge and Voidable Preference Reconsidered in Light of Sherwood Partners*, 28 *CARDOZO L. REV.* 1447, 1463 (2006).

¹⁴⁹ 11 U.S.C. § 903 (2012).

¹⁵⁰ *Id.*

¹⁵¹ Memorandum of Decision on Debtor’s Motion for Entry of an Order Authorizing Rejection of Executory Employment Contract with Joseph P. Moran III, *In re City of Cent. Falls, R.I.*, 468 B.R. 36 (Bankr. D.R.I. 2012) (No. 11-13105-FJB), 2011 WL 9933766 at *4.

Code as both precluding Puerto Rico municipalities from participating in Chapter 9 proceedings and preempting Puerto Rico laws that govern debt restructuring for Puerto Rico municipalities.”¹⁵² However, as discussed above, it is apparent that Congress intended to bar Puerto Rico from Chapter 9 of the Bankruptcy Code. Whether or not this may be unfair and regardless of whether or not Puerto Rico needs a bankruptcy outlet to solve its fiscal problems, it is not the Commonwealth’s place to overturn Congressional law. “States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.”¹⁵³ The court in *Franklin* looked closely at the text and legislative history behind 11 U.S.C. § 903 before agreeing that Puerto Rico would find no solace in that clause.¹⁵⁴ Municipal bankruptcy is not a right, as evidenced both by Congress’s manifest intent in excluding Puerto Rico and the fact that not all states allow their municipalities to utilize Chapter 9. Thus, although Puerto Rico may believe that municipal bankruptcy is crucial for the Commonwealth’s survival, Congress has preempted it from following that route.

B. The Recovery Act Creates an Unconstitutional Impairment of Contracts

The next argument against the Recovery Act is that it violates the Takings Clause of the U.S. Constitution, which states that “[n]o State shall . . . pass any . . . [l]aw impairing the Obligation of Contracts”¹⁵⁵ The court in *Franklin* analyzed this issue but did not go further than denying Puerto Rico’s motion to dismiss while stating that the bondholders had a plausible claim.¹⁵⁶ Even if the Recovery Act were not preempted, if PREPA went into bankruptcy and forced creditors to restructure their debt, it would constitute an improper abrogation of the Commonwealth’s bond contracts.

Courts have generally read the Contracts Clause somewhat liberally in favor of the states, although it still represents a high hurdle for the Recovery Act to overcome.¹⁵⁷ Bankruptcy laws occupy a unique space:

¹⁵² *Franklin Cal. Tax-Free Trust*, slip op. at 1, 38-39.

¹⁵³ *Int’l Shoe Co. v. Pinkus*, 278 U.S. 261, 265 (1929).

¹⁵⁴ *Franklin Cal. Tax-Free Trust*, slip op. at 1, 40-41.

¹⁵⁵ U.S. CONST. art. I, § 10, cl. 1.

¹⁵⁶ *Franklin Cal. Tax-Free Trust*, slip op. at 1, 65.

¹⁵⁷ *Trust Co. of N.Y. v. New Jersey*, 431 U.S. 1 (1977).

[w]hile section 10 of Article I of the Constitution is directed to the States alone, we think it nevertheless states the policy of the founders of the Government on the question of impairing the obligation of contracts and that any Act of the national legislature that does impair the obligation of contracts is contrary to that policy and not within the powers delegated to the National Government, except in specific cases, such as bankruptcy.¹⁵⁸

However, in the past, some have tried to extend this exception to state insolvency laws. “From time to time . . . it has been stated that a state insolvency act is limited by the Contract Clause of the Constitution in authorizing composition of preexisting debts . . . but it all depends on what is affected by such a composition and what state power it brings into play.”¹⁵⁹ When looking at a Contracts Clause claim, courts look at (1) “whether the state law has . . . operated as a substantial impairment of a contractual relationship” and (2) whether it was “reasonable and necessary to serve an important government purpose.”¹⁶⁰ The purpose of the Recovery Act is to allow Puerto Rican municipal corporations to restructure their debts from the contractual terms of the bonds, meeting the first prong. In regards to the second prong, Puerto Rico sees the looming economic and humanitarian consequences of a PREPA default as a compelling reason for the passage of the Recovery Act. Even with a liberal reading of the Contracts Clause in their favor, Puerto Rico’s justifications for the passage of the Recovery Act ring hollow.

To try and avoid the preemption and Contracts Clause barriers, Puerto Rico characterizes the Recovery Act not as a bankruptcy act, but as an “orderly” debt enforcement act, which actually improves the position of the bondholders.¹⁶¹ Puerto Rico relies upon *Faitoute Iron & Steel Co.*, where, facing a Contracts Clause challenge, “the Court upheld emergency [state] legislation restructuring municipal debt even though creditors were thereby deprived of the right to enforcement of claims against the municipality.”¹⁶² Relying upon this precedent would allow a court to

¹⁵⁸ *Johnson v. United States*, 79 F. Supp. 208, 211 (Ct. Cl. 1948). Bankruptcy is exempted from this because it has long been recognized that bankruptcy is necessary for a healthy economy, and that for it to be effective, the restructuring or dispersal of debts may be necessary.

