REFORMING MUNICIPAL BANKRUPTCY: LESSONS FROM PUERTO RICO

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I. INTRODUCTION

Domestically and abroad, governmental bankruptcy is on the rise.[1] Reasons why abound and vary, but a few broad trends stand out. First of all, as populations age, pension and healthcare liabilities increase. For another reason, debt financing has become a more common practice for cities, states and countries alike. Meanwhile, reverberations from the recession continue to reduce revenues. Intergovernmental lending has been reduced, and taxes have declined along with salaries and employment rates.[2]

Governmental insolvency is costly and inefficient. Where there is no relevant bankruptcy law, the debtor can become mired in litigation, as in Argentina's decade-long war with its hedge fund creditors.[3] The traditionally stable municipal bond market has become increasingly volatile, discouraging ordinary investors and raising the cost of borrowing.[4] And negative externalities abound when the debtor is in the business of providing crucial public services.

Where insolvency law does apply to a public debtor, as with Detroit, the legal procedure offers little comfort to creditors.[5] History has seen few filings under Chapter 9, U.S. bankruptcy law's proceeding for governmental debt adjustment. The lack of precedent prevents lenders from anticipating *ex ante* the outcome of their claims. As a result, municipal bonds are not optimally priced, and overall lending is inefficiently restricted.

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[1] Jeffrey B. Ellman & Daniel J. Merrett, *Pensions and Chapter 9: Can Municipalities Use Bankruptcy to Solve Their Pension Woes?*, 27 EMORY BANKR. DEV. J. 365, 365–66 (2011).

[2] *See* STATE BUDGET CRISIS TASK FORCE, FINAL REPORT (2014), http://www.statebudgetcrisis.org/wpcms/wp-content/images/Report-of-the-State-Budget-Crisis-Task-Force-Full.pdf.

[3] Daniel Cancel, *Topsy-Turvy Bond Market Means No Default Pain: Argentina Credit*, BLOOMBERG BUS. (Dec. 29, 2014, 8:00 PM), http://www.bloomberg.com/news/articles/2014-12-30/topsyturvy-bond-market-means-no-default-pain-argentina-credit.

[4] Michael J. Casey, *Argentina's Default Is a Warning to Frothy Government Bond Markets*, WALL ST. J. (Aug. 3, 2014, 5:33 PM), http://blogs.wsj.com/moneybeat/2014/08/03/argentinas-default-is-a-warning-to-frothy-government-bond-markets/.

[5] Steven Church, *Muni Mutual Fund Exposure to Detroit Falls on New Analysis*, THE BOND BUYER (July 29, 2013, 4:12 PM), http://www.bondbuyer.com/issues/122_145/muni-mutual-fund-exposure-to-detroit-falls-on-new-analysis-1054176-1.html; Bloomberg News, *Detroit bankruptcy teaches muni bond investors painful lessons*, CRAIN'S DETROIT BUS. (NOV. 7, 2014, 5:52AM), http://www.crainsdetroit.com/article/20141107/NEWS01/141109896/detroit-bankruptcy-teaches-muni-bond-investors-painful-lessons.

Expansion and reform of Chapter 9 could turn the law from a foe to a friend of investors. Expansion would enhance predictability, a premium goal in lending law. With reforms, Chapter 9 could serve rather than stymie economics.

Bankruptcy law is legally, economically, and ethically complex. As scholarship on municipal bankruptcy acknowledges, additional complexities arise when the debtor is a government. Legally, a host of additional balance-of-power issues arise on top of typical federalist bankruptcy issues. Financially, a bankruptcy judge must assess projections of future financial performance, which involve future tax collection predictions when the debtor is a government. Ethically, additional issues arise when the debtor is in the business of providing public services.

This article provides an in-depth case study of Puerto Rico, a governmental debtor that is currently in financial crisis, to propose efficiency-enhancing reforms for Chapter 9. Because of Puerto Rico's unique status as a U.S. Commonwealth, the island provides a useful lens through which to examine legal issues affecting insolvent states, cities, and countries alike.

Recent legal scholarship on Chapter 9 surveys the various political, legal, and structural problems complicating governmental insolvency. This article fills a gap by, first of all, allowing the reader to consider legal solutions upon a foundation of in-depth, practical and financial understanding of a representative governmental debtor. Secondly, the article draws recent scholarship to its relevant conclusion by proposing concrete amendments to municipal insolvency law.

II. CHAPTER 9 AND THE PUERTO RICO EXCLUSION

When a borrower cannot pay back his creditors in the amount or time they originally agreed upon, it may appeal to federal law to scale back its obligations. If the borrower is a private firm, the relevant law is outlined in Chapter 11 of Title 11 of the U.S. Code.[6] If the borrower is a government, the relevant law is in Chapter 9.[7]

Though corporations, individuals, banks and railroads located within Puerto Rico may appeal to federal bankruptcy law just like corporations, individuals, banks or railroads located within any of the fifty states of the U.S., neither Puerto Rico nor any of its political subdivisions, public agencies, or *instrumentalities* may amend their debt obligations under the Code. When read in conjunction, two statutory provisions exclude Puerto Rico from Chapter 9: municipality is defined as a "political subdivision or public agency or instrumentality of a State"[8] whereas "the term 'State' includes the District of

[6] 11 U.S.C. §§ 1101–1174 (2015).
[7] §§ 901–946.
[8] § 101(40).

Columbia and Puerto Rico, except for the purpose of defining who may be a debtor under chapter 9 of this title."[9]

Why did Congress choose to treat Puerto Rico differently under bankruptcy law in this limited way? Neither the statutory language nor legislative history provides a reason. Congress passed the modern Bankruptcy Code in 1978.[10] The Act included an identical version of what is now 11 U.S.C. § 109(a), which specifies that "only a person that resides in the United States . . . or a municipality may be a debtor under this title,"[11] and defining municipality as a "political subdivision or public agency or instrumentality of a State."[12] The 1978 version of the act did not define *State* or mention Puerto Rico at all. Then, as now, Puerto Rico was not a state but a Commonwealth.

The legislative history of the Bankruptcy Code from 1978 is utterly silent concerning Puerto Rico. The first time Congress considered the Commonwealth while legislating on bankruptcy was to include Puerto Rico under the Code so that it would not be distinguishable from a state. In 1981, Congress introduced the Bankruptcy Amendments Act with the purpose of clarifying and correcting technical errors in the 1978 Act. The Act added the definition of *State* that the modern law includes in § 101(52) and explained the amendment as follows:

> This amendment amends the definition of "state" to include the District of Columbia and Puerto Rico. These governmental units were inadvertently left out of the definition of 'state' during the passage of the Reform Act . . . .
>
> This amendment adds a rule of construction for the term "United States" when used in a geographical sense. The effect of this addition . . . is to clarify that the Reform Act applies to those who reside, have a domicile, or have property in the Commonwealth of Puerto Rico, the District of Columbia or the territories or possessions of the United States. Absent the amendments made by this subsection and subsection (c) of the bill, the Reform Act could be construed as not applying to those areas and debtors residing there could not seek relief in the bankruptcy courts.[13]

The original purpose, then, of the modern Code provision defining *state* was to include Puerto Rico under the law in order to ensure that Puerto Ricans could file for federal bankruptcy. The legislative history did not explain the final

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[9] § 101(52).
[10] Pub. L. No. 95-598, 92 Stat. 2549 (1978).
[11] *Id.* at § 109(a).
[12] 11 U.S.C. § 101(29).
[13]

clause of § 101(52), excluding Puerto Rico from the *state* in the narrow context of determining who may be a Chapter 9 debtor.

A subsequent 1983 hearing provides limited insight into the amendment. Congressman Frank R. Kennedy consulted with famed bankruptcy scholar Vern Countryman and included the following comment in the legislative history: "I do not understand why the municipal corporations of Puerto Rico are denied by the proposed definition of 'State' the right to seek relief under Chapter 9, but the addition of the definition of 'State' is useful."[14] Congress never addressed Countryman's question, and the 1981 definition of *state*, explicitly including Puerto Rico under the Code in general and explicitly excluding Puerto Rico from Chapter 9, stands today.

Because Puerto Rico is a governmental unit, it cannot file under Chapter 11[15] or any other Code provision.[16] As a result, the Commonwealth, its municipalities and its public corporations may not restructure their debt under federal law.

The Northern Mariana Islands, a U.S. territory and Commonwealth, like Puerto Rico, dealt with a similar situation in 2013. The U.S. District Court held that the public retirement fund could not file under Chapter 11 because it was a governmental unit. Judge Robert J. Faris acknowledged that federal law, under this interpretation, left the petitioner "caught between an irresistible force . . . and an immoveable object."[17] However, he reasoned,

> Congress did not intend that the Bankruptcy Code could solve all problems, least of all the financial problems of governmental units. The dismissal of this case will leave the Fund and its beneficiaries at the mercy of the Commonwealth government, but Congress intended that the local government, rather than a federal court, should address such problems.[18]

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[14] S. Hrg. 98-574, 326 (1983).

[15] Like Puerto Rico, the Northern Mariana Islands constitute a U.S. territory and Commonwealth, and are thus excluded from Chapter 9 as well as Chapter 11 for amending their own debt obligations. *See In re* Northern Mariana Islands Retirement Fund, No. 12-00003, 2012 WL 8654317, at *3 (D. N. Mar. I. June 13, 2012) (holding that the Northern Mariana Islands Retirement fund could not file for bankruptcy under Chapter 9 because it was a municipal instrumentality).

[16] Within Title 11, there are five different types proceedings available depending on the type of debtor: (1) Chapter 7 proceedings, which are available to individuals and most private corporations; (2) Chapter 13 proceedings, which are available only to individuals; (3) Chapter 11 proceedings, which are available to individuals, private corporations, and railroads; (4) Chapter 12 proceedings, which are available to family farmers and fishermen; and (5) Chapter 9 proceedings, which are only available to municipalities. 11 U.S.C. § 109.

[17] *In re N. Mar. I. Ret. Fund*, 2012 WL 8654317, at *3.

[18] *Id.*

In effect, Puerto Rico took Judge Faris' advice and passed its own governmental restructuring law in June of 2014. The Public Corporation Debt Enforcement and Recovery Act permitted certain public corporations to modify their debt obligations by creditor approval or judicial enforcement.[19] Modeled on Chapter 11, the P.R. Recovery Act aimed to protect creditors and stabilize the bond market while allowing debtor agencies to provide essential power, highway, water and sanitation services[20] and incorporated federal Bankruptcy Code case law as precedent.[21]

However, in February 2015 the P.R. Recovery Act was struck down the on federal preemption grounds.[22] The decision leaves Puerto Rico with no legal avenue to restructure its debt obligations and lawmakers devoid of power to change this untenable situation.

III. Puerto Rico's Current Economic State

Puerto Rico is financially distressed. As of the island's most recent operating report, the island's total outstanding public service debt was $71.435 billion, equivalent to 101% of its gross national product for 2013.[23] The Commonwealth's general fund budget has generated deficits for decades, which it covers primarily with further debt financing.[24] Between 2007 and 2011, the gross national product contracted every year; its subsequent growth has been minimal.[25] The population decreased by 2.2% from 2000 to 2010 and an additional 3% from 2013, due largely to emigration. The average age of the population is increasing.[26] Employment has declined steadily each year since 2000, and unemployment currently averages 14.3%.[27]

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[19] *See* Puerto Rico Public Corporation Debt Enforcement and Recovery Act, 2014 P.R. Laws 371 [hereinafter P.R. Recovery Act]. *See also* GOV'T DEV. BANK FOR P.R., THE FACTS ABOUT PUERTO RICO'S PUBLIC CORPORATIONS DEBT ENFORCEMENT AND RECOVERY ACT, http://www.gdb-pur.com/documents/FactsAbout DebtEnforcementAndRecoveryAct.pdf.

[20] P.R. Recovery Act §§ 101, 128–137, 2014 P.R. Laws 395, 420–28. *See also* Lorraine McGowen, *Summary of Puerto Rico Public Debt Enforcement and Recovery Act*, ORRICK, HERRINGTON & SUTTCLIFFE LLP: RESTRUCTURING ALERT (July, 2014), http://s3.amazonaws.com/cdn.orrick.com/files/Puerto Rico.pdf.

[21] P.R. Recovery Act § 103(p), 2014 P.R. Laws at 406.

[22] Franklin Cal. Tax-Free Trust v. Puerto Rico v. García-Padilla, 85 F. Supp. 3d 577, 583 (D.P.R. Feb. 6, 2015).

