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After Debt: A Path Forward for Puerto Rico

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Summary
This Issue Brief summarizes events surrounding the current debt crisis in Puerto Rico and presents a two-step plan for restructuring Puerto Rico's debt and encouraging more effective governance. This plan draws extensively on the previous experiences of debt crises in municipalities on the U.S. mainland. Step one entails the creation of a financial control board (FCB) for Puerto Rico, monitored by the U.S. federal government but involving significant Puerto Rican representation. Step two would be for Congress either to craft a restructuring framework applicable to all of America's territories, or to extend the existing bankruptcy laws in Chapter 9 of the Bankruptcy Code (with modifications) to Puerto Rico and its municipalities.

Keywords
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Over the last decade, recession has plagued the economy of Puerto Rico—a Commonwealth territory of the United States—and the island has increased its public debt by an unmanageable amount in order to balance budgets and provide necessary services.

A lack of economic opportunity, which compelled many of the territory's citizens to move to the U.S. mainland or to leave the labor force altogether, worsened the dire fiscal state of the island, which receives federal revenues but does not collect federal income taxes from its residents (see Figures 1 and 2).

As of April 2016, Puerto Rico has amassed roughly $72-73 billion in debt and is unable to meet its payment obligations, to say nothing of its $44 billion in unfunded pension liabilities. The Commonwealth has a debt-to-income ratio in excess of 100 percent.[1] Puerto Rico's municipalities, including its public utility companies, owe much of this debt to creditors comprising, in large part, U.S.-based mutual funds and hedge funds. A significant portion of Puerto Rico's debt, however, is attributable to the territory itself in the form of general obligation (GO) bonds (see Figure 3).

Not even the island's largest creditors know exactly which parts of the Commonwealth are responsible for which debts, and Puerto Rico has complicated matters further by using funds appropriated to various government agencies to pay its guaranteed GO debt. Necessarily, this has involved further cuts to government

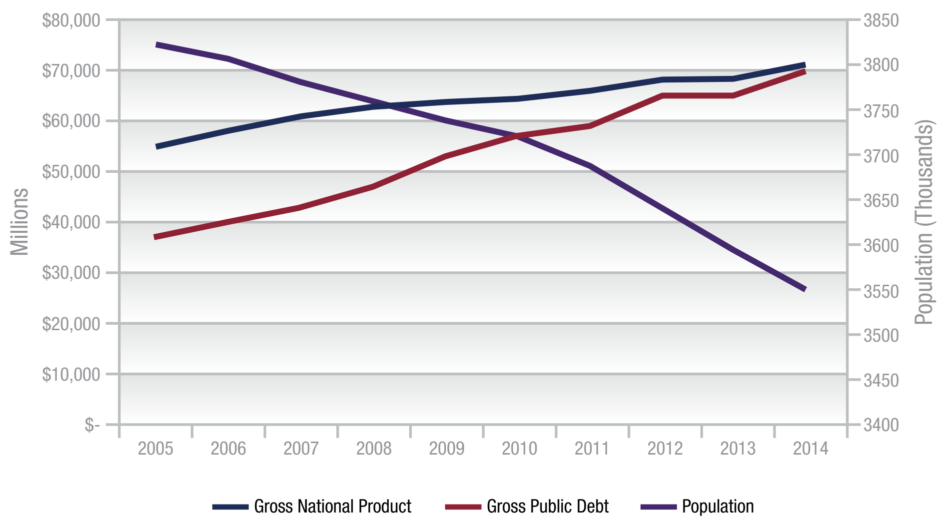
SUMMARY

- This Issue Brief summarizes events surrounding the current debt crisis in Puerto Rico and presents a two-step plan for restructuring Puerto Rico's debt and encouraging more effective governance. This plan draws extensively on the previous experiences of debt crises in municipalities on the U.S. mainland.
- Step one entails the creation of a financial control board (FCB) for Puerto Rico, monitored by the U.S. federal government but involving significant Puerto Rican representation, which would terminate its active role in Puerto Rico's affairs once fiscal benchmarks are established and satisfied. This FCB needs to have more authority than envisioned in the proposal by Senate Democrats, but less than that recommended in draft legislation from House Republicans.
- Step two would be for Congress either to craft a restructuring framework applicable to all of America's territories, or to extend the existing bankruptcy laws in Chapter 9 of the Bankruptcy Code (with modifications) to Puerto Rico and its municipalities.
- Together, these two steps would remove the risk that Puerto Rico will pick and choose which obligations to pay and ensure that creditors' priorities will be honored—all the while avoiding a true taxpayer-funded bailout. But Congress must act quickly.