¹⁵⁹ *Faitoute Iron & Steel Co. v. City of Asbury Park, N.J.*, 316 U.S. 502, 513 (1942).

¹⁶⁰ *United Auto., Aero., Agric. Implement Workers of Am. Int’l Union v. Fortuño*, 633 F.3d 37, 41 (1st Cir. 2011).

¹⁶¹ The Puerto Rico Electric Power Authority’s Motion to Dismiss the Amended Complaint at 19 n.3, *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518 (D.P.R. July 21, 2014) [hereinafter *Franklin Motion to Dismiss*].

¹⁶² Stewart E. Sterk, *The Continuity of Legislatures: Of Contracts and the Contracts Clause*, 88 COLUM. L. REV. 647, 684-85 (1988).

find that Puerto Rico justly used its police powers to fill the purported legislative gap to resolve the emergency situation.

Puerto Rico relies on *Faitoute* to show that the legislative “gap” which leaves PREPA unable to file for bankruptcy under federal laws can be remedied through the use of the Commonwealth’s police power to avoid a catastrophe.¹⁶³ One of the key findings by the court in *Faitoute*, which echoes the present Puerto Rican situation, was the pressing necessity of passing the law due to unexpected and dire financial conditions.¹⁶⁴ Seeing the potentially catastrophic consequences that a PREPA default could have, Puerto Rico sees the present situation as justifying the passage of the Recovery Act.¹⁶⁵

While *Faitoute* has not been outright rejected, its usefulness as precedent has come under heavy scrutiny. “First, other than in one limited instance, *Faitoute Iron & Steel Co. v. City of Asbury Park*, courts have always interpreted the Contracts Clause of the United States Constitution to prohibit the states from enacting legislation providing for municipal bankruptcies.”¹⁶⁶ Not only is *Faitoute* unique in this regard, but courts have distinguished *Faitoute* on its facts, severely limiting its precedential value.¹⁶⁷ The court in *Franklin* agreed that Puerto Rico’s reliance on *Faitoute* was misguided, drawing a distinction based on the very narrow tailoring of the law at issue in *Faitoute*.¹⁶⁸

As grim as Puerto Rico’s situation may be, the consequences of a PREPA default are not sufficient to justify a law allowing the unconstitutional impairment of contracts. Even if the Recovery Act were not preempted, it should be deemed unconstitutional based on Contracts Clause principles. Restructuring the bondholders contracts against their will is an unconstitutional use of the Commonwealth’s powers, and if allowed, opens up a floodgate of potential misuse.

C. *The Recovery Act Constitutes an Unconstitutional Taking*

If PREPA filed for bankruptcy under the Recovery Act, the restructuring of its debt would provide the utility with relief but would constitute an unconstitutional taking from bondholders.

¹⁶³ *Franklin* Motion to Dismiss, *supra* 161, at 19 n.4.

¹⁶⁴ *Faitoute Iron & Steel Co.*, 316 U.S. at 511.

¹⁶⁵ See *supra* Part II.

¹⁶⁶ *In re City of Detroit*, Mich., 504 B.R. 97, 143 (Bankr. E.D. Mich. 2013) (internal citation omitted).

¹⁶⁷ *Id.*

¹⁶⁸ *Franklin Cal. Tax-Free Trust*, slip op. at 1, 55-56.

In *Franklin*, the bondholders made two assertions about how the Recovery Act facilitated an unconstitutional taking.¹⁶⁹ First, they argued that it annulled their contractual right to appoint a receiver in the event of a default; the court found that this was a plausible claim but did not analyze it.¹⁷⁰ Second, the bondholders alleged that the Recovery Act took away the lien that the bond covenants gave them on PREPA revenues; however, the court determined that this claim was not yet ripe.¹⁷¹ Aside from these particular claims, the Recovery Act raises other issues concerning unconstitutional takings.

While states have the power to confiscate property under the Constitution, it is heavily curtailed by the Fifth Amendment.¹⁷² The Fifth Amendment states that “private property [shall not] be taken for public use, without just compensation.”¹⁷³ Courts have previously held that “the Takings Clause applies unreservedly to the Commonwealth of Puerto Rico.”¹⁷⁴ Nevertheless, “[t]he Fifth Amendment does not proscribe the taking of property; it proscribes taking without just compensation.”¹⁷⁵

The Recovery Act creates vast potential for unconstitutional takings during the course of a bankruptcy.¹⁷⁶ Section 129(d) of the Recovery Act reads,

[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.¹⁷⁷

Normally once a bankruptcy petition is filed, “[a]dequate protection in the form of either cash payments or a replacement lien must be provided the creditor whose collateral is decreasing in value or is being consumed during the stay.”¹⁷⁸ The Supreme Court conceptualized the idea of adequate protection based on the protections found in the Takings Clause.¹⁷⁹ Section 129(d) of the

¹⁶⁹ *Id.* at 65.