[23] GOV'T DEV. BANK FOR P.R., COMMONWEALTH OF PUERTO RICO: FINANCIAL INFORMATION AND OPERATING DATA REPORT 14 (2014), http://www.gdbpr.com/documents/CommonwealthReport-October302014.pdf [hereinafter P.R. Fin. Rep.].

[24] *Id.* at 15.

[25] *Id.* at 23.

[26] *Id.* at 24.

[27] *Id.* at 48.

Future balanced budgets are unlikely, given higher debt service and pension funding obligations beginning in 2016.[28] In March and October 2014, the Commonwealth issued $900 million of new notes at high interest rates.[29] The bonds have dispersed claimholders and short maturities, and thus could be called "dangerous debt" because of the burdens they place on the island.[30] Reflecting this high risk of default, all three major credit-rating agencies rate these bonds as non-investment grade.[31]

An additional source of debt crippling Puerto Rico is its public pension system, which is nearly insolvent.[32] In 2014, the government contributed $98.6 million less to its pension plan than promised the prior year, increasing unfunding ratios to roughly 15%. In December 2013, Puerto Rico introduced legislation scaling back its unsustainable pension obligations to the Judiciary and to the Teachers' Retirement Systems. Merely days thereafter, Puerto became embroiled in litigation with the pensioners. On appeal to the Puerto Rico Supreme Court, the government lost the suit to its teachers,[33] and won the suit with the Judiciary, but only for judges taking office on or after December 24, 2013.[34] Despite its legislative attempts, these cases have significantly limited Puerto Rico's hope of a statutory solution to its impending pension debt crisis.

A. Market Effect

Despite Puerto Rico's weak economy, investors snatched up its most recent bond issuances. High trading levels drove up prices, reflecting the market's opinion that the island's IOU's were meaningful or reliable.[35]

Why would investors take Puerto Rico's payment promises seriously, given the island's history of unbalanced budgets and present state of financial

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[28] *Id.* at 33, 45–46.

[29] On October 10, 2014, the Government Development Bank for Puerto Rico—the Commonwealth's fiscal agent and financial advisor—issued $900 million of notes backed by the Commonwealth, scheduled to mature by June 30, 2015. *Welcome Message*, GOV'T DEV. BANK FOR P.R., http://www.gdb-pur.com/about-gdb/welcome.html (last visited March 5, 2016); P.R. Fin. Rep., *supra* note 23, at 7. *See also* Mike Cherney, Al Yoon, & Matt Wirz, *Investors Flip for Puerto Rico's Debt Offering,* WALL ST. J. (March 12, 2014, 8:24 PM), http://online.wsj.com/news/articles/SB10001424052702304914904579 435191727908068.

[30] Patrick Bolton & David A. Skeel, Jr., *Inside the Black Box: How Should A Sovereign Bankruptcy Framework Be Structured?*, 53 EMORY L.J. 763, 774 (2004) (arguing that the issuance of dangerous debt increases the risk of debt crisis and the cost of restructuring).

[31] Maria Armental, *Fitch Downgrades Puerto Rico General Obligation Bonds*, WALL ST. J. (July 9, 2014, 8:11 PM), http://www.wsj.com/articles/fitch-downgrades-puerto-rico-general-obligation-bonds-1404 951069.

[32] Robert Slavin, *Puerto Rico Falters on Pensions*, BOND BUYER (Sep. 26, 2014, 12:28 PM), http://www.bondbuyer.com/news/regionalnews/puerto-rico-falters-on-pensions-1066492-1.html.

[33] Asocn. de Maestros de P.R. v. Sis. de Ret. para Maestros de P.R., 190 P.R. Dec. 854 (2014).

[34] Germán J. Brau v. ELA, 190 P.R. Dec. 315 (2014).

[35] *See* Cherney et al., *supra* note 29.

distress? An optimistic reason is that some investors believe in the government's economic overhaul plans. Governor Padilla has undertaken major spending cuts and economic development plans, some of which have already seen moderate success. Thus borrowing would currently be underpriced because investors are betting that the Commonwealth will create more value going forward.

A more skeptical reason is that investors are betting on a bailout from the federal government. One reason bailouts create marketplace inefficiencies is their unpredictability. Investors price debt according to the likelihood of timely payment. The more that timely payment would require an uncertain external bailout, the higher the chance is of mispricing. In Puerto Rico's case, a bailout is even less predictable than usual because of the island's convoluted and unstable relationship with the federal government. The Obama administration has issued explicit and contradictory statements both that it would and would not bail out Puerto Rico.

Given federal income tax policy, such as triple tax-free status and recently enacted excise taxes on U.S. manufacturing companies operating in Puerto Rico, which Forbes criticized as a "backdoor bailout,"[36] investors predicting federal assistance would not be off base.

Puerto Rico's bond are triple-tax free, meaning that bondholders residing anywhere in the United States do not have to pay state, local or federal taxes on interest or maturity payments. In contrast, most other municipal bonds are only exempt from local taxes in the geographical area where they are issued. All else held equal, Puerto Rican bonds are more valuable to, for example, a New York-based resident than bonds from another U.S. city or state, because the New York investor would not discount Puerto Rican payments by his tax rate.

As a result of federal tax preferences for Puerto Rican bonds, many large U.S. mutual funds hold Puerto Rican bonds. This means that, although Puerto Rico is a tiny island far off in the Atlantic Ocean, a default on its municipal bonds will ripple back to the mainland and make waves throughout the national bond market.

Puerto Rico's bond market resembles the pre-Dodd Frank residential mortgage market. In both situations, the federal government did not merely fail to regulate unsustainable lending, but worse, encouraged over-lending through tax law. In the case of pre-financial crisis mortgage lenders, federal income tax policy incentivizes mortgage borrowing and home ownership. In the present case of Puerto Rico's over-issuance, triple-tax-free status subsidizes the island's bonds relative to those from other issuers. So long as current tax policy persists, Puerto Rico will continue borrowing at unsustainable levels; investors will continue buying the debt at artificially low rates; and U.S. taxpayers will bear the burden, if not directly through a bailout, then indirectly through tax policies.

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[36] Martin Sullivan, *The Obama Administration's Backdoor Bailout Of Puerto Rico*, FORBES: TAXES (Jan. 28, 2014, 9:35 AM), http://www.forbes.com/sites/taxanalysts/2014/01/28/the-obama-administrations-backdoor-bailout-of-puerto-rico/#5a94585f182e.

B. Reasons for Puerto Rico's Financial Distress

This section discusses four primary reasons for Puerto Rico's financial distress:

(A) rational fiscal irresponsibility by politicians, (B) municipal structure, (C) issues specific to individual public corporations, and (D) dependence on the U.S. To be sure, this is an oversimplification. These categories overlap with one another, and there is a fine line between cause and effect when there is a downward spiral. I focus on these reasons because they are high on the cause-effect chain. This is useful because the best legal solutions address root causes rather than mere effects.

Additionally, I focus on what public administration scholars would call internal factors as opposed to external factors. External factors are, by definition, outside of the local government's control, and as such cannot be solved by local legal regime.[37] Internal factors, on the other hand, are a good place for lawmakers to focus their attention.

C. Rational Fiscal Irresponsibility of Politicians

Like most states, Puerto Rico legally requires politicians to balance the budget. The Commonwealth's Constitution mandates that "the appropriations made for any fiscal year shall not exceed the total revenues estimated for that fiscal year," and holds the governor, his executive branches, and the legislature responsible for doing so.[38]

The statutorily mandated budget-making process also requires budgetary balancing. Each year, governmental agencies petition the Office of Management and Budget [hereinafter OMB], a governor-appointed wing of the executive branch, for funds. The OMB evaluates the requests and, based on the Department of Treasury's revenue estimates and Government Development Bank's [hereinafter GDB] lending margin, works with the governor to create a budget. The governor then submits the budget to the legislature, which holds hearings where the agency heads defend their funding requests. The legislature may amend the budget but must allocate existing or raise additional funds if their amendment would otherwise create a deficit. The governor then may sign the amended budget if and only if it is balanced. He may reduce but not increase spending at this point.[39] He also has the power to veto the budget wholesale, which the legislature may override by two-thirds majority vote.

The government has issued high levels of debt, which it uses to fund its basic operations. Puerto Rico's constitution limits long-term, Commonwealth-

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[37] Keeok Park, *To File or Not to File: The Causes of Municipal Bankruptcy in the United States*, 16 J. PUB. BUDGETING, ACCT. & FIN. MGMT. 228, 241 (2004).
[38] P.R. Const. art. VI, § 7.
[39] *Id.* art. III, § 20.

guaranteed debt to 15% of average internal revenues of the two preceding fiscal years. The average is 13.7%, which will increase.[40] The Constitutional requirements address the current fiscal year and do not monitor such long-term debt.

Puerto Rico does not lack legal requirements, as balanced budget provisions abound throughout Commonwealth law. But the island does lack sufficient enforcement mechanisms. The politicians are not effective self-monitors because their personal interests conflict with the interest of the island as a whole. Political office holders only internalize the short-term costs and benefits of their decisions. The citizens will feel long-term effects, such as bonds with long-term maturity dates, after the politician has left office. This misalignment of interests creates an agency cost. The politicians in charge of budget-making are agents who manage taxpayers' money. When politicians use taxpayer dollars in a way that enhances politicians' reputations but ultimately costs taxpayers to a greater extent, inefficiency arises known as agency cost.

Monitoring can reduce agency costs. But Puerto Rico, like many governmental entities, lacks effective monitors. The politicians are not effective monitors of one another because the theoretical checks and balances in place are, in practice, weak. Although the budget-making process involves various agencies, all of them are executive branch members that the government appoints and oversees. The legislature's role, holding hearings and making some amendments, is limited, and the judiciary is absent from the process.

Empirical evidence shows that citizens have not effectively monitored their representatives either. Puerto Rico failed to enact a balanced budget for the last 14 years, from 1999 to 2013.[41] The government's budgetary predictions have been consistently and significantly inaccurate. As of early January 2015, revenues were already $36 million below projected and expenses were significantly higher than projected for the first quarter of 2015.[42]

D. Municipal Structure and Interdependence of Public Corporations

At an area of 3,515 square miles, Puerto Rico is smaller than Connecticut, but has a labyrinthine economic and political structure more appropriate for a larger geographical entity. The Commonwealth is divided into 78 municipalities, each electing its own mayor and dividing further into barrios. The executive branch of the Commonwealth owns 51 public corporations as well as 15 executive departments, several of which are further divided into agencies and sub-agencies. The public corporations are funded by revenues from service rates, subsidies

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[40] P.R. Fin. Rep., *supra* note 23, at 16.
[41] Danica Coto, *Puerto Rico Presents First Balanced Budget In Over A Decade*, HUFFINGTON POST (April 30, 2014, 9:35 AM), http://www.huffingtonpost.com/2014/04/30/puerto-rico-balanced-budget_n_5239509.html.
[42] P.R. Fin. Rep., *supra* note 23, at 15–16.

from the Central Government, and publicly issued bonds. The governor appoints most of the public corporations' board members, subject to senate approval.

In Puerto Rico, the Commonwealth, public entities, and municipalities have separate operating budgets and issue their own bonds. But the Commonwealth's General Fund subsidizes the public corporations' basic operational budgets. The GDB, a public corporation that borrows from public markets, serves as financial adviser and fiscal agent to the Commonwealth, and finances the public corporations, General Fund, and municipalities. When any of these entities have been unable to meet their expenses, the GDB has extended them financing and in this way has functioned as a lender of last resort.[43] The legally separate governmental entities are, in practice, highly integrated. When one public corporation in Puerto Rico suffers, credit ratings agencies downgrade bonds issued not only by that corporation, but also by the other corporations and by the General Fund.[44]

When legal identities do not match practical realities, inefficiencies ensue. Creditors of the General Fund, or of a public corporation or municipality, will be unable to predict *ex ante* exactly to whom they are lending. From an economic perspective, this is problematic because lenders will not be able to price interest accurately. From a fairness perspective, unclear boundaries undermine the parties' and judges' ability to respect creditors' *ex ante* expectations. It is difficult to honor lending agreements when it is unclear exactly who the borrower is.

Some of the island's political subdivisions may still be useful, to the extent that the public corporations and municipalities have separate issues and therefore benefit from specialized management. But intra-governmental loans erode any clarity to investors that the subdivisions could provide.