services, exacerbating the population exodus. Unlike municipalities (e.g., Detroit) that are hampered by severe debt and economic stagnation and reside within the U.S. states, Puerto Rican municipalities cannot declare Chapter 9 bankruptcy to restructure their debt obligations because Puerto Rico's municipalities (along with Washington, D.C.) were excluded from Chapter 9 by a 1984 amendment to the Bankruptcy Code. Yet a federal appellate court held that the Commonwealth must abide by Chapter 9 restrictions that apply to all U.S. states and which prohibit debt restructuring outside of bankruptcy. Lacking obvious means for sufficient fiscal reform, the island has taken matters into its own hands.

In this Issue Brief, I will summarize the recent events surrounding the debt crisis in Puerto Rico. I will then present a two-step plan for restructuring Puerto Rico's debt and encouraging more effective governance in a manner that, on the one hand, promotes the island's democratically elected authority and, on the other hand, addresses concerns that any federal intervention constitutes a "bailout." [2]

FIGURE 1: PUERTO RICO'S GNP, DEBT, AND POPULATION



Source: Government Development Bank for Puerto Rico

THE CURRENT STATE OF THE TERRITORY

In January 2016, Puerto Rico missed a second consecutive debt payment, as it was unable to meet all of its interest rate obligations. Despite the territory's heralded inability to satisfy future interest payments on its debt, including $422 million in payments due in May and $2 billion in July, Congress has been slow to take action. Draft legislation from Republicans in the House Committee on Natural Resources, which has jurisdiction over all U.S. territories, has stoked sharp criticism from the Commonwealth. An earlier Senate bill proposed by Democratic Senator Bob Menendez (D-NJ) received a more favorable reception from Puerto Rico, but was strongly criticized by Congressional Republicans.

Sensing a threat to its democratically elected authority, and uncertain whether Congress will act, the Commonwealth demonstrated its independence by passing legislation permitting Puerto Rico's governor to impose a moratorium on any debt payments through the beginning of 2017 while

NOTES

1 For comparison, this is well above the maximum 60 percent level that the EU requires of its members.

2 The recommendations in this Issue Brief come from Clayton P. Gillette and David A. Skeel, Jr., "A Two-Step Plan for Puerto Rico", Institute for Law and Economics, U. Penn. 16-3 (2016). Available at http://ssrn.com/abstract=2728466.

3 For more information on this proposal, see Reuters, http://www.reuters.com/article/us-usa-puertorico-debt-idUSKCN0X81MY.

4 See Franklin California Tax-Free Trust vs. Puerto Rico, 805 F.3d 322 (1st Circuit 2015) for the case that struck down the Recovery Act.

5 For discussion of the various forms and roles of financial control boards, see Clayton P. Gillette, "Dictatorships for Democracy: Takeovers of Financially Failed Cities", 114 Columbia Law Review, 1373 (2014).

6 Some of the entities that have issued debt in Puerto Rico, and there are at least 18 of them, might not qualify as "municipalities" and some might not meet Chapter 9's insolvency requirement. These include the Government Development Bank, which serves as the Commonwealth's fiscal agent, Prepa, the public electricity company, and COFINA, a conduit for the issuance of bonds secured by sales taxes.

7 Clayton P. Gillette and David A. Skeel, Jr., "Governance Reform and the Judicial Role in Municipal Bankruptcy", Yale Law Journal (2016).