¹⁷⁰ *Id.* at 70.

¹⁷¹ *Id.* at 26.

¹⁷² U.S. CONST. amend. V.

¹⁷³ *Id.*

¹⁷⁴ *Deniz v. Municipality of Guaynabo*, 285 F.3d 142, 146 (1st Cir. 2002) (citing *Tenoco Oil Co. v. Dep’t of Consumer Affairs*, 876 F.2d 1013, 1017 n.9 (1st Cir. 1989)).

¹⁷⁵ *Williamson Cnty. Reg’l Planning Comm’n v. Hamilton Bank*, 473 U.S. 172, 194 (1985).

¹⁷⁶ The Recovery Act, *supra* note 81.

¹⁷⁷ *Id.*

¹⁷⁸ S. Rep. No. 95-989, at 4 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5790.

¹⁷⁹ *Id.* at 49; *see* *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273 (1940).

Recovery Act would allow PREPA to sidestep these restrictions whenever they believed that the “police power justifies” such an action.¹⁸⁰ Even though the court did not reach a decision on this issue, the vast potential for misuse that this section represents is another reason to hold the Recovery Act unconstitutional.

D. The Recovery Act Creates an Improper Stay of Federal Litigation

The Recovery Act’s automatic stay provision is an improper attempt by the Commonwealth to limit federal litigation. Similar to the Bankruptcy Code, the Recovery Act contains a stay which prevents the commencement or enforcement of certain actions against the debtor or the debtor’s estate.¹⁸¹ If PREPA were to file for bankruptcy under the Recovery Act, the stay would automatically stop any ongoing litigation, and prevent the subsequent filing of any federal proceedings. However, “state courts lack any power under the Constitution to enjoin proceedings in federal court.”¹⁸² The Court in *Franklin* declined to address this issue, as the claims were not yet ripe. However, this provides yet another basis for finding the Recovery Act unconstitutional.¹⁸³

The automatic stay under the Recovery Act stays “the commencement or continuation, including the issuance or employment of process, of a judicial, arbitral, administrative, or other action or proceeding against the petitioner” for “any act to collect, assess, or recover on a claim against the petitioner that arose before the filing of a petition under Chapter 3 of this Act, including any act to obtain possession or control of property belonging to the petitioner.”¹⁸⁴ Even though the stay under the Recovery Act may not last for the duration of the bankruptcy, it would still impermissibly bar federal litigation, contrary to federalism principles.

IV. ALTERNATIVES TO THE RECOVERY ACT

While PREPA and Puerto Rico’s situation may seem grim, there are alternatives to the constitutionally deficient Recovery

¹⁸⁰ The Recovery Act, *supra* note 81.

¹⁸¹ *Id.*

¹⁸² Complaint at 13, *Franklin Cal. Tax-Free Trust v. Commonwealth of PR.*, No. 14-1518 (D.P.R. June 28, 2014); *see also* *Donovan v. Dallas*, 377 U.S. 408 (1964).

¹⁸³ *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518 (FAB), slip op. at 1, 55-56 (D.P.R. Feb. 6, 2015).

¹⁸⁴ The Recovery Act, *supra* note 81.

Act. Many of these other options would avoid in whole, or in part, the catastrophic impact that the Recovery Act would have on the Commonwealth, its people, its investors, the global economic market, and the legal community.

Even if the Recovery Act were to stand, under its own provisions, it could have limited utility. Together, dissenting bondholders hold a total of approximately \$2.1 billion out of the \$8.6 billion in outstanding PREPA debt.¹⁸⁵ Not only is this proportion of opposing investors important for its dollar amount, but also for the wrench it could throw into a possible PREPA Recovery Act reorganization, by blocking the creditor agreement to restructuring plans. In both Chapter 2 and Chapter 3 of the Recovery Act, approval by a certain percentage of a class of investors is required, and together the dissenting bondholders hold nearly 25% of PREPA's debt, giving them the potential opportunity to disrupt an attempted reorganization under the Recovery Act.

One of the core issues with the Recovery Act is that Puerto Rico is trying to step in and legislate in an area reserved for the federal government. There are no ways to save the Recovery Act from its constitutional defects. The most feasible way to solve PREPA's problems is to find a solution that minimizes the economic repercussions of turning around PREPA. There are solutions that can accomplish this goal while avoiding the Recovery Act's constitutional pitfalls; for example, Puerto Rico could introduce legislation to Congress to change the Federal Bankruptcy Code or eschew a forced legislative restructuring altogether. There are also financially focused alternatives PREPA could pursue, including a private workout with creditors or trying to turn around its business. The complexity of the situation and the potential for severe global consequences prevents an easy solution, but the following alternatives, or some combination of them, would at least provide a better solution than the Recovery Act.