E. Issues Specific to Individual Public Corporations

The financial troubles of the individual public corporations mirror and contribute to the financial troubles of the Commonwealth overall. As of 2013, the combined deficit for the corporations was $800 million and their combined debt totaled $20 billion.[45] Ratings agencies downgraded most of the corporations to

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[43] *See* ARTURO C. PORZECANSKI, AM. U., THE GOVERNMENT DEVELOPMENT BANK: AT THE HEART OF PUERTO RICO'S FINANCIAL CRISIS 2 (2014), http://auapps.american.edu/aporzeca/www/The%20GDB%20at%20the%20Heart%20of%20Puerto%20Ricos%20Financial%20Crisis.pdf (arguing that "[t]he GDB facilitated the decade-long borrowing binge that paved the road to the Commonwealth's current fiscal crisis").

[44] The P.R. Recovery Act only applied to some of the governmental corporations, explicitly excluding other governmental issuers, *e.g.*, the general fund, sales tax-backed bond, and the University of Puerto Rico. However, ratings agencies downgraded the all issuers alike. Aldo Ceccarelli, *Puerto Rico—Restructuring and Downgrading Debt*, WELLS FARGO ASSET MGMT.: ADVANTAGEVOICE (July 17 , 2014). https://blogs.wellsfargo.com/advantagevoice/2014/07/ puerto-rico-restructuring-and-downgrading-debt-excerpt/.

[45] P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 373.

below investment grade in mid-2014.[46] Interest rates and bond yields decreased, which has restricted the public corporations' access to private lenders as well as to the capital markets. Puerto Rico relies on debt financing to cover its basic operating expenses and capital needs, so the public corporations have not been able to finance their operations.[47]

The three large public corporations with outstanding debt attributable to tax-exempt securities which the government's rehabilitation efforts and this paper focus on are: (1) Puerto Rico Highways and Transportation Authority ("PRHTA"), (2) Puerto Rico Electric Power Authority ("PREPA"), and (3) Puerto Rico Aqueduct and Sewer Authority ("PRASA").[48]

1. *Puerto Rico Highway and Transportation Authority ("PRHTA")*

The Puerto Rico Highways and Transportation Authority builds, operates and maintains the island's roads and mass transportation facilities. The corporation endured net operating losses of $530.8 million in 2010, $511.8 million in 2012, and $567.7 million in 2013,[49] and accumulated operational losses of $349 million between 2010 and 2013.[50] Borrowing from the GDB to cover operations added over $2 billion to PRHTA's liabilities between 2009 and 2012.[51]

As of its most recent financial reports, released in March 2014, total operational expenses, from payroll, highway, train, and bridge administration and maintenance, utilities, and the mass transportation system totaled $168,980,000, exceeding operational revenues, which totaled $130,253,000 (derived from tolls, train fares, and "other income"). [52] Non-operational revenues, though, coming from gas taxes, cigarette taxes, investment income, and vehicle licensing fees, totaled $411,420,000.[53] Promisingly, many of these non-operational revenues

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[46] *Id.* at 374.
[47] *See id.* at 375.
[48] The P.R. Recovery Act applies solely to governmental corporations, other than the following: the Children's Trust; the Employees Retirement System of the Government of the Commonwealth of Puerto Rico and its Instrumentalities; Government Development Bank for Puerto Rico and its subsidiaries, affiliates, and any entities ascribed to it; the Judiciary Retirement System; the Municipal Finance Agency; the Municipal Finance Corporation; the Puerto Rico Public Finance Corporation; the Puerto Rico Industrial Development Company, the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority; the Puerto Rico Infrastructure Financing Authority; the Puerto Rico Sales Tax Financing Corporation (CoFInA); the Puerto Rico System of Annuities and Pensions for Teachers; and the University of Puerto Rico. P.R. Fin. Rep., *supra* note 23, at 40.
[49] *Id.* at 167.
[50] P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 378.
[51] *Id.*
[52] P.R. HIGHWAYS & TRANSP. AUTH., FINANCIAL RESULTS AND DEBT COVERAGE CALCULATION (2014), http://www.bgfpr.com/spa/investors_resources/documents/05-15-14-ACT-QuarterlyInfMar2014.pdf.
[53] *Id.*

increased due to new legislation passed by the government in 2013[54]. Even so, ratings were downgraded to below investment grade in 2014, and the agency is facing a liquidity crisis.

A major reason for PRHTA's financial distress is an unprofitable contractual relation that it is locked into. PRHTA's revenues from tolls have declined significantly since PRHTA transferred operation and income of two large toll plazas to Goldman Sachs and Albertis Infrastructure under a public-private partnership agreement entered into on September 22, 2011.[55]

Governor Padilla has defended the deal, arguing that the private operators will make badly needed highway improvements. But the Commonwealth will lose out on $90 to $95 million of toll revenues that the roads generate annually, which Albertis and Goldman will now collect. PRHTA entered the agreement out of urgency. The corporation needed the upfront payment to pay down its debt, which exceeded $6 billion at the time. Contracts entered out of financial desperation are often not the best deal for the distressed party in the long run. However, breaking the contract without a special legal mechanism would incur substantial damages fees for PRHTA.

2. *Puerto Rico Electric Power Authority ("PREPA")*

PREPA generates and distributes the island's electric power.[56] This public corporation has been operating at a deficit since June 2011.[57] As of the Authority's most recent fiscal report, total assets were $10,157,253 in 2013, down from $10,253,852 in 2012. Total liabilities for 2013 were $10,948,638, up from $10,157,253 in 2012. PREPA operated at a net deficit of $791,385 in 2013, up from a $515,686 deficit in 2012 and a $169,495 deficit in 2011.[58]

Thus, PREPA's expenses are rising, and revenues are falling. Global oil prices, a classically external problem, are at the root of many of these problems. The island's reliance on oil, though, results from internal policies. Puerto Rico's energy industry and infrastructure are outdated, which in turn results in the hike in expenses and a high opportunity cost from non-existent energy technology. The Commonwealth's dependence on oil and obsolete energy policy have made

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[54] Act 31-2013 increased the petroleum product tax from $3.00 to $9.25 per barrel. It also increased the cigarette excise tax revenues by $20 million. Act No. 30-2013, in turn, transferred the Commonwealth's General Fund motor license fees to PRHTA, increasing PRHTA's revenues by around $80 million in FY2014. P.R. Fin. Rep., *supra* note 23, at 4.

[55] ERNST & YOUNG PUERTO RICO LLC, AUDITED FINANCIAL STATEMENTS, REQUIRED SUPPLEMENTARY INFORMATION AND SUPPLEMENTAL SCHEDULES 16 (2013), http://www.gdb-pur.com/investors_resources/financial_statements/PRHighways-AFS-6-30-2013-FINAL.pdf, at 16.

[56] *PREPA Is...*, P.R. ELEC. POWER AUTH., http://www.prepa.com/aeees_eng.asp (last visited March 5, 2015).

[57] PREPA Report, at 5.

[58] *Id* at 8.

investors reluctant to loan to PREPA.[59] Further, investors lack faith in PREPA because the public corporation is overly leveraged.[60] PREPA's long-term debt totaled $8.895.7 billion in 2013, $8,935.5 billion in 2012, and $8,089.0 billion in 2011.[61] The dwindling population, both a result from and continuing cause of the island's larger economic problems, has reduced demand for power, and thus reduced PREPA's revenues from rates.

PREPA has managed to buy itself some time by renegotiating contractual obligations with individual creditors. On August 14, 2014, PREPA entered into forbearance agreements with 60% of its creditors that extended PREPA bonds' maturity dates to March 31, 2015. The forbearance agreements posed several new costs and inefficiencies to PREPA's already strained budget. First of all, PREPA incurred additional costs for itself, paying an additional $1.4 million forbearance fee, $500,000 to bank lenders and $1 million to bondholders every month until the new maturity date.[62] Secondly, PREPA encountered inefficiencies arising from legal inconsistencies under said forbearance agreement. Under the contracts' terms, the forbearance agreement is governed by New York law whereas the amendments to the bond agreement are to be governed by Puerto Rico law. The Commonwealth of Puerto Rico court and the United States District Court for Puerto Rico were both granted jurisdiction to hear disputes arising under the new agreements.[63] Additionally, the agreements introduced conflicting deadlines for PREPA to introduce a restructuring plan and amended priority in a manner inconsistent with federal bankruptcy law, introducing further uncertainty.

3. *Puerto Rico Aqueduct and Sewer Authority ("PRASA")*

PRASA owns and operates the Commonwealth's water and wastewater systems. The corporation operates at a continually increasing deficit, with net losses of $39.6 million in 2011, $136.8 million in 2012, and $291.9 million in 2013.[64] Between 2012 and June of 2013, operating revenues decreased by $77.4 million to $735.7 million, while operating expenses increased by $77.7 million to $1.027.6 billion, respectively.[65] Moody's downgraded its ratings of PRASA's

[59] *See* P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at 379.
[60] P.R. Fin. Rep., *supra* note 23, at 164.
[61] PREPA Report, *supra* note 53 at 15.
[62] Matt Wirz, *Puerto Rico Paying $9 Million for Power Bond Forbearance*, WALL ST. J.: MONEYBEAT (Aug. 15, 2014, 3:55 PM), http://blogs.wsj.com/moneybeat/2014/08/15/puerto-rico-paying-9-million-for-power-bond-forbearance.
[63] Robert Slavin & Kyle Glazier, *PREPA Pacts Reinforce Banks' Priority Over Bondholders*, THE BOND BUYER (Aug. 27, 2014, 11:37 AM), http://www.bondbuyer.com/news/regionalnews/prepa-pacts-reinforce-banks-priority-over-bondholders-1065640-1.html.
[64] P.R. Fin. Rep., *supra* note 23, at 166.
[65] ERNST & YOUNG LLP, AUDITED FINANCIAL STATEMENTS: PUERTO RICO AQUEDUCT & SEWER AUTHORITY, YEARS ENDED JUNE 30, 2013 AND 2012 4 (Dec. 31, 2013), https://www.acueductospr

Commonwealth-guarantee revenue bonds by one notch, to BB, and of PRASA's revenue bonds from BB+ to BB- in June 2014.

The ratings agency attributed the June 2014 downgrade largely to general skepticism of the Commonwealth's business climate and was more hopeful about PRASA's economic health than other public corporations.[66] PRASA raised its water rates steeply in 2013, which ratings agency Standard and Poor's [hereinafter S&P] found hopeful for establishing PRASA's financial independence from the central government's budget, and giving PRASA capital to invest in potentially lucrative projects.[67] PRASA has also cut personnel and energy costs in a manner S&P considered "credit positive."[68] PRASA's capital structure is basically sustainable, with sufficient liquidity so that, unlike PREPA, the corporation does not urgently need to amend its debt obligations.

F. Dependence on Capricious U.S. Funding

Puerto Rico relies on funding from the federal government: Congress provides both direct federal aid in addition to substantial tax breaks to incentivize business in Puerto Rico.[69]

Over the last few decades, the U.S. federal government has weaned Puerto Rico from some other federal support. Most significantly, Congress repealed the possessions tax credit, which incentivized American corporations to do business in Puerto Rico.[70] § 936, a federal income tax exemption for U.S. companies operating in Puerto Rico, was ultimately repealed in 2006 following a 10-year phaseout.[71]

Before the credit was repealed, U.S. corporations' possessions claiming tax credits comprised most of Puerto Rico's manufacturing sector and employed many Puerto Ricans. With the repeal of § 936, the largest employers left the island, taking jobs and corporate tax dollars with them, from which the

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.com/INVESTORS/download/Financial%20Statements/2013%20PRASA%20Audited%20Financial%20Statements%20FINAL.pdf [hereinafter PRASA Report].

[66] "The lower SACP is because we view the current climate surrounding all Puerto Rico obligations as creating adverse business conditions for PRASA." STANDARD & POOR'S RATINGS SERVICES, PUERTO RICO AQUEDUCT & SEWER AUTHORITY; GENERAL OBLIGATION EQUIVALENT SECURITY; WATER/SEWER 3 (July 14, 2014), http://www.gdb-pur.com/investors_resources/documents/SPDowngradePRASAJul142014.pdf.

[67] *Id.* at 3.

[68] *Id.*

[69] For a complete overview of federal aid programs to Puerto Rico, *see* Alexis Z. Tejeda Marte, *Los Fondos Federales en Puerto Rico: Un Affair con los Estados Unidos*, 80 REV. JUR. U. P.R. 493 (2011).

[70] The tax credit was phased out in a ten-year period ending in 2006. U.S. GEN. ACCT. OFF., GAO 06-541, PUERTO RICO: FISCAL RELATIONS WITH THE FEDERAL GOVERNMENT AND ECONOMIC TRENDS DURING THE PHASEOUT OF THE POSSESSIONS TAX CREDIT (2006), http://www.gao.gov/assets/160/157687.pdf.