8 Professors Mitu Gulati and Robert Rasmussen have argued that Puerto Rico's creditors are subject to an implied duty of good faith that could be used to catalyze a voluntary restructuring.   Mitu Gulati & Robert Rasmussen, "Puerto Rico—

simultaneously extending a relief proposal of its own to creditors. Specifically, Puerto Rico would like to cut down the debt that is directly or indirectly owed by the territory, about $49-50 billion, through new public debt offerings, in a direct appeal to creditors who fear that the alternatives (i.e., Congressional legislation or lawsuits filed by the creditors themselves against the territory for breaching debt contracts) could lead to worse repayment outcomes.[3] The problem here is that, even if most bondholders favor this non-bankruptcy restructuring, any restructuring arrangement without a majority voting provision is not binding on bondholders who do not consent—and there could be a lot of them.

As for the remainder of the debt, most of which belongs to public utility companies, the Commonwealth attempted to establish grounds for restructuring that portion via bankruptcy-like proceedings when it passed a 2014 law known as the Recovery Act. The legality of the legislation was challenged and, initially, opposing creditors won rulings in federal trial and appellate courts to halt the law's implementation.[4] However, the Supreme Court surprised both the Commonwealth and its creditors by deciding to take the case. The Court heard oral arguments in late March, signaling that the future of the Recovery Act, and what its restructuring capabilities could mean for the rest of Puerto Rico's public debt, is far from certain.

Although Puerto Rico's creditors would welcome a financial control board (FCB), they have lobbied aggressively against proposals to create a bankruptcy or other federal restructuring option for Puerto Rico, especially proposals that would extend both to Puerto Rico's municipalities and to the territory itself. Creditors that are willing to at least consider a restructuring option insist that it rely entirely on majority voting by each class of creditors, and that a restructuring not be "crammed down" on any class of creditors that votes against it.

Congressional relief for the territory has proponents and critics in both political parties and for different reasons. What is clear is that any rescue measure—extending Chapter 9, developing a territory-specific solution, or otherwise—must address the full burden of Puerto Rico's debt. At best, it also would assist in correcting the larger problem of dysfunctional governance on the island. While Puerto Rico may not want limits on its democratically elected authority, as called for in the bills proposed by the Senate and the House Committee on Natural Resources, the Commonwealth remains unable to grow its way out of debt, and thus far, it has given no indication that it can navigate its current economic challenges or avoid similar ones in the future. Some financial controls are warranted, but the details matter a lot.

STEP ONE: AN EFFECTIVE FINANCIAL CONTROL BOARD

Financial control boards serve the purpose of restructuring democratic processes that have failed to provide services that are desired (or needed) by constituents at a tax price that induces residents and firms to remain. A properly designed FCB that has authority over Puerto Rico's budgets and related issues can play a critical role in the rehabilitation of the territory's distressed government. An FCB can provide expertise to officials, assurances to capital markets, and a way to overcome political obstacles to financial reform that elected officials might find unattractive. In constraining the authority of elected officials, the FCB further addresses the moral hazard of local overspending that can

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Debtor, Heal Thyself," FT Alphaville, Jan. 14, 2016, available at http://ftalphaville.ft.com/2016/01/14/2148906/guest-post-puerto-rico-debtor-heal-thyself.

precede requests for financial relief from the federal government.

For an FCB in Puerto Rico to be effective, it must have significant Puerto Rican representation, but Congress must establish it and set its parameters. This approach has worked to overcome severe financial distress in major municipalities on the U.S. mainland, especially in the cases of New York City in the 1970s and Washington, DC in the 1990s.[5] An FCB augments, rather than replaces, elected officials. If designed appropriately, it only minimally will disrupt democratic processes and it will withdraw as soon as the controlled entity (i.e., Puerto Rico) satisfies objective benchmarks consistent with financial stability. Here is a summary of what it should look like:

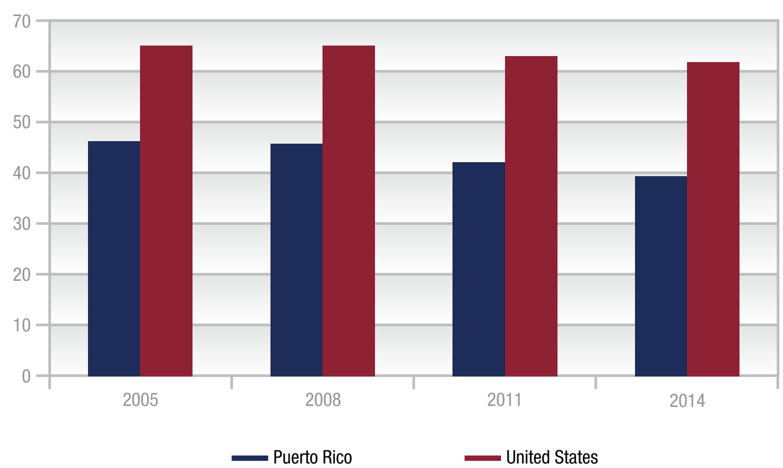
APPOINTMENT OF MEMBERS

President Obama, after consultation with the Chair of the House Committee on Natural Resources, currently Rep. Rob Bishop (R-UT), and the Resident Commissioner for Puerto Rico in the House of Representatives, Pedro Pierluisi, would make the following appointments to a seven-member board.

- Two ex-officio members: Governor Garcia Padilla of Puerto Rico and U.S. Secretary of the Treasury, Jack Lew
- Three of five voting members from Puerto Rico, giving Puerto Rico majority representation on the board
- Two of five voting members from the private sector, providing substantial experience in budgeting, public debt, and capital markets

The inclusion of the Puerto Rican Governor provides legitimacy to the FCB, and it also allows him to benefit from the expertise of the other members of the board. The presence of the U.S. Treasury Secretary or his designate ensures representation of federal interests in the fiscal health of the U.S. territory. All seven appointments find precedence in state FCBs.

FIGURE 2: LABOR FORCE PARTICIPATION RATE



Source: Government Development Bank for Puerto Rico; U.S. Bureau of Labor Statistics

POWERS OF THE BOARD

1. The FCB should have the authority to negotiate with creditors and enter into binding debt adjustment agreements, once the board is able independently to determine and provide transparent and credible portrayals of Puerto Rico's current financial situation.
2. The control board should be given both authority and funding to commission and review audits of Puerto Rico or any of its municipalities and affiliated entities.
3. The FCB should be able to approve or disapprove annual budgets and five-year plans, the latter of which it would commission. Such plans increase transparency by providing benchmarks against which actual spending can be measured. After the FCB withdraws, benchmarks will be necessary for observing deviations in expenditures. However, the FCB would not be permitted to determine spending priorities within a balanced budget, as that would undermine the authority of democratically elected officials.
4. Board approval should be required for all substantial contracts, including collective bargaining agreements with public service unions.
5. The FCB should have authority to approve or disapprove any new debt issuances.
6. While the FCB should not replace elected officials, as was done in Detroit, the FCB could ensure fiscal prudence by receiving and disbursing all revenues that would flow to the Commonwealth. This finds precedence in New York City and

Washington, DC control boards. The capturing of revenues may be politically infeasible, but disbursement capability during a control period is beneficial even by itself.

7. The board should impose "best practices" for budgeting and accounting, as well as sanctions, including removal, against officials who violate its orders or policies.

TERMINATION AND REINSTATEMENT OF BOARD

The FCB would terminate its active management role in the Commonwealth once fiscal benchmarks are established and satisfied. It would, however, reassert an active role if deficits or other specified signs of crisis returned.