A. *Introduce Legislation to Congress*

Puerto Rico's nonvoting congressional delegate in the U.S. House of Representatives has already introduced legislation that would allow Puerto Rico to take advantage of U.S. municipal bankruptcy laws.¹⁸⁶ Passage of this law would permit Puerto Rico

¹⁸⁵ Hunter, *supra* note 126.

¹⁸⁶ Michael Aneiro, *House Bill Proposes Puerto Rico Bankruptcy; S&P Downgrades PREPA Utility*, BARRON'S (July 31, 2014, 4:58 PM), <http://blogs.barrons.com/incomeinvesting/2014/07/31/house-bill-proposes-puerto-rico-b>.

to file for municipal bankruptcy while avoiding the constitutional issues that the Recovery Act faces. However, this would not address PREPA's underlying structural problems or many of the economic issues of the situation.

The proposed legislation simply reads, “[t]o amend title 11 of the United States Code to treat Puerto Rico as a State for purposes of Chapter 9 of such title relating to the adjustment of debts of municipalities.”¹⁸⁷ This bill provides a better option than the Recovery Act because it attempts to achieve the same goal as the Recovery Act within the structure of the American legislative system. Many of the constitutional problems of the Recovery Act arose because it was an attempt to sidestep the involvement of the federal government. While this may seem like an attractive option, there is no real timetable for when the law could be passed. Since its introduction on July 31, 2014, there has been little progress on the bill; it was “[r]eferred to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law” on September 26, 2014.¹⁸⁸ The hearing was finally held on February 26, 2015.¹⁸⁹ At the hearing, arguments were presented on all sides of the issue. Proponents for the bondholders claimed that it would be unfair to uphold a law that seriously undermines the position of bondholders who negotiated the bond covenants under the assumption that a Puerto Rican municipal bankruptcy was impossible.¹⁹⁰ Conversely, a representative from the GDB expressed the belief that their *Franklin* appeal would be successful and that the Recovery Act was the best solution for PREPA's problems.¹⁹¹ Proponents of the bill emphasize that Puerto Rico should be granted the autonomy to make its own decision concerning municipal bankruptcies as other states do, to take it out of the current “infantilizing no man's land it finds itself in under current bankruptcy law.”¹⁹² The new law has been backed by both the National Bankruptcy Conference as well as the Commonwealth's Governing Party.¹⁹³

¹⁸⁶ Andrew Bary, *Puerto Rico Downgrade Raises Default Fears*, BARRON'S (July 1, 2014), <http://online.barrons.com/news/articles/SB50001424053111904248904580003610191234810>.

¹⁸⁷ Puerto Rico Chapter 9 Uniformity Act of 2014, H.R.5305, 113th Cong. (2014).

¹⁸⁸ *Id.*

¹⁸⁹ *Hearing on H.R. 870, supra* note 54.

¹⁹⁰ *Id.* at 6 (testimony of Thomas Mayer).

¹⁹¹ *Id.* at 7 (testimony of Melba Acosta-Febo).

¹⁹² *Id.* at 2 (testimony of John Pottow, Univ. of Mich. Professor of Law).

¹⁹³ Andrew Scurria, *House Bill Would Open Up Ch. 9 to Puerto Rico Public Cos.*, LAW360 (Aug. 1, 2014, 5:01 PM), <http://www.law360.com/articles/563298/house-bill-would-open-up-ch-9-to-puerto-rico-public-cos>.

There are arguments, however, to be made against this course of action. The bondholders who invested billions in PREPA and its tax-free bonds relied on the fact that the utility could not enter municipal bankruptcy; to retroactively apply this law would be unfair to them.¹⁹⁴ Additionally, both PREPA and Puerto Rico will need to be able to continue to raise money to remain solvent in the near future.¹⁹⁵ Investor confidence in Puerto Rican bonds is already at a low point, and passage of this law could further drive away the investors that the Commonwealth and its public utilities will need for future bond offerings.¹⁹⁶ Currently, PREPA is only able to continue operating because creditors have extended the utility's short-term loans, but there is no guarantee that they will continue to do so.¹⁹⁷

While this option is attractive because it avoids constitutional issues, there is no set timeframe for when this option could have an effect on PREPA's situation. Representative Pierluisi, the Puerto Rican Congressman who introduced the bill, is handcuffed by the fact that he cannot vote on the bill due to his status as non-voting delegate. Even if passed, the bill could drive away the investors that the island needs to avoid an economic collapse and would not avoid the economic issues associated with such a large-scale municipal bankruptcy. This option should still be pursued, if only to serve as a last resort to provide an orderly restructuring if PREPA is forced to choose between bankruptcy or default.