[71] U.S. GEN. ACCT. OFF., GAO/GGD 93-109, TAX POLICY: PUERTO RICO AND THE SECTION 936 TAX CREDIT (1993), http://www.gao.gov/products/GGD-93-109.

Commonwealth has not recovered. Manufacturing has declined by two thirds since the repeal.

New industries have not arisen to offset the decline. Puerto Rico's tax base has declined significantly since 2006, leaving the island with reduced revenues from which to meet debt obligations, most significantly to public employee pension holders and bondholders. Puerto Rico thus built its economy around low-tech jobs, and low-wage manufacturing, service and tourism sectors.[72] Once § 936 was repealed, though, Puerto Rico could not compete with lower-wage assembly plants in Latin America, whose doors had opened during the course of § 936.[73]

In this way, federal assistance provided an obfuscatory band-aid, hiding the deeper wounds festering beneath from investors' and voters' eyes. Federal funds have been a nostrum, cushioning Puerto Rico from the rock bottom it would otherwise hit if it had to face its unsustainable economy lacking a sufficient revenue base for the social services it must provide on its own. Until 2008, the government was the largest employer on the island. Government payroll still exceeds all sectors in employment, with the next largest sector, trade, totaling 156,500 as of 2014, and all other sectors below 100,000.[74] Disproportionate dependence on the U.S. economy opens the island up to unnecessary levels of risk. In 2014, 71.8% of Puerto Rico's exports were shipped to the mainland United States, and 47.2% of Puerto Rico's imports came from the mainland United States. Just like an individual investor may minimize risk by diversifying his portfolio, a country stands well to diversify risk by putting its eggs in multiple baskets. Since Puerto Rico's eggs are all in the U.S's basket, any economic problems on the mainland leave the island reeling. Also, Puerto Rico relies heavily on debt financing with high deficit levels. A business that employs itself with money borrowed under empty promises is not generating value, and as such is unsustainable.

Although § 936 has been repealed, the hydra of capricious federal funding through tax benefits has reared another head in the form of Puerto Rico Act 154 of 2010 [hereinafter Act 154].[75] This "backdoor bailout," enacted in 2010, imposes

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[72] For an investor's view on the subject, see Richard P. Larkin, *Puerto Rico's Worst Case Scenario: R-E-C-O-V-E-R-Y*, HJ SIMS (Oct. 10, 2013), http://www.hjsims.com/news-views/puerto-ricos-worst-case-scenario-recovery/#.VKrQ4WTF_-U.

[73] *See Can Puerto Rico Reinvent Itself as a Global Competitor*, KNOWLEDGE @ WHARTON (Aug. 22, 2012), http://knowledge.wharton.upenn.edu/article/can-puerto-rico-reinvent-itself-as-a-global-competitor/.

[74] For a comprehensive set of statistical data on the topic, see GOV'T DEV. BANK FOR P.R., STATISTICAL APPENDIX 2015, http://www.gdb-pur.com/economy/documents/ApendiceEstadistico2015.pdf.

[75] 2010 P.R. Laws __.

an excise tax on multinational corporations doing business in Puerto Rico.[76] Proceeds go to the Commonwealth.[77] In return, the multinational corporations receive federal tax credit. Puerto Rico relies heavily on Act 154 proceeds. In 2012, 2013 and 2014, Act 154 revenues accounted for 21.6%, 19.7%, and 20.3% of Puerto Rico's general fund revenues, respectively.[78] Riskily, only six corporations account for 75% of the Act 154 payments. Repeating history, Act 154 is scheduled to expire in 2017, leaving investors uncertain about their money and citizens uncertain about their jobs.

Puerto Rico relies on a number of unreliable federal grants to fund essential governmental services, including education and healthcare.[79] The U.S. has historically cut such funding with little warning. Additionally, the U.S. allocates funds on a per capita basis. Thus as Puerto Rico's population continues to declines, U.S. funding will decrease. Population decline does not necessarily correspond to declining demand for social services, especially when, as in Puerto Rico, the people leaving the island are relatively young and well-educated, compared to those who stay behind.

U.S. capriciousness in granting funds creates risk and uncertainty for investors interested in Puerto Rico. Like any risk, federal reliance increases the cost of investing in the island, undermining economic self-sufficiency and vitality. U.S. capriciousness is a quasi-external factor resulting from Puerto Rico's not-quite political status *vis à vis* the mainland. Not quite a state, Puerto Rico only has half the power to determine its own status,[80] because admitting the Commonwealth as a mainland state would require both majority support from Puerto Ricans as well as majority support from Congress plus presidential approval.[81] As of the last Puerto Rican plebiscite on the matter in 2012, 50% of Puerto Ricans favored statehood.[82] Because Puerto Ricans are perceived as overwhekmingly Democratic,[83] Congress is unlikely to approve statehood so long

[76] For an in-depth analysis of the effect of Act 154 on Puerto Rico's economy, see Felipe Rodríguez Lafontaine, *Puerto Rico Act 154: The Beginning of the End? Effects of Act 154 on Future Economic Development*, 2 U. P.R. Bus. L.J. 216 (2011).

[77] C. W. London, *Bail-out By the Back Door*, THE ECONOMIST (Jan. 29, 2014, 12:52) http://www.economist.com/blogs/freeexchange/2014/01/puerto-rico.

[78] P.R. Fin. Rep. *supra* note 23, at 18.

[79] *Id.* at 19.

[80] I am borrowing the language of "not quite" statehood from President Clinton in a different context. "Not quite a State, not quite a city, not quite independent, not quite dependent," President Clinton described D.C. in remarks that would apply equally well to Puerto Rico. U.S. GEN. ACCT. OFF., GAO-96-126, DISTRICT GOVERNMENT; INFORMATION ON ITS FISCAL CONDITION AND THE AUTHORITY'S FIRST YEAR OF OPERATIONS 7 (1996).

[81] U.S. CONST. art. IV.

[82] P.R. S. Con. Res. 24, 17th Legis. Assembly (2013).

[83] Steve Mufson, *Puerto Rican debt crisis forces its way onto presidential political agenda*, WASH. POST: BUS. (July 8, 2015), https://www.washingtonpost.com/business/economy/puerto-rican-debt-crisis-forces-its-way-onto-presidential-political-agenda/2015/07/07/40ea8aae-1ffe-11e5-aeb9-a411a84c9d55_story.html.

as Republicans control Congress.[84] So long as the island remains a territory, federal policy regarding the island will be unpredictable. Congress is unrestrained by federal law in how it chooses to fund and how not to fund Puerto Rico. Territory status means Puerto Rico elects a non-voting member of Congress and does not vote for president, leaving the island unrepresented in federal fund allocation decisions.

Puerto Rico's dependence on the U.S. costs the island in several ways. First of all, the federal government is capricious, which injects further risk into Puerto Rican projects for potential investors. Secondly, the band-aid effect infantilizes the island, holding it back from forming a modern economy to compete in the global marketplace. Third, and most broadly, Puerto Rico's unique, undefined, and ever-evolving status creates uncertainty. Uncertainty is costly in and of itself, as investors raise risk premiums they charge for unpredictable projects. And uncertainty leads to litigation, such as the various Supreme Court cases that hammer out, amendment by amendment, which Constitutional clauses apply to Puerto Rico.[85]

IV. Solutions Other Than Statutory Restructuring

In this section, I describe the options available to an insolvent sovereign debtor other than statutory restructuring: (1) out-of-court restructuring through negotiations with individual debt holders, (2) defaulting, and (3) economic development. Puerto Rico serves as a case study for examining the pros and cons of these alternatives.

A. Out-of-Court Restructuring through Creditor Negotiations

Bonds are voluntary contractual agreements. If both parties consent, they are free to change their obligations by entering into a new contract. This voluntary process, called a bond exchange, is available to the Commonwealth.[86] PREPA's forbearance agreements are akin to bond exchanges. They represent new agreements with existing credit holders, and ease the debtor's unsustainable obligations by buying it some time.

A bond exchange is a partial solution at best.[87] One reason is that it is unlikely to happen at all. The only reason that a debtor would initiate

[84] Jason Koebler, *Despite Referendum, Puerto Rico Statehood Unlikely Until At Least 2015*, U.S. NEWS & WORLD REP. (Nov. 7, 2012, 4:52 PM), http://www.usnews.com/news/articles/2012/11/07/despite-referendum-puerto-rican-statehood-unlikely-until-at-least-2015.

[85] *See generally* David M. Helfeld, *Understanding United States-Puerto Rico Constitutional and Statutory Relations Through Multidimensional Analysis*, 82 REV. JUR. U. P.R. 841 (2013).

[86] For an overview of sovereign debt terms, see Molly Ryan, *Sovereign Bankruptcy: Why Now and Why Not in the IMF*, 82 FORDHAM L. REV. 2473, 2479–82 (2014).

[87] For a discussion of the benefits and drawbacks of collective action clauses, see Bolton & Skeel, *supra* note 30, at 772 –77.

negotiations would be to give its creditors less favorable terms. Investors are free to disapprove bond exchanges and retain their initial agreements. It takes not only a long-sighted, but also a generous investor, to voluntarily agree to worse terms (and in economic terms, a synonym for "generous" is "irrational"). Although it may be in the collective best interest of all creditors to renegotiate terms so that the debtor can actually meet its obligations rather than default, it is in the interest of individual creditors to hold onto their initial, more favorable agreements, so long as they have the resources to litigate and enforce their original payment terms. In PREPA's case, 40% of creditors did not agree to forbearance agreements and can be characterized as holdouts.[88]

Non-bankruptcy law awards first in time, first in right, which perversely incentivize creditors to race to sue the debtor when it breaches a contract. This destroys value and impedes fairness in two ways. First of all, creditors are rewarded based on their litigation resources and tactics rather than their *ex ante* agreements. Secondly, litigation diverts resources away from operations. In litigation, a firm might dry up revenues that it could otherwise use to get back on its feet, which would create value for creditors as well as for shareholders.

A creative approach to dealing with the collective action problem in the absence of collective legal proceedings is to insert modification clauses into bond indentures. Modification clauses empower a majority of bondholders to alter the terms of all outstanding bonds. If the majority of bondholders agree to an amendment, the amendment binds all creditors of that issuance. The most popular type of modification clause is the collective action clause ("CACs").[89] A related clause is the "exit consent," where investors who agree to an exchange offer must pledge their vote to amend the original bond terms as a condition of participating in the exchange.[90]

Modification clauses are of only limited power to counteract collective action problems. For one reason, these clauses do nothing to overcome the initial hurdle of convincing the first creditors to participate in a bond exchange, but only solve the problem of later holdouts.[91] Additionally, CACs and exit consents are only useful if they are actually present in the original bond agreements. Even then, they are limited because they are binding only upon bondholders of that issuance. Some governments have begun to include modification clauses in their bonds,[92] but many, including Puerto Rico, have not.[93]

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[88] *See, e.g.*, Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1320 (2002).

[89] Stephen J. Choi, Mitu Gulati & Eric A. Posner, *The Evolution of Contractual Terms in Sovereign Bonds*, 4 J. LEGAL ANALYSIS 131, 140 (2012).

[90] Jill E. Fisch & Caroline M. Gentile, *Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring,* 53 EMORY L.J. 1043, 1091 (2004).

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[92] *See, e.g.*, Matina Stevis and Katy Burne, *Greek Legal Maneuvers Raise Fears of Euro-Zone Debt Fallout*, WALL ST. J. (Feb. 23, 2012, 4:54 AM), http://blogs.wsj.com/eurocrisis/2012/02/23/greek-legal-maneuvers-raise-fears-of-euro-zone-debt-fallout/.

Bond exchanges can have negative market externalities. If the debtor asks individual creditors to renegotiate, the creditors in general will become nervous about the possibility of default. They will rush to sell their bonds, driving down prices and exacerbating the financial state of a debt-reliant borrower like Puerto Rico.

A separate problem with bond exchanges arises from the fact that politicians would be the ones negotiating on behalf of the borrower. Politicians will rationally behave in a way that benefits their constituents, even if it harms bondholders. Especially in the case of triple tax-free Puerto Rico, investors are likely to be nonlocal and therefore have no voice in electing the politicians who make decisions that affect them. Additionally, politicians' interests are short term, spanning the length of their time in office, whereas bond obligations are long term.