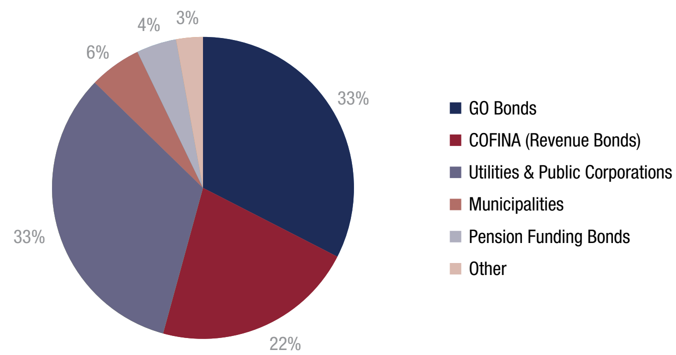
STEP TWO: A RESTRUCTURING LAW FOR U.S. TERRITORIES—NOT JUST PUERTO RICO

The discipline provided by an FCB, though critical, will not be enough to alleviate Puerto Rico's financial distress. A second step is required. Congress either should give Puerto Rico and its municipalities access to the existing municipal bankruptcy laws in Chapter 9 of the Bankruptcy Code, or it should craft an alternative restructuring framework for all of America's territories. A sufficient rescue package could utilize either approach, but the latter option is preferable because it naturally takes into account the idiosyncrasies of territories and it maintains key distinctions between them and the states. Congress's authority to enact a new restructuring law would come from the Territories Clause in Article IV of the U.S. Constitution and the Bankruptcy Clause in Article I.

Regardless of approach, both the territories themselves and their municipalities should be eligible for relief, meaning Chapter 9 would need to be amended to include both the territory and its municipalities if Congress selects that option. Only allowing municipalities to restructure their debts, as the case of Puerto Rico shows, ignores large portions of government debt owed directly or indirectly by the territory itself (roughly $50 billion with Puerto Rico), which could prevent a territory from returning to fiscal health.[6] Such an approach is not available to U.S. states, as only their municipalities have recourse to bankruptcy and not the state itself. Crafting a solution applicable exclusively to territories in order to address the crisis in Puerto Rico, therefore, would signal to states that they should not expect similar treatment, and it would assuage any concerns that the law is not "uniform," as required by the Bankruptcy Clause.

The Puerto Rican Governor and the FCB each should be given independent authority to invoke the new law. If the territory itself files to initiate restructuring and meets the law's entrance requirements, any of its municipalities or affiliated entities should be permitted to file as well, and the latter group should not be subject to the insolvency requirement (see Footnote 6). Per the Bankruptcy Code, all of these entities need to be treated separately, but the option to develop a single reorganization plan should remain on the table.

FIGURE 3: BREAKDOWN OF PUERTO RICAN DEBT



Source: Commonwealth of Puerto Rico Financial Information and Operating Data Report, November 2015

KEY PROVISIONS OF TRADITIONAL BANKRUPTCY TO INCORPORATE INTO A NEW RESTRUCTURING LAW

1. Impose an automatic stay on litigation to prevent creditors from "racing to the courthouse." Puerto Rico already faces a growing number of costly lawsuits due to its missed debt payments.
2. Ensure that a majority vote binds each class of creditors.

3. Provide the right to assume desirable contracts and terminate undesirable contracts, with some special restrictions regarding collective bargaining agreements.
4. Allow financing to be provided by public or private entities. There need not be a designated source of public funding akin to what the Dodd-Frank Act of 2010 mandates for systemically important financial institutions.
5. Creditors must be protected by definitions of "unfair discrimination" and "best interests" in order to avoid another Detroit scenario. The rule of law took a beating in the Detroit bankruptcy. Creditors who held that city's GO bonds, which had the same priority as pensions, received only about 41 percent of what they were owed, and several classes of creditors that voted against the plan received far less. Pensioners, meanwhile, received 60-70 percent. To protect the future investment potential of Puerto Rico, Congress should explicitly require that recovery rates for creditors with the same priority cannot deviate more than a specified amount, such as 15 or 20 percent. This would be a way to "discriminate fairly." Additionally, Congress should define "best interests" to mean that a restructuring plan guarantees as much recovery for creditors as is reasonably possible, as opposed to the "something's better than nothing" ruling handed down in Detroit.
6. The "feasibility" requirement should include governance reform. Bankruptcy courts should decline to approve a restructuring plan as feasible if it does not address obvious governance dysfunction that is frequently a primary cause of fiscal distress.[7] Puerto Rico exemplifies this dysfunction, as about 120 government agencies provide services on the island with insufficient centralization to avoid overlap and to coordinate responsibilities. A plan that fails to eliminate or consolidate government agencies should be rejected as not "feasible."