B. *PREPA Default or U.S. Government Bailout*

If it came down to it, PREPA could follow the path chosen by Argentina and default on its debts, taking the utility out of the Recovery Act. Investors on edge since Detroit's municipal bankruptcy have feared a Puerto Rican debt default and its potential consequences.¹⁹⁸ PREPA has previously come perilously

¹⁹⁴ *Hearing on H.R. 870, supra* note 54, at 4 (testimony of John Pottow, Univ. of Mich. Professor of Law).

¹⁹⁵ *See supra* Part II.

¹⁹⁶ *Hearing on H.R. 870, supra* note 54, at 4 (testimony of Thomas Mayer, Partner, Kramer Levin Naftalis & Frankel LLP).

¹⁹⁷ Brian Chappatta, *Puerto Rico's Power Agency Wins Bank Loan Extension to March*, BLOOMBERG (Aug. 15, 2014, 1:00 PM), <http://www.bloomberg.com/news/2014-08-14/puerto-rico-electric-authority-gets-bank-loans-extended-to-march.html>.

¹⁹⁸ *Puerto Rico's Debt Crisis: Neither a State nor Independent, supra* note 22.

close to a default, which it only avoided through a last minute credit extension.¹⁹⁹

Puerto Rico's economy is already struggling, and if PREPA defaulted, it could tip the Commonwealth's economy towards its own default. "The ability of the commonwealth or any of its authorities to issue debt has diminished substantially . . . and the restructuring law is one of the key reasons."²⁰⁰ If the mere threat of a municipal restructuring had such an effect on the Commonwealth's finances, it is hard to imagine how drastic of an effect a full-blown default could have. A default by the island itself would pose a greater threat to the world's economy than the effects of just a PREPA default.²⁰¹

Some have speculated that if PREPA were forced to default, the United States Government would intervene with a bailout to prevent economic ripple effects.²⁰² In January 2014, when investors started taking notice of the island's distress, it was reported that "[t]he White House [was] not considering a financial bailout for Puerto Rico, where chronic fiscal challenges have raised the specter of a Detroit-like bankruptcy."²⁰³ The federal government has also shown its willingness to allow municipal bankruptcies to proceed when it declined to provide a bailout to Detroit in its own record-breaking municipal bankruptcy.²⁰⁴ While a PREPA default may become an unavoidable fact at some point, it is not an option that should be willingly pursued. Indeed, it would be a grave mistake for the Commonwealth to default based on the assumption that the U.S. government would provide a bailout.

¹⁹⁹ *Puerto Rico's PREPA Gets Extension From Creditors*, REUTERS (July 31, 2014, 2:26 PM), <http://www.reuters.com/article/2014/07/31/usa-puertorico-prepa-idUSL2N0Q628120140731>.

²⁰⁰ CB Online Staff, *Moody's Details Dim View of Recovery Act*, CARIBBEAN BUS. (July 24, 2014, 7:15 AM), <http://www.caribbeanbusinesspr.com/news/moodys-details-dim-view-of-recovery-act-98946.html>.

²⁰¹ See *supra* Part II.

²⁰² Charles Tatelbaum, *Puerto Rico May Be the Next Big Bailout For U.S. Taxpayers*, REAL CLEAR MKTS. (Apr. 10, 2014), http://www.realclearmarkets.com/articles/2014/04/10/puerto_rico_may_be_the_next_big_bailout_for_us_taxpayers_100998.html.

²⁰³ Mark Felsenthal, *White House Not Considering Puerto Rico Bailout*, OFFICIAL SAYS, REUTERS (Jan. 22, 2014, 4:56 PM), <http://www.reuters.com/article/2014/01/22/us-usa-puertorico-finances-idUSBREA0L23V20140122>.

²⁰⁴ Jackie Calmes, *\$300 Million in Detroit Aid, But No Bailout*, N.Y. TIMES (Sept. 26, 2013), http://www.nytimes.com/2013/09/27/us/300-million-in-detroit-aid-but-no-bailout.html?pagewanted%3Dall&_r=0.

C. *PREPA Private Workout with Creditors*

PREPA could also attempt to consensually restructure some of its debt with creditors through a private workout. This would give PREPA some breathing room to hopefully effectuate an internal restructuring of its processes. To some extent, PREPA has already completed a small workout. In July 2014, some of the holders of PREPA's lines of credit agreed to extend payment deadlines to ease the pressure on the utility, which, at the time, was about to default.²⁰⁵ In response, the executive director of PREPA stated, "[t]his latest show of support from our bondholders, bond insurers and lenders provides us with additional time to evaluate all available options to ensure we are reaching the best possible outcome for our employees, customers, creditors and suppliers," indicating a willingness to make changes to become profitable again.²⁰⁶