Giving politicians decision-making power with regards to debt issuance is problematic from a broader social welfare perspective, as politicians' interests align with only a small portion of the population. Taking on debt provides liquidity so the government can function today, signaling the politician's aptitude to his constituents and the sovereignty's economic health to the market. But the risk of false signaling is high. Politicians will rationally impose unrealistic future restrictions on the sovereignty to improve the government's reputation today at the expense of realistic obligations tomorrow.

B. Defaulting

The sovereign may opt for default and simply refuse to pay creditors the money they are owed, which would amount to a breach of contract.[94] For example, Argentina defaulted on its public and private debt obligations in 2001.[95]

There are several problems with the default option. First of all, legally, default is not a solution at all. The debtor in default still has the same contractual obligations to creditors, plus, depending on the agreement terms, any additional obligations triggered by default. Creditors could also sue for breach of contract. Litigation would create additional expenses for the debtor. Default leaves the insolvent borrower worse than where it started.

Secondly, legal uncertainty surrounding default inefficiently discourages lending in the long-term and broader marketplace. Argentina's situation provides a glimpse into Puerto Rico's future if the island were to take the default route. The country came to a repayment agreement with most creditors, but some hedge funds held out and began decade-plus-long litigation against the country

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[93] To examine Puerto Rico's bond agreements, see *Tax-Exempt Securities*, GOV'T DEV. BANK FOR P.R., http://www.gdb-pur.com/investors_resources/exempt-securities.html.

[94] For a historical overview of sovereigns in default and economic discussion thereof, see Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors?*, 37 INT'L LAW. 103, 108 (2003).

[95] Christina Marie Wilson, *Argentina's Reparation Bonds: An Analysis of Continuing Obligations*, 28 FORDHAM INT'L L.J. 786, 798–800 (2005).

to demand payment in full.[96] In 2012, the Southern District of New York shocked the markets by holding that a boilerplate clause in the debenture, the *pari passu* clause, entitled the holdout creditors to full payment.[97] The Second Circuit affirmed,[98] and the Supreme Court has denied multiple writs of certiorari.[99] Argentina remains entangled in costly litigation, strapped for cash, and effectively shut out of the international bond market.[100]

Regardless of the outcome on the specific legal questions in Argentina's case, default damages the issuer's credibility. In the realm of bond creditors, lack of credibility increases the cost of and ultimately restricts lending by increasing risk premiums. For Puerto Rico, which, like many developing nations, uses debt financing to fund essential governmental services, restricted access to the credit markets translates into reduced public services.

As the Argentina cases illustrate, uncoordinated litigation by individual creditors wastes resources and creates perverse incentives. The decisions for the bondholders award the most litigious creditors and dis-incentivizes bargaining in the name of the collectivity. For these reasons, default is a costly and flawed alternative.[101]

C. Economic Development: Raising Revenues and Decreasing Liabilities

If the borrower raises enough money and reduces spending, it will not need to cut down its existing debt obligations because it will be able to service them. This is often politicians' preferred plan, and, analogously, management's plan in many an optimistic private context. Puerto Rico is no exception. The materials that the island presents to investors focus on the governor's plans to increase revenue and, to a lesser extent, cut costs. The 2015 budget assumes a revenue increase of $528 million in 2015 over 2014. The government is more conservative but also less reliable in its expense predictions. It projected expenditures of $9.565 billion, which represent an increase over the actual 2014 expenditures of $9.245 billion, but a decrease in the predicted 2014 expenditures

[96] Kathy Gilsinan, *65 Words Just Caused Argentina's $29-Billion Default*, THE ATLANTIC, (Jul. 31, 2014, 11:59 AM), http://www.theatlantic.com/international/archive/2014/07/65-words-just-caused-argentinas-29-billion-default/375368/.
[97] NML Capital, Ltd. v. Republic of Argentina, 2012 WL 5895650, at *3 (S.D.N.Y. Nov. 21, 2012).
[98] NML Capital, Ltd. v. Republic of Argentina, 727 F.3d 230 (2d Cir. 2013).
[99] Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 201 (2013) (mem.), Republic of Argentina v. NML Capital, Ltd., 134 S. Ct. 2819 (2014) (mem.).
[100] Matt Wirz and Christopher Whittall, *Plan to Sell Argentine Debt Collapses*, WALL ST. J. (Feb. 26, 2015, 6:56 PM), http://www.wsj.com/articles/argentina-planned-bond-sale-dropped-1424973179.
[101] For an empirical study of the costs of default, see Eduardo Borensztein & Ugo Panizza, *The Costs of Sovereign Default*, 56 IMF STAFF PAPERS 683, 690–97 (2009).

of $9.770 billion.[102] The government passed an emergency austerity law in June of 2014, and also counts the P.R. Recovery Act amongst its cost cutting measures.[103]

Investors should take these optimistic projections with a grain of salt. Many of the government's predictions rely on shaky assumptions and risky undertakings.

For example, the 2015 revenue predictions assume increased tax collections, from $4.847 billion in total income tax collections in 2014[104] to $5.313 billion in 2015.[105] Magically, the government also plans to reduce both individual and corporate marginal tax rates while still increasing collections to the tune of roughly $460 million.

Further, the island depends on the unreliable U.S. tax subsidies for its revenue predictions. The Act 154 excise tax is one of Puerto Rico's most significant revenue sources. For the past three years, revenues from Act 154 comprised 20% of the Commonwealth's General Fund revenues. A large portion of Puerto Rico's corporate tax revenues comes from just a handful of taxpayers. Only six corporate taxpayers paid 75% of these collections last year. If any one were to leave the island, tax revenues would decrease significantly and unexpectedly. Not only are the revenue collection sources risky, but also, they are temporary. Act 154-2010 is set to expire in 2017.[106]

On the individual income tax side, the government is proposing a massive, fundamental overhaul of tax policy, switching from a U.S. style tax on salary to a European style tax on consumption.[107] Like on the corporate side of tax collection, the island's revenue eggs are currently in too few taxpayer baskets. 78% of individual income tax collections last year came from less than 10% of all tax filers.[108]

As Puerto Rico illustrates, the economic development option is the best alternative in terms of minimizing pain, but the worst option in terms of feasibility. It is rational for politicians in a distressed public entity to

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[102] P.R. Fin. Rep. at 7.

[103] *Id.* at 39.

[104] *Id.* at 100. The Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act, 2014 P.R. Laws 273, aims to reduce spending by (i) freezing and reducing public labor compensation and benefits, (ii) reallocating some public corporations' savings into General Fund treasuries, (iii) freezing allocations to the University of Puerto Rico, Judicial Branch, Legislative Assembly, and municipalities, (iv) reducing rates that the government would pay for its own water and services, (v) implementing a payment plan for legal judgments, and (vi) strengthens oversight of the executive branch by the OMB.

[105] OFF. OF MGMT. & BUDGET, PROPOSED BUDGET 2014–2015: NET REVENUES TO THE GENERAL FUND 2, http://www2.pr.gov/presupuestos/PresupuestoAprobado2014-2015/Informacin%20de%20Referencia/Ingresos%20Consolidados%20del%20Estado%20Libre%20Asociado%20de%20Puerto%20Rico.pdf.

[106] P.R. Fin. Rep. at 19.

[107] COMMONWEALTH OF P.R., UPDATE ON FISCAL AND ECONOMIC PROGRESS 49 (2014). http://www.gdbpr.com/documents/FY15Q1UpdateOnFiscalAndEconomicProgressWebcast103014.pdf.

[108] *Id.* at 46.

overestimate future revenue streams. Term limits misalign politicians' incentives with the long-run health of the economy. An estimate of future revenue increases, to the extent creditors believe them, allows the borrower to live well today and suffer tomorrow, when payment becomes due. By the time tomorrow rolls around, the politicians will have left office.

V. LESSONS FROM PUERTO RICO

This section considers statutory legal solutions to Puerto Rico's problems, which represent the inefficiencies that plague insolvent governments in general. It (1) argues that a statutory scheme for bankruptcy would be more efficient than non-statutory alternatives; and (2) suggests specific amendments to Chapter 9, several of which are inspired by the P.R. Recovery Act, to improve federal bankruptcy law economically.

A. Efficiency of Bankruptcy Law Over Non-Statutory Alternatives

As the Puerto Rico case study illustrates, contractual mechanisms are inefficient solutions to insolvency.[109] Default is not a solution but rather a new problem. And economic development solution is ideal in theory but unlikely in practice.

Bankruptcy law has the potential to minimize costs, both in terms of dollars and in terms of welfare more broadly. Lending transactions will not always go as planned. When the pie is too small to feed everyone, some parties will be disappointed. Complex debtors and multiple creditors are involved in large public debt issuances, each of whom wants as much of the pie for himself as possible.

Article I, § 8—delegating to Congress the authority to establish "uniform laws on the subject of bankruptcies throughout the United States"—is the Founders' attempt to balance these interests.[110] The clause reflects James Madison's idea that uniform bankruptcy laws were essential to a healthy national economy, with vibrant intra- and international lending. As he wrote, "[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different States that the expediency of it seems not likely to be drawn into question."[111] In the words of astronaut and former Eastern Airlines CEO Frank Borman, bankruptcy law is to

[109] *See* COMM. ON INT'L ECON. POLICY & REFORM, REVISITING SOVEREIGN BANKRUPTCY 20 (2013), http://www.brookings.edu/~/media/research/files/reports/2013/10/sovereign-bankruptcy/ciepr_2013_revisitingsovereignbankruptcyreport.pdf (arguing that "contracts as interpreted by judges have proven inadequate to mediate the tension between the lack of enforcement and the impossibility of discharge in sovereign debt.").

[110] U.S. CONST. art. I, § 8, cl. 4.

[111] THE FEDERALIST NO. 42 (James Madison) http://www.constitution.org/fed/ federa42.htm.

capitalism what hell is to Christianity. In order for commercial transactions to occur at the outset, most rational parties need a reliable plan B for when things don't go as planned. Bankruptcy law represents over 200 years of judges and legislators formulating a plan B that is as fair and reliable as possible to all the parties involved.[112]

Underlying and enabling rehabilitative provisions of the law is the ingenious, optimistic idea that the parties' interests will cease to conflict if they focus on growing the pie rather than on snatching pieces for themselves. This rehabilitative concept is original to U.S. law, though has begun to catch on abroad in governments that traditionally focus on liquidation.[113]

Leaving aside the detailed provisions of U.S. bankruptcy law and Chapter 9, bankruptcy law generally poses a solution over the non-statutory alternatives by simply existing. To paraphrase Woody Allen, 80% of a successful bankruptcy law is just showing up.[114] When creditors know at the outset of a transaction that, in the worst case scenario, they will be dealt with by federal law, which seeks to maximize their payout and treat them fairly, they will be more comfortable lending at the outset. In economic terms, comfortable means having enough information to price the loan accurately, so the interest rates reflect the chance of a diminished outcome in a plan B scenario. The more predictable outcomes are, the more comfortable each individual creditor will feel. The more comfortable each individual feels, the healthier the credit market will be overall. In a healthy credit market, Puerto Rico would be able to borrow money to fund infrastructure projects and individuals will be able to borrow money to pay for new homes and cars. If the creditor thinks that the chance the borrower will be unable to repay is high, the creditor will charge high interest rates initially, and the borrower may or may not choose to take the loan. Unchanging, uniform bankruptcy law sets the stage for a healthy credit market. The more predictable the Plan B outcome is to creditors at the outset of a transaction, the safer lending is. Federal statutes are more predictable than contract and common law because they change less frequently, both over time and between jurisdictions.

Municipal bankruptcy law has only existed in the United States since the 1930s.[115] Throughout history, there have been far fewer Chapter 9 filings than Chapter 11 filings. In this way, municipal creditors have a less reliable plan B than corporate creditors. But the Chapter 9 plan B is still more predictable than the non-statutory alternatives. Although there is some variation from one Chapter 9 case to another, each one is a unified legal proceeding, overseen by a neutral

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[112] *See* Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5 (1995) (for a history of U.S. bankruptcy law).

[113] Manfred Balz, *The European Union Convention on Insolvency Proceedings*, 70 AM. BANKR. L.J. 485, 498 (1996).

[114] Susan Braudy, *He's Woody Allen's Not-So-Silent Partner*, N.Y. TIMES, Aug. 21, 1977, at 83.

[115] For a history of municipal bankruptcy law in the U.S., see Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 427–42 (1993).

arbiter,[116] that imposes an automatic stay,[117] and requires creditor plan approval.[118] The judge as neutral arbiter monitors the debtor's managers, easing the agency costs of rationally irresponsible politicians at play in Puerto Rico, such as unrealistic budgetary promises and unsustainable debt issuances.