ECONOMIC CONSIDERATIONS AND ALTERNATIVE OUTCOMES

The two steps of this plan are closely connected. Of particular importance is the authority given to the FCB to initiate the restructuring process. However, as comprehensive as this plan may be, Puerto Rico still needs a larger plan for future economic growth. The Commonwealth clearly would benefit from federal correction to some harmful economic constraints, like the artificial restriction on Medicaid reimbursements for territories. Another often-mentioned source of relief would be a relaxation of the federal minimum wage requirement, which is relatively high for the Puerto Rican economy. This idea has found favor among some economists in both political parties.

MORATORIUM AND VOLUNTARY RESTRUCTURING

Absent Congressional action, Puerto Rico could use its moratorium authority to halt payment on some or all of its future debt payments through early 2017 to give itself breathing room while coordinating debt restructuring with creditors outside of bankruptcy via new debt issues. Some creditors have offered their own proposals already. For this to be successful, an overwhelming number of creditors would need to support the strategy and withhold lawsuits. Averse to the presence of a control board, the Commonwealth is attempting to orchestrate this scenario presently. Some commentators have argued that Puerto Rico could draw on existing law to force its creditors to negotiate in good faith.[8] But it is not clear whether or not this ad hoc restructuring strategy is a viable course.

RECOVERY ACT RESURRECTION

The Supreme Court could rule in favor of the Commonwealth and reassert the validity of the Recovery Act, which would allow Puerto Rico to restructure the debt belonging to its public utility companies ($22-23 billion). Such a ruling certainly would be appealed, likely for violating the Contracts Clause of both the Puerto Rican and U.S. Constitutions, and it could take many years for the island to implement the Act in any way.

A TAXPAYER-FUNDED BAILOUT

A true bailout might be demanded from U.S. taxpayers if Congress does nothing and Puerto Rico is unable to work out new arrangements with its creditors to write down some of its current debt. Since it is now clear that the territory is insolvent (and facing costly lawsuits from some creditors), the debt crisis could evolve into a humanitarian crisis if the island is forced to default outright (i.e., runs out of cash entirely). The Government Development Bank already has been reduced to a "bridge bank" simply for financing essential public services, and it is rapidly exhausting its capital.

CONCLUSION

Bankruptcy or a territorial restructuring law can mitigate Puerto Rico's debt problems, so long as terms like "unfair discrimination," "best interests," and "feasibility" are properly defined in response to recent rulings on municipal bankruptcies. The financial control board and restructuring law for territories proposed in this Issue Brief draw extensively on the experience of other debt crises in U.S. municipalities, such as those in New York City and Detroit. These two steps remove the risk that Puerto Rico will pick and choose which obligations to pay, and they ensure that creditors' priorities will be honored. An FCB would augment elected leadership and correct broken democratic processes, while bankruptcy law would avoid the need for a true taxpayer-funded bailout.

This plan will only work if Puerto Rico addresses its dysfunctional governmental structures and receives federal policy support for overcoming its long-lasting recession and population flight. Relative to the proposal from Senate Democrats, this plan calls for an FCB with greater oversight and decision-making authority. And compared to the Republican draft legislation from the House, which in its initial form gave too much power to the FCB, this plan provides a more balanced approach. There is a path forward for Puerto Rico, but it requires Congress to act this year.

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David Skeel is the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania's School of Law. He is the author of *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* (Wiley, 2011), *Icarus in the Boardroom* (Oxford, 2005) and *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton, 2001), as well as numerous articles and other publications. He has been interviewed on The News Hour, Nightline, Chris Matthews' Hardball (MSNBC), National Public Radio, and Marketplace, among others, and has been quoted in the and other newspapers and magazines. Skeel has received the Harvey Levin award three times for outstanding teaching, as selected by a vote of the graduating class, the Robert A. Gorman award for excellence in upper level course teaching, and the University's Lindback Award for distinguished teaching. In addition to bankruptcy and corporate law, Skeel also writes on sovereign debt, Christianity and law, and poetry and the law, and is an elder at Tenth Presbyterian Church in Philadelphia.