While this was certainly a beneficial step for PREPA to take in the short-term, it does not address the many long-term issues that PREPA faces. PREPA has deep-seated operating and economic issues that need to be addressed for the utility to escape the financial morass that led to the passage of the Recovery Act.²⁰⁷ Nonetheless, PREPA has not invested in more efficient production systems because the costs are prohibitive, and they need to borrow money to merely continue producing electricity.²⁰⁸

Outside of a forced debt restructuring in the bankruptcy context, it seems unlikely that PREPA would be able to convince investors to willingly take a reduction in their expected returns. The Argentine situation illustrates this difficulty: the country tried to commence negotiations with bondholders, and after being unable to reach an agreement, decided to unilaterally default on its debt, damaging the country's economic relationships and global reputation.²⁰⁹

However, while a workout may be difficult, there are incentives that PREPA could provide to bondholders to convince them to engage in meaningful negotiations. If Congress passes Representative Pierluisi's law, the specter of a constitutionally

²⁰⁵ *Puerto Rico's PREPA Gets Extension From Creditors*, *supra* note 199.

²⁰⁶ *Id.*

²⁰⁷ Richard Chesley, *The Examiners: PREPA Restructuring Requires Time, Liquidity*, WALL ST. J. (Oct. 7, 2014, 12:02 PM), <http://blogs.wsj.com/bankruptcy/2014/10/07/the-examiners-prepa-restructuring-requires-time-liquidity/>.

²⁰⁸ *Id.*

²⁰⁹ Taos Turner, *Argentina Warns U.S. Relations Could Worsen Over Appointee's Affiliations*, WALL ST. J. (Nov. 3, 2014, 5:11 PM), <http://online.wsj.com/articles/argentina-warns-u-s-relations-could-worsen-over-appointees-affiliations-1415042456>.

sanctioned restructuring could make investors more pliable. Additionally, PREPA could attempt to build off of its earlier extension and show investors that it has a feasible plan to become profitable in the future. Any of these talks would be hampered by the current investor distrust of PREPA and Puerto Rico, which could be remedied by repealing the Recovery Act. A workout with creditors would avoid the Recovery Act's constitutional issues and allow PREPA a short term respite but would fail to address the changes needed to pull PREPA out of its economic tailspin.

D. *Turn Around the Business*

The most optimistic solution is for PREPA to change its operating processes and become profitable again, enabling it to pay its debts and avoiding the Recovery Act altogether. This would not be an easy task to accomplish, as the utility is facing a host of economic and operating issues. Nevertheless, there are some short-term changes that PREPA could make that would allow it to then make the more costly changes to ensure profitability for the long term.

PREPA has several factors working in its favor to begin this process. "The Authority's Current Forecast for fiscal years 2014 through 2018 predicts a 1.3% growth in total energy sales for fiscal year 2014, with an average annual growth rate of 1.2% in fiscal years 2014 through 2018."²¹⁰ Compared to a 1.1% growth forecast in the mainland U.S., PREPA has a rapidly growing customer market.²¹¹ Additionally, the price of crude oil has been dropping, recently hitting a three-year low, which will help PREPA lower its operating costs.²¹² In fact, based on these factors, "[t]he Consulting Engineers believe[] the Authority will receive sufficient revenues in fiscal year 2014 with the existing rates to cover current expenses . . . and to exceed its 120% debt service coverage requirement."²¹³ If this forecast proves true, PREPA could look away from short-term debt obligations and begin planning for the future.

For PREPA to stay viable for the long term, it would need to adopt more efficient means of generating energy and raise its rates to customers. "PREPA has not raised its 'base rate'—the

²¹⁰ URS, FORTIETH ANNUAL REPORT ON THE ELECTRIC PROPERTY OF THE PUERTO RICO ELECTRIC POWER AUTHORITY 1 (2013), available at <http://www.aeepr.com/INVESTORS/DOCS/Financial%20Information/Annual%20Reports/Consulting%20Engrs%20Annual%20Report%20FY2013.pdf>.

²¹¹ *Id.*

²¹² *U.S. Crude Settles Above \$77 After Hitting 3-Year Low*, CNBC (Nov. 4, 2014, 2:54 PM), <http://www.cnbc.com/id/102148210#>.

²¹³ URS, *supra* note 210.

rate that pays for everything other than fuel and purchased power—in nearly 26 years,” something that mainland public utilities regularly do to cover costs.²¹⁴ Even a modest increase, accompanied by renewed efforts to collect delinquent accounts, could be a boon to the utility. In 2012, Fitch determined that, for PREPA to become an efficient and sustainable entity, it needed to reduce its reliance on gas-powered power plants.²¹⁵ PREPA could use the savings from the dropping price of gas as a catalyst to begin this transition. According to a 2012 report, PREPA’s “value could be increased by as much as \$1.2 billion through a full implementation of performance improvements that would bring one-time savings as well as ongoing operating cost reductions.”²¹⁶

This option is attractive because it would avoid the economic ripple effects of a large municipal bankruptcy, as well as the costly and potentially embarrassing litigation that would accompany it. A PREPA turnaround could energize Puerto Rico as a whole and lead to renewed economic self-sufficiency for the island. As attractive as this option may sound, it is not a feasible option on its own. The cost cutting changes that PREPA would need to implement are currently a source of contention in the Puerto Rican Senate, and some top officials have been unable to agree on a restructuring plan.²¹⁷ Additionally, PREPA would likely be unable to borrow the vast sums of money it would need to make infrastructure upgrades. If it could be implemented, a business practice overhaul would be the best option for all involved, but standing alone it is insufficient to solve PREPA’s issues.