The automatic stay freezes actions against the debtor and prevents creditors from racing one another to the courthouse. The debtor can focus on growing the pie rather than on duplicative legal proceedings like Argentina. The creditors can rest easy that a situation in which quicker creditors to the courthouse would be paid first and drain the debtor's assets will not occur. In Puerto Rico, the automatic stay would have barred both a teachers' suit against the government for modifying public pensions[119] as well as the hedge funds' suits against the government for passing debt reform legislation, which eventually led to the P.R. Recovery Act being overturned. It would have also obviated PREPA's need to negotiate with creditors individually for forbearance agreements, which incurred additional direct costs as well as litigation expenses upon the island.

Creditor voting provisions under the Code divide creditors into classes according to the types of claim. For the plan to be approved, both a majority of creditors within each class and a majority of the classes must sign on. Judicial approval depends partly on whether the plan pays creditors according to a statutorily determined order. Under the absolute priority requirement, junior creditors may not be paid before senior creditors are paid in full. Whether a creditor is senior or junior depends in significant part on the creditors' initial contractual expectations. For example, creditors are senior to equity holders, which preserves the parties' ex ante expectations about who would get paid first. The creditor voting provisions delicately balance the goals of protecting all creditors, minimizing the power of holdouts, and ensuring that the debtor pays until it hurts. In a governmental bankruptcy, creditor voting could be valuable as a symbolic stamp of approval that the debtor's plan going forward serves the interest of creditors. For example, in Puerto Rico, fiscal stringency measures that the government took outside of bankruptcy involved reducing pension payments to public employees. This resulted in the costly litigation by judges and teachers. Had the fiscal stringency measures been imposed through a bankruptcy plan rather than emergency law, the symbolic stamp of approval from other creditors would quell costly litigation and protest from unhappy creditors. A plan that involved cutting governmental services such as public pension payments would be unpopular even if it would be in the long-term interest of the economy. A creditor vote in its favor could signal to voters the necessity of an unpopular plan,

[116] 11 U.S.C. § 921(b).
[117] *Id.* at § 901 (making the § 362 *automatic stay* available for Chapter 9 proceedings).
[118] *Id.* (making § 1122 applicable to Chapter 9 cases).
[119]

so citizens would not vote responsible parties out of office for taking responsible stringency measures.[120]

For these reasons, a Chapter 9 creditor is in a better position than a creditor of a municipality in default, pursuing ad hoc negotiations, or relying on economic development plans without a statutory restructuring scheme. With every new Chapter 9 case that follows existing precedent that sets clear, well-reasoned precedent going forward, the municipal creditor's position becomes more predictable and efficient. In this way, every time an insolvent municipality does not file under Chapter 9, it creates an opportunity cost. The municipal credit market misses out on a chance to make Chapter 9 more reliable and valuable.

By barring Puerto Rico from the Code and leaving the island to resort to non-statutory measures for debt adjustment, Congress imposes an opportunity cost on the municipal credit market at large. The cost will be especially high because the Commonwealth, with its quasi-state, quasi-city, and quasi-sovereign status, would have set relevant precedent for a wide variety of types of Chapter 9 debtors. Additionally, because of Puerto Rico's triple tax-free status and the resultant ubiquitousness of its debt, investors in every state will feel the effects of the exclusion in the short-term.

B. Suggested Code Amendments Inspired By the P.R. Recovery Act

The P.R. Recovery Act provided two mechanisms for public corporations to restructure their debt: Chapter 2 and Chapter 3. Chapter 2 essentially facilitated out-of-court workouts. The section provided a framework for negotiations, with minimal judicial participation but with provisions in place to minimize collective action problems. In effect, Chapter 2 retroactively added CACs to debt contracts, and in so doing overcame the initial collective action hurdle inherent to contractual solutions: that it is never in a creditor's best interest to renegotiate for less favorable terms than he had initially.

Although a stand-in for Chapter 9, the P.R. Recovery Act improves upon federal law from an economic perspective. The Commonwealth law incorporated innovations from legal scholarship and Chapter 11 into a governmental bankruptcy in a way that Chapter 9 could adopt.

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[120] For an overview of bankruptcy law's policy goals, see 1 COLLIER ON BANKRUPTCY P1.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011). *See also* the legislative history of the current municipal bankruptcy law, describing the law's purpose, "to provide a forum where distressed cities, countries and minor political subdivisions . . . of their own volition, free from all coercion, may meet with their creditors under the necessary judicial control and assistance in an effort to effect an adjustment of their financial matters upon a plan deemed mutually advantageous." H.R. REP. NO. 73-207 (1933); H.R. REP. NO. 94-686 (1976). For an overview of bankruptcy law theories, see also Yaad Rotem, *What Is Missing in Corporate Bankruptcy Theories? Revisiting the Efficiency Rationale*, 39 ISR. L. REV., no. 3, 2006, at 190.

1. *Clarification of Intragovernmental Boundaries and Central Bank Role*

A major concern of would-be Chapter 9 filers is damage to the credit ratings of related governmental entities and on the municipal credit market as a whole. For example, in August, 2011, the governor of Alabama urged Jefferson County commissioners not to file because "it could ripple out and hurt the credit of the whole state."[121] Ensuring that a Jefferson County would, indeed, affect Alabama creditors, Governor Robert Bentley offered to back the county's newly issued debt with the city's moral authority. As a result, the county dragged its feet, but eventually filed two months later.[122]

A similar ripple effect occurred when PRASA's credit was downgraded along with the rest of the island's debt. Although PRASA itself was financially healthy, credit agencies downgraded the public corporation because it was interconnected with the remainder of the Puerto Rican government. The reason for this downgrade was the fuzzy boundaries and open-ended intra-governmental loans that characterize Puerto Rico's government. The Commonwealth's Central Bank, which one economist described as acting "as the government's 'piggy bank[,]'"[123] enables the broad gaps between distinct legal identities and blurred economic realities of the Commonwealth government's corporate structure. In PRASA's case, the interconnectedness represented an inefficiency. The corporation's ratings were needlessly lowered below the level of actual risk to investors investing in the corporation, because of Puerto Rican creditors' general inability to tell exactly which entity they are lending to due to the blurred intragovernmental boundaries.

The P.R. Recovery Act addresses the root of the ripple effect problem by clarifying the role of the central bank and establishing strict boundaries around the separate public corporations' budgets.[124] The public corporations are distinct legal entities from the GDB and Commonwealth's general fund, and the P.R. Recovery Act intends to bring practice in line with legal reality. Specifically,

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[121] Mary Williams Walsh, *A County in Alabama Puts Off Bankruptcy*, N.Y. TIMES, Aug. 12, 2011, http://www.nytimes.com/2011/08/13/business/jefferson-county-alabama-puts-off-bankruptcy-decision.html?_r=0.

[122] Mary Williams Walsh, *Alabama Governor Fails to Prevent County's Record $4 Billion Bankruptcy Filing*, N.Y. TIMES, Nov. 9, 2011, http://www.nytimes.com/2011/11/10/us/alabama-governor-fails-to-prevent-jefferson-countys-record-4-billion-bankruptcy-filing.html.

[123] Porzecanski, *supra* note 43, at 3.

[124] The P.R. Recovery Act is part of a larger plan by Governor García-Padilla to spin off the public corporations' budgets from the general fund and GDB. For example, P.R. Pub. L. 24-2014, 2014 P.R. Laws 60, required public corporations to identify sources of repayment in order to secure GDB loans. The Government of the Commonwealth of Puerto Rico Special Fiscal and Operational Sustainability Act, P.R. 2014 P.R. Laws __, declares a state of fiscal emergency and requires public corporations to cover their operational expenses with revenues rather than loans and debt refinancing. For a full description of other measures that Puerto Rico took during 2014 to reorganize the island's public corporations and scale back debt levels, see P.R. Recovery Act, Statement of Motives, 2014 P.R. Laws at __.

a public corporation reorganizing its debt under the P.R. Recovery Act must commit to a recovery program that allows the entity to become financially self-sufficient, rather than dependent upon the General Fund and Government Development Bank.[125] The GDB must approve this plan.[126]

Whereas the P.R. Recovery Act acknowledges the interconnectedness of its governmental entities and takes steps to address resulting inefficiencies, Chapter 9 does little to clarify intragovernmental boundaries to creditors. A state must authorize a filing by one of its subdivisions but is free to extend any or no financial assistance to creditors of the debtor. Governor Bentley was right to be concerned that a Jefferson County filing would affect Alabama's credit rating. But instead of employing a sensible way to counteract the chance of contagion by assuring creditors as to the separateness between the county's and state's budgets, he took the opposite approach, backing the county's budget with the state's authority. In the long run, blurring boundaries between state and municipal budgets will confuse creditors and thwart *ex ante* attempts to price municipal bonds accurately. Lenders will not be able to valuate their loans when it is unclear whether they are creditors of Jefferson County, the entire state of Alabama, or some ever-changing combination of the two. Chapter 9 does nothing to address this fundamental inefficiency inherent to governmental lending on the front end and budget blurring on the back end during times of insolvency.

This deficiency is characteristic of U.S. bankruptcy law overall. U.S. law generally upholds formalistic legal entity structures and does not address corporate groups as such. For example, the Bankruptcy Code is silent on parent liability for subsidiaries' liability.[127] Some case law has arisen in the absence of statutes that deal with corporate groups. In bankruptcy, the common law doctrine of substantive consolidation allows judges to treat separate corporate entities as one. The court's substantive consolidation power derives from its general equitable powers under § 105(a) of the Bankruptcy Code, permitting the judge "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the law.[128] Not only does substantive consolidation lack a specific statutory basis, but also, U.S. courts have failed to establish consistent case law for determining when substantive consolidation is appropriate. Like veil piercing, the substantive consolidation test is fact-specific

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[125] *See* P.R. Recovery Act, Statement of Motives, § 202(b) (mandating that "[i]n connection with a consensual debt relief transaction, an eligible obligor must prepare and commit itself…to a recovery program that—(a) allows the eligible obligor to become financially self-sufficient based on such financial and operational adjustments as may be necessary or appropriate to allocate the burdens of consensual debt relief equitably among all stakeholders."). Further, the program may include interim milestones and performance targets to improve margins, increase revenues, and reduce expenses. P.R. Recovery Act § 202(c).

[126] P.R. Recovery Act § 202(b).

[127] Marcus Lutter, *Limited Liability Companies and Private Companies*, *in* INT'L ENCYCLOPEDIA OF COMP. L. 13, ch. 2, § 203, at 102 (1998).

[128] 11 U.S.C § 105(a) (2010).

and varies from one jurisdiction to another. The Third Circuit[129], Second Circuit,[130] and D.C. Circuit[131] have all announced vague, differing approaches to substantive consolidation.

As a result, creditors of multi-entity groups in the United States cannot determine *ex ante* exactly which assets they would have a claim upon in the event of default. The lack of statutory guidelines addressing corporations collectively leaves a good deal of discretion in individual judges' hands, which undermines creditors' ability to predict their fate at the outset and price lending optimally.

2. *Refocus of Authorization Requirements Towards Boundary Transparency*

The eligibility requirements in Chapter 9 of the Bankruptcy Code illustrate the conflicts between federalism and efficiency. U.S. municipal debtors must meet four initial eligibility requirements in order to file under Chapter 9.[132] Of these, provisions § 109(c)(5)(A) and (B) further efficiency goals. To meet requirements (A) or (B), the prospective debtor must take a long, hard look at its financials, determine a realistic plan to meet its debt obligations as completely and promptly as possible, so as to be likely to obtain creditor approval, and attempt to bargain with creditors out of court. Pre-filing planning protects creditors and debtors alike from a bankruptcy preceding that is more trouble than it is worth, as bankruptcy is costly and disruptive. As the judge explained in In re Sullivan County, a foundational Chapter 9 case, "some sort of comprehensive plan is required as one of the 'screening factors' to avoid a too early and rapid resort to the bankruptcy courts by municipalities."[133] Right off the bat, the Code catalyzes negotiations, transparency, and sound financial planning.

The eligibility requirement under § 109(c)(2), on the other hand, derives from federalist concerns and undermines efficiency. This provision requires that a Chapter 9 debtor be "specifically authorized, in its capacity as a municipality or by name, to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law."[134] The purpose of the

[129] *See*, *In re:* Owens Corning, 419 F. 3d 195 (3d Cir. 2005).
[130] *See*, In re Augie/Restivo Baking Co., Ltd., 860 F.2d 515 (2d Cir. 1988).
[131] *See*, In re Auto-Train Corp., Inc., 810 F.2d 270 (D.C. Cir. 1987).
[132] 11 U.S.C.A § 109(c)(5) (2010), requires the debtor to either (A) present the creditors with a plan for debt adjustment and obtain the agreement of each impaired class agrees to; (B) attempt in good faith but fail to present creditors with a plan and obtain agreement from the majority of each impaired class; (C) be unable to negotiate with creditors because doing so would be impracticable; or (D) reasonably believe that a creditor may attempt to obtain a transfer that is voidable under § 547.
[133] *In re* Sullivan County Regional Refuse Disposal District, 165 B.R. 60, 78 (Bankr. D.N.H. 1994) (citing 4 COLLIER ON BANKRUPTCY ¶ 900.03 (15th ed.); 6 NORTON BANKRUPTCY LAW & PRACTICE § 136.25 (1993)).
[134] 11 U.S.C.A § 109(c)(2) (2010).

requirement is balancing the federal power to enact bankruptcy laws with the Tenth Amendment, which reserves contract power to the states. Together with § 903, which provides, "this 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,"[135] § 109 "allows states to act as gatekeepers to their municipalities' access to relief under the Bankruptcy Code."[136]

The specific authorization requirement has been the topic of extensive litigation and statutory deliberation around the country. For example, in In re Timberon Water & Sanitation Dist., Timberon, a New Mexican municipal water and sanitation district, was denied access to Chapter 9 for failing to meet the § 109(c)(2) state authorization requirement, despite a state law empowering the district "to sue and be sued and to be a party to suits, actions and proceedings"[137] as well as a resolution by the district's governing body declaring the district insolvent and declaring its intent to file under Chapter 9.[138] In the case, In re New York City Off-Track Betting Corp., after extensive deliberation, the Bankruptcy Court ultimately held that the debtor met the requirement after the governor issued an executive order that authorized the filing.

Many of the Code's inefficiencies arise from federalist concerns. Chapter 9 struggles to balance the Tenth Amendment, which protects state jurisdiction over contract law, against Article I, Section 8, which delegates bankruptcy power to Congress.[139] Throughout the history of bankruptcy law, Congress has spent a good deal of time, litigation, and taxpayer money juggling Tenth Amendment state authority against Article I, section 8 federal bankruptcy authority. The first version of Chapter 9 was passed in May of 1934 as "Chapter IX," as tensions escalated between the late Lochner-era court, which prioritized contracts, and the Depression era population, who desperately needed a way to scale back debt obligations.[140] The drafters took great care to obviate Commerce Clause and Tenth Amendment challenges, stating in Section 80 that the statute should not

[135] 11 U.S.C.A § 903.
[136] *In re* City of Vallejo, 403 B.R. 72, 75 (Bankr. E.D. Cal. 2009).
[137] *In re* Timberon Water & Sanitation Dist., 2008 WL 5170581, at 1.
[138] *Id.*, at 2.
[139] Federal jurisdiction of bankruptcy law is necessary because the federal government has broader authority to impair contracts, including lending agreements, than state governments. *See* ERWIN CHEMERINSKY, CONSTITUTIONAL LAW: PRINCIPLES AND POLICIES 646–55 (4th ed. 2011) (citing U.S. CONST. art. I, § 10 (mandating that "no State shall . . . pass any . . . law impairing the Obligation of Contracts") as prohibiting only state behavior, not federal behavior).
[140] Between the late 19th Century and 1937, the Court embraced *laissez-faire* politics and restricted both state and federal legislative powers by narrowly defining Congress' interstate commerce powers, as in United States v. E.C. Knight, 156 U.S. 1(1895), interpreting the Tenth Amendment as substantively protecting a zone of state powers into which the federal government could not intrude, as in Hammer v. Dagenhart ("the Child Labor Case"), 247 U.S. 251 (1918), and prohibiting governmental interference with the freedom to contract as violative of economic substantive due process, as in Lochner v. New York, 198 U.S. 45 (1905). *Id.* at 252–53, 630–31.

"be construed to limit or impair the power of any state to control, by legislation or otherwise, any political subdivision thereof in the exercise of its political or governmental powers."[141] Nonetheless, the pre-Roosevelt era court struck down Chapter IX just two years later, in a 5-4 decision in Ashton v. Cameron County Water Improvement District.[142] Even were a state to agree to Chapter IX, the Ashton court held, federal jurisdiction over municipal bankruptcy would still violate federalist principles. The Ashton court advanced two separate reasons for the judiciary's role in preserving federalism: (1) to protect the states' freedom from federal tyranny,[143] and (2) to preserve separate spheres of state and federal activity as a goal unto itself, as an optimal balance of powers.[144] Since then, the authorization requirement has been amended and amended again to reach a balance between state and federal power. Most recently, the law was amended in the mid-1990s to require specific authorization by the state rather than general authorization for its municipalities to file under Chapter 9.

Anyone seeking to preserve Tenth Amendment concerns is up for a lot of work by way of wasteful transaction costs and uncertain outcomes. Tenth Amendment jurisprudence is in a confused state in general. The Court vacillates over whether the Tenth Amendment is "but a truism"[145] or a more meaningful clause.[146] Specifically in the bankruptcy context, the Code and courts alike are unclear as to the proper role of states and Congress in lawmaking.

Under the P.R. Recovery Act, a public corporation seeking debt adjustment under Chapter 2 or 3 must receive authorization from the GDB, which the governor can request or the GDB can provide independently. Unlike Chapter 9, which gives free reign to states in determining whether to authorize municipal bankruptcy, and why or why not to do so, the P.R. Recovery Act's authorization requirement has a clear purpose. As § 202 and the Statement of Motives discusses, the purpose of the P.R. Recovery Act is disentangling intra-governmental lending and leaving the public corporations self-sufficient. GDB authorization is intended to ultimately give the filer greater financial autonomy.

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[141] 11 U.S.C.A. § 903. (Section 80(k) of the 1934 Bankruptcy Act).

[142] Ashton v. Cameron Cty. Water Improvement Dist., 298 U.S. 513 (1936).

[143] For example, the *Ashton* court cautions: "If obligations of states or their political subdivisions may be subjected to the interference here attempted, they are no longer free to manage their own affairs." *Id.* at 896.

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[145] The phrase *but a truism* comes from a 1941 Supreme Court decision—expressing the Court's view from the New Deal era until the 1990s—that the Tenth Amendment was not, itself, a restriction on Federal power, but merely a restatement of balance of power principles outlined throughout the Constitution. United States v. Darby, 312 U.S. 100, 124 (1941).

[146] Additionally complicating matters is the interplay between Tenth Amendment and Commerce Clause jurisprudence. If the Tenth Amendment is not "but a truism," but a more meaningful restriction on Congressional ability to legislate outside of its enumerated powers, the scope of Congressional enumerated powers becomes a critical question for determining whether Tenth Amendment violations exist.

This will result in clearer budgetary boundaries, increasing informational transparency to creditors and ultimately making lending more efficient.

The authorization requirement can be valuable by legitimizing the proceeding in the eyes of creditors. The debtor must demonstrate fiscal emergency in order to receive GDB authorization. The fiscal emergency requirement ensures that public corporations will not resort to the P.R. Recovery Act to restructure obligations merely because they are unfavorable. As such, the authorization requirement would theoretically legitimize the procedure in investors' eyes, assuaging them that debtors will not abuse the Act by filing to seek an unfair advantage.

Chapter 9 would benefit from clarifying the goal of the authorization requirement, and refocusing the goal towards informational transparency for creditors. The authorization requirement could require a clear statement from the state about the financing role it intends to play in the bankruptcy going forward. This would clarify budgetary boundaries to creditors and allow efficient pricing. It would also reduce transaction costs by giving courts a clear sense of the purpose of the authorization requirement. The courts in Timberon and New York City Off Track Betting spent a significant amount of time and money determining the debtors' authorization. A clear statement of Congressional intent would mitigate these costs. These amendments would reduce the inefficiencies that derive from the authorization requirement without sacrificing Tenth Amendment state authority.

A clearer statement of authorization requirement purpose from Congress would inspire more consistent authorization laws at the state level. Currently, state legislatures have responded disparately to the state authorization requirement. For example, in California, a state statute broadly authorizes all municipal filings in advance; Connecticut municipalities wishing to file under Chapter 9 must receive specific approval from the governor, and a Georgia municipality is statutorily prohibited from filing.

One of the main reasons federal rather than state bankruptcy law makes sense from a law and economics perspective is having uniform law from state to state. Giving creditors certain, consistent treatment from state to state incentivizes them to lend at lower rates, benefitting the economy overall by allowing capital to flow more freely, at more efficient prices. This is one reason that the Constitution delegates bankruptcy authority to the federal government and contains a uniformity requirement.[147] In other words, the more consistent treatment that creditors could expect among the states, the more willing creditors would be to lend in the first place, and the more easily the government could ensure creditors' fair treatment.

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[147] *See generally*, Judith Schenck Koffler, *The Bankruptcy Clause and Exemption Laws: A Reexamination of the Doctrine of Geographic Uniformity*, 58 N.Y. U. L. Rev. 22 (1983). Professor Koffler argues that state exemption laws render the uniformity requirement meaningless and nullify the power of federal bankruptcy jurisdiction as intended by the Founders.

Uniform bankruptcy laws benefit debtors as well.[148] Before ratification, inconsistent bankruptcy laws amongst the states meant that a debtor's obligations could be discharged in one colony and still remain binding next door. Debtor's prisons were especially miserable, squalid quarters, where, unlike ordinary prisons, inmates had to pay for their own food and lodging while in prison. While bankrupt municipalities cannot literally be sent to debtor's prison, endless litigation is a prison of its own, as Argentina can attest. But the Tenth Amendment limitations on Chapter 9 work at crosshairs with the goal of uniformity.

3. *Use of Financial Advisors*

The Puerto Rico Act statutorily empowers a judge to appoint a special commissioner who "must be a person of recognized expertise in financial matters, including insolvency proceedings."[149] Chapter 9, on the other hand, does not make use of financial advisors. As the Collier monograph notes, "failing to retain a qualified financial advisor with significant experience in municipal finance is likely to be penny-wise and pound-foolish."[150]

Chapter 9 would benefit if, like the P.R. Recovery Act, the law anticipated or even required the judge to consult with a financial adviser. The judge's role in an insolvency proceeding is to ensure the plan's feasibility. Essentially, a restructuring plan is in one half a valuation of the debtor's business, which involves estimates of future cash flows, and in the other half a blueprint for dividing those future cash flows. The judge's initial approval of the plan thus hinges half on the judge's sense of whether these predictions are realistic, and, in the other half, a determination of whether the proposed division is fair.

Assessing whether predictions about future cash flows are realistic is the job description of a financial advisor, not a judge. Judicial determination of plan feasibility at the outset is an especially more important protection of creditors' rights in a governmental proceeding.[151] In a corporate bankruptcy, creditors have greater legal and market recourse against a debtor who ends up unable to fulfill his plan obligations. In a governmental bankruptcy, creditors' remedies against a debtor who, after plan approval, does not fulfill his obligations are more limited.

4. *Enforcement*

Chapter 9's only means of executing a reorganization plan is § 943(b)(7), which requires a Chapter 9 plan to be "in the best interests of creditors" and "feasible." But the Code neither defines "feasible," nor provides relevant factors

[148] This is incidental because the Founders were not concerned with the treatment of debtors, which has become a central policy concern of modern bankruptcy law.
[149] Recovery Act § 109(b).
[150] 1-Monograph1 COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 4.
[151] *See* discussion, *supra*, under Enforcement.

for a judge to consider in a feasibility analysis. The lack of statutory guidance creates ambiguity for creditors, debtors, and judges, increasing transaction costs. For example, the bankruptcy court in the Colorado Chapter 9 case In re Mount Carbon Metro discussed the meaning of *feasibility* at length, delving into the legislative history and history of the Code in general.[152] The thorough judicial opinion concluded with a definition of feasibility resembling that in § 363(g) of the Puerto Rico Act. Had the U.S. legislature included a similar provision in the statute, the actual costs of litigation as well as indirect costs arising from uncertainty would have been avoided.

Not only does the vagueness of the feasibility requirement under U.S. law create transaction costs by parties uncertain about *feasibility*'s meaning, but also, the vagueness speaks to the lack of enforcement provisions in place for Chapter 9 plans, robbing them of potential value. Chapter 9 lacks any means of ensuring that a debtor actually implement a plan, other than the vague feasibility standard, which the judge determines prior to confirmation.