E. A Combination of Solutions and PREPA’s Future Prospects

The most feasible solution to PREPA’s short- and long-term problems will require a combination of the aforementioned solutions. Any plan will have to be done without the Recovery Act, as there is no way to remedy the statute’s constitutional defects. The best solution will involve stop-gap measures to allow PREPA to continue operation, while at the same time preparing

²¹⁴ *Hearing on H.R. 870, supra* note 54, at 4 (testimony of Thomas Mayer, Partner, Kramer Levin Naftalis & Frankel LLP).

²¹⁵ FITCH RATINGS, *supra* note 10.

²¹⁶ John Marino, *PREPA Profits on Rising Oil Prices; Faces Financial Obstacles to Decreasing Oil Dependence*, CARIBBEAN BUS. (Apr. 23, 2014, 12:00 AM), http://www.caribbeanbusinesspr.com/prnt_ed/prepa-profits-on-rising-oil-prices-faces-financial-obstacles-to-decreasing-oil-dependence-9805.html.

²¹⁷ CB Online Staff, *Bhatia Ramps Up Push for Energy Reform*, CARIBBEAN BUS. (Mar. 26, 2014, 7:05 AM), <http://www.caribbeanbusiness.pr/news/bhatia-ramps-up-push-for-energy-reform-95237.html>.

contingency plans if these methods fail, and having long term goals to become profitable.

The first goal will be to gain some financial breathing room in the short term. PREPA needs to continue to draw loans to operate, but also needs capital to upgrade its power plants. PREPA could begin by attempting to build off of the small workout they recently realized with creditors and obtain either a further extension on the debt, or agree to pay the debt back at a lower rate over a longer period of time.²¹⁸ To convince creditors to deal with them, PREPA will likely need to make operating changes to assure creditors that they are on track towards profitability. This would require PREPA to raise its rates, in turn requiring the Puerto Rican Senate to agree on some middle ground regarding this issue.²¹⁹ While this may be an unpopular move in the short term, a modest rate increase could greatly benefit PREPA and Puerto Rican citizens in the long term. Additionally, PREPA would need to overhaul its collections systems, as the utility has outstanding accounts receivable of approximately \$1.8 billion.²²⁰ Even collecting a small portion of this amount would increase confidence that PREPA will become profitable, while simultaneously increasing the capital that PREPA has to work with. Unfortunately, during this collections process PREPA may need to cut off service to delinquent customers. If this were done systematically and on a small and managed scale, and not as a result of a mass default and shutoff, the impact of the shutoffs could be minimized and the public outcry that Detroit faced could be avoided.²²¹

For PREPA to be able to make the necessary structural changes to its operations, it will need capital to do so.²²² While raising rates and collecting accounts receivable are a good start, PREPA would eventually need to raise money on the open market to be able to afford the necessary upgrades. To do so, PREPA would need to regain investor confidence in the utility's ability to pay back its debts. To begin this process, PREPA could show a reaffirmation of its intent to stand by its debts to bondholders by

²¹⁸ See Christian Thompson, *Guess What's Going on in Puerto Rico; You Have To: Opening Line*, BLOOMBERG BUS. WEEK (Sept. 17, 2014, 5:58 AM), <http://www.bloomberg.com/news/articles/2014-09-17/guess-what-s-going-on-in-puerto-rico-you-have-to-opening-line>.

²¹⁹ CB Online Staff, *supra* note 217.

²²⁰ Edward Krudy, Megan Davies & Lisa Lambert, *Update 4-Puerto Rico's PREPA Urged to Get Tough on \$1.8 Bln Owed*, REUTERS (Nov. 17, 2014, 3:46 PM), <http://www.reuters.com/article/2014/11/17/usa-puertorico-idUSL2N0T71CQ20141117>.

²²¹ See Lopez, *supra* note 115.

²²² Michelle Kaske, *Puerto Rico Facing Debt Risk Beyond Power Utility: Muni Credit*, BLOOMBERG (Jan. 13, 2015, 8:00 PM), www.bloomberg.com/news/2015-01-14/puerto-rico-facing-debt-risk-beyond-power-utility-muni-credit.html.

urging the Commonwealth to repeal the Recovery Act or vowing not to utilize the Recovery Act. This would allow PREPA to more easily raise money to begin making some of the structural changes necessary to reduce its reliance on oil and move toward more sustainable methods of production. Hopefully, with a combination of increased income and capital raised from investors, PREPA could retrofit its power plants, enabling the utility to become economically self-sustaining.

In preparing for the future, Puerto Rico should continue to push for Congress to pass legislation allowing Puerto Rican municipalities to utilize Chapter 9 of the U.S. Bankruptcy Code.²²³ This should not be done with the intention of using bankruptcy as an end goal, but as a safety valve in case PREPA cannot be brought back on track. Although municipal bankruptcies have far reaching effects and everything possible should be done to avoid them, ultimately, a default would be worse.

Following these recommendations would solve a number of the problems outlined in this note. First, by repealing the Recovery Act, the aforementioned constitutional issues would be avoided. This would also help PREPA and Puerto Rico raise their credit rating and increase investor confidence, potentially reversing the path towards a Greek-like financial crisis. Once the changes have been made to make PREPA a more efficient entity, the focus should become preserving this status. Puerto Rico Senate President Batia has stated, “[a] state monopoly that regulates itself is a natural conflict of interest . . . [PREPA] decides the fate of its competitors,” which could very well be one of the contributing factors to PREPA’s current slide towards insolvency.²²⁴

This conflict of interest could be resolved by privatizing PREPA. However, this is not a solution that would be in the best interests of the Commonwealth and ultimately may not be possible. “A full privatization of the Puerto Rico Electric Power Authority (Prepa) would only be feasible with an increase in electricity rates or a restructuring of its debt, according to a 2012 report by Alvarez & Marsal (A&M) for the Government Development Bank (GDB).”²²⁵ The key reason for this difficulty is that the report “valued . . . [PREPA] at about half the amount

²²³ Scurria, *supra* note 16.

²²⁴ John Marino, *Prepa Privatization Talk Grows With Concerns Over Power Costs*, CARIBBEAN BUS. (Sept. 3, 2013, 12:00 AM), http://caribbeanbusinesspr.com/prnt_ed/prepa-privatization-talk-grows-with-concerns-over-power-costs-8947.html.

²²⁵ John Marino, *2012 Report Details Prepa Privatization Options*, CARIBBEAN BUS. (Sept. 15, 2014, 12:00 AM), http://www.caribbeanbusinesspr.com/prnt_ed/2012-report-details-prepa-privatization-options-10412.html.

of its long-term debt.”²²⁶ Privatization would also carry a host of downsides for the utility. If privatized, PREPA would lose the cheaper financing that it receives as a municipal corporation.²²⁷ Additionally, privatization would likely lead to massive rate hikes for Puerto Ricans who are already dealing with a struggling economy.²²⁸ Beyond this, privatization could also lead to job cuts, further harming Puerto Rico’s struggling economy.²²⁹

The better solution to this problem is currently being debated in the Puerto Rican Senate, where Representative Rodriguez has proposed the formation of an Energy Regulatory Commission to create an independent regulator for the Puerto Rican energy market.²³⁰ “The board would not only be charged with setting prices, but could also order cuts in operational expenses, resolve disputes between parties and take other significant actions.”²³¹ The creation of this Commission would be a boon to PREPA and Puerto Rico as a whole. PREPA’s consecutive years of losses and its decision not to keep up with technological advances in power generation implies that a form of oversight would be a beneficial change for the utility. By taking the power to make some of these decisions out of PREPA’s hands, the Commonwealth can eliminate PREPA’s conflict between doing what is best for the utility and what is in the best interests of the public that it serves. Ultimately, this will be PREPA’s best option to continue as a viable entity. Between making the financial changes outlined above and repealing the Recovery Act, PREPA can hopefully begin to become profitable and serve as a catalyst to rejuvenating the Puerto Rican economy as a whole.

CONCLUSION

While there may be no clear or immediately apparent means of saving PREPA, the Recovery Act was not the correct response to the situation. Its passage runs afoul of the Constitution and deep-seated notions of federalism, raising more problems than it solves. The Recovery Act is burdened by constitutional concerns that outweigh its proposed utility. Aside from this, allowing PREPA to either default on its debt or to enter bankruptcy without first trying to save the utility would

²²⁶ *Id.*

²²⁷ *Id.*

²²⁸ *Id.*

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

create a global economic crisis that could be avoided. Although several potential solutions to PREPA's situation were provided, ultimately the utility's fate may depend on factors beyond its control, including the economy of Puerto Rico as a whole. Lastly, although none of the provided alternatives are perfect, they at least provide some semblance of hope that PREPA can remain viable while avoiding the constitutional morass in which the Recovery Act is mired.

Michael K. Piacentini[†]

[†] J.D. Candidate, Brooklyn Law School, 2016; B.A., B.S., University of Delaware, 2012. Thank you to the staff and editors of the *Brooklyn Law Review* for all of their hard work on this note. A special thanks to my family for all of their continuing support.