The P.R. Recovery Act, on the other hand, contains actual enforcement mechanisms. The Act creates an independent commission to oversee compliance with the plan.[153] The public corporation must report to the commission every six months. If the corporation fails to meet statutorily specified milestones, the commission will inform the governor and the public. The Commission may make recommendations for curing non-compliance, which may "include the replacement of some or all of the management or the governing body of the eligible obligor."[154]

The P.R. Recovery Act is an inspirational model in that it merely contains an enforcement mechanism at all. Further, its particular enforcement mechanism is effective because it addresses root causes of the fiscal crisis: misaligned incentives between politicians' relatively short-term interests in their careers, and the Commonwealth's long-term interest in the health of its economy, and insufficient monitoring to reduce resulting agency costs. The Commission itself monitors politicians and also facilitates public monitoring of politicians. The Commission may even suggest firing politicians, which voters have the power to do.

Chapter 9, on the other hand, refrains from interfering in the political process. § 904, limitation on jurisdiction and powers of court, states: "Notwithstanding any power of the court, unless the debtor consents or the plan so provides, the court may not, by any stay, order, or decree, in the case or otherwise, interfere with—(1) any of the political or governmental powers of the

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[152] *See, e.g.*, *In re* Mount Carbon Metro. Dist., 242 B.R. 18, 31–42 (Bankr. D. Colo. 1999) (discussing the lack of statutory language or case law defining the *feasibility* requirement, and discussing the requirement at length).
[153] Recovery Act § 203.
[154]

debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property."

The purpose of § 904 is respecting the Tenth Amendment. But in doing so, the law neuters its effectiveness by refusing to deal with a fundamental cause of municipal insolvency: because politicians internalize short-term costs to the government's economy as reputational damages, and do not internalize long-term costs to the government because political terms are limited, politicians' interests are *per se* misaligned with the economic health of the government they represent.

So long as democratically elected representatives are responsible for making budgets, this conflict will persist and motivate unwise financial decision-making. A truly effective municipal bankruptcy law must address this endemic and ubiquitous agency cost.

The Puerto Rico law takes further steps to ensure that plans are actually put into practice. § 363(g) requires that "the petitioner shall be able to make all mandatory payments provided by the plan and perform public functions." § 363(h) mandates that "confirmation of the plan is not likely to be followed by the need for further financial reorganization of the petitioner," a requirement mimicking the § 1129(a)(11) for Chapter 11 confirmation, which references liquidation and is not incorporated into Chapter 9.[155]

Chapter 3 debtors must undertake fiscal stringency measures. § 315(o) requires for confirmation that "the petitioner shall have proved to the Court that it undertook…a reasonable program of cost reductions and income enhancements to try to maximize its repayment of affected debt under the plan." Chapter 3 thus offers an additional way for the court to oversee elected officials' budgetary decisions, and ensure that they prioritize economic efficiency over popular appeal. If they do not, the Commission will make their non-compliance known to the public, who may punish wayward officials by firing them through the voting process. By contrast, Chapter 9 lacks a statutory fiscal stringency requirement.

Not only must the Puerto Rico judge determine feasibility of the plan prior to confirmation, and in a well-defined way, but also, once the plan is put into place, in independent commission oversees compliance. A statutory bankruptcy has the potential to create value by introducing predictability for creditors into what would otherwise be an uncertain, risky environment. But without enforcement, predictability and therefore value of the proceeding in creditors' eyes is watered down.

5. *DIP Period Judicial Monitoring*

In both Chapter 9 cases and hypothetical P.R. Recovery Act cases, the government has a good deal of power to manage its own business affairs during

[155] 11 U.S.C. § 1129(a)(11) requires that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan."

the course of the proceeding. Like § 363 in Chapter 11 of the Bankruptcy Code, § 307 of the P.R. Recovery Act provides a shortcut for the debtor to sell "all or substantially all" of its assets before plan confirmation. Both provisions require judicial approval.

Under current federal law, § 363 does not apply to Chapter 9 cases.[156] Chapter 9 does not incorporate § 363 because Congress wanted to give municipalities freedom to make budgetary decisions. To preserve the federalist balance of powers, insolvent municipalities do not need court approval to sell significant assets outside of the ordinary course of business.

However, a judicial approval requirement has benefits that Chapter 9 debtors miss out on. A judicial approval requirement protects creditors' interests and legitimizes the debtor's decisions. This is especially important for a debtor in possession [hereinafter DIP].[157] During the DIP period of a bankruptcy, legitimization benefits the debtor because managers of an insolvent entity *per se* lack legitimacy. Their prior decisions are responsible for the business's mess.

Legitimization enhances public and investor confidence. In Puerto Rico, the governor's decision to partially privatize the public corporation PRHTA in 2011 was akin to a DIP decision without judicial approval. The government decided to transfer operation and income of its two large toll plazas to Goldman Sachs and Albertis Infrastructure.[158] Creditors and citizens were concerned that the arrangement was a poor deal for the Commonwealth in the long run, designed to save political face and pay off debts with a short term cash infusion.[159]

If PRHTA had conducted the transfer under § 307, the court would have evaluated whether the transfer was a good business decision for both the agency in the long run as well as for its creditors. Court approval would ease creditors' and citizens' concerns that the transfer was made by incompetent or unscrupulous managers. The judicial stamp of approval would restore faith in the government's budgetary decisions in the eyes of citizens and creditors alike, rehabilitating the economy.

Because Chapter 9 lacks judicial approval requirements for significant DIP sale, creditors will be less likely to trust municipal debtors' business decisions. Although under federal law, the municipal DIP has the power to make these decisions whether the creditors like them or not, the debtor's interests are met

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[156] *See* 11 U.S.C. § 901 (cross-listing applicable statutes to Chapter 9).

[157] Under federal law, the debtors' managers may apply to run the firm during the bankruptcy proceedings. The period after filing and before plan confirmation is known as the DIP period. 11 U.S.C. § 1107.

[158] PRESS OFFICE OF THE GOVERNOR OF P.R., PUERTO RICO TO GET $1.4 BILLION IN ITS FIRST P3 TOLL ROAD DEAL (June 20, 2011), http://www.app.gobierno.pr/wp-content/uploads/2011/06/News-Release-ENG.pdf.

[159] *See* Alan Schankel, *PR Highway and Trans: A Bumpy Road*, JANNEY FIXED INCOME STRATEGY (June 13, 2013), http://www.janney.com/File%20Library/Fixed%20Income/prhta-a-bumpy-road.pdf; Carlos Márquez & John Marino, *First Phase of Highways PPP Underway*, CARIBBEAN BUS., (July 26, 2010, 12:00 AM), http://www.caribbeanbusinesspr.com/prnt_ed/news02.php?nw_id=3744&ct_id=0.

better when creditors have faith in its economy. In a broad sense, creditor faith encourages lending overall. In a more immediate sense, creditor distrust will inspire litigation.

For example, Detroit, when in Chapter 9, considered selling the city's artwork collection, valued between $2.8 and $4.6 million, to pay pension debts.[160] As a matter of law, Detroit was free to make this decision without creditor or judicial approval. But the Detroit Institute of Art, despite being owned and financed by the city, threatened to "fight and litigate every piece of art that the city would sell…in order to make it a very lengthy and painful piece of litigation" for the City.[161]

Had the sale received judicial authorization, the museum would not have wasted its time challenging the sales in court. Under § 363, a judge would have considered the costs and merits *ex ante*, and obviated costly and unnecessary litigation on the back end.

The Puerto Rico procedure for § 307 sales puts a good deal of power in the court to protect creditors and assess the debtor's business decisions.[162] Chapter 9 would do well to permit § 363 sales, which can be an important means of increasing estate value, with significant judicial oversight to legitimize the process. Puerto Rico provides an inspirational model in this regard.

6. *DIP Period Creditor Monitoring*

Chapter 9 formally incorporates the portions of Chapter 11 that empower creditor committees.[163] But in practice, the role of creditors' committees is more

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[160] Matthew Dolan, *Detroit Museum Raises Nearly $27 Million to Help Stave Off Sale*, WALL. ST. J. (July 16, 2014, 1:14 PM), http://www.wsj.com/articles/detroit-museum-raises-nearly-27-million-to-help-stave-off-sale-1405530845.

[161] Brent Snavely & Matt Helms, *Orr Says Settlement With DIA Averted Costly Legal Fight*, DETROIT FREE PRESS (*Oct. 2, 2014, 7:28 PM)* http://www.freep.com/story/news/local/detroit-bankruptcy/2014/10/02 /bankruptcy-preview-day/16562469.

[162] "No transfer shall be approved unless the petitioner, or GDB on behalf of the petitioner, or GDB on behalf of the petitioner, shall have included in its request for approval the reasons why such proposed transfer is reasonably likely to maximize value for creditors, in the aggregate, consistent with enabling the continued carrying out of the petitioner's public functions and the Court shall have found such reasons plausible." P.R. Recovery Act § 307.

[163] In Chapter 11 proceedings, creditors' committees step in to monitor debtors as they run their business during the debtor-in-possession period. § 1102 requires the U.S. Trustee to appoint an unsecured creditors' committee in Chapter 11 cases, and permits the court to appoint creditor committees in cases under other chapters, including Chapter 9, on request of a party in interest and if necessary to ensure adequate representation of creditors or shareholders. § 1103 empowers creditor committees to hire lawyers and accountants, and lists the duties of committees as follows:

> A committee appointed under section 1102 of this title may
>
> (1) consult with the trustee or debtor in possession concerning the administration of the case;

limited in a Chapter 9 case than in a Chapter 11 case. For one reason, the Chapter 11 debtor must pay creditor committees' attorney fees. In a Chapter 9 case, however, the debtor will not necessarily pay creditors' committees fees.[164] For Tenth Amendment reasons, it is outside the power of bankruptcy law or courts to require municipal debtors to make these payments.[165] Doing so would violate 11 U.S.C. § 904, which provides that "unless the debtor consents or the plan so provides, the court may not . . . interfere with any of the political or governmental powers of the debtor; any of the property or revenues of the debtor; or the debtor's use or enjoyment of any income-producing property."

In a Chapter 11 case, creditor committees play an important monitoring role during the critical, risky DIP period. During the DIP period, the fox is guarding the henhouse. Debtor's management continues to make all business decisions and does not even need court approval for decisions in the ordinary course of business. This is risky for two reasons. First of all, assuming the debtor is insolvent, management has already gone a long way towards proving its incompetence in making business decisions. Secondly, when a firm is in the zone of insolvency, managements' interests in saving their jobs and reputations diverge from shareholders' and creditors' interests. This increases potential costs and the need for monitoring.[166]

> (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
> (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
> (4) request the appointment of a trustee or examiner under section 1104 of this title; and
> (5) perform such other services as are in the interest of those represented.

§ 1109 gives creditor committees standing to raise and hear "any issue in a case under this chapter." Chapter 9 incorporates § 1102, § 1103, and § 1109. Creditor committee appointment is required in a Chapter 11 case, but optional in a § 1102 case. Chapter 9 does not incorporate § 1104, so § 1103(c)(4)—empowering the creditors' committee to request appointment of a trustee or an examiner—is moot in a Chapter 9 case.

[164] Rather, the debtor itself must propose paying creditor committees' expenses, because only the debtor may propose a plan. The court will propose the debtor's proposal if it is reasonable. *See, e.g.*, *In re* Castle Pines N. Metro. Dist., 129 B.R. 233 (Bankr. D. Colo. 1991) (requiring the Chapter 9 debtor to pay the creditors' committee's reasonable attorney fees as an administrative expense).

[165] The Tenth Amendment limits the bankruptcy court's power under § 904. 6-901 COLLIER ON BANKRUPTCY P 901.04; United States v. Bekins, 304 U.S. 27 (1938).

[166] For a thorough discussion of this point, see N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

Creditors' committees have the potential to increase welfare by monitoring a wasteful debtor in possession.[167] In Chapter 9, the Tenth Amendment demands even broader deference to the debtor-in-possession's decisions. But here, the Tenth Amendment demands such excessive judicial deference to the debtor-in-possession's decisions. The limited role of creditors' committees in Chapter 9 exemplifies the Tenth Amendment's interference with an economically efficient restructuring regime.

In contrast, under the P.R. Recovery Act, the court must appoint a creditors' committee in any Chapter Three proceeding.[168] The P.R. Recovery Act debtor must reimburse as administrative expenses the creditors' committee for at least two law firms' and a financial advisor's fees.[169] This makes more sense than the Chapter 9 approach, which exclusively empowers the debtor to appoint its own monitor--or not. Under Puerto Rico's law, in contrast, the power to monitor the debtor ultimately lies with the creditors, as granted by statute and executed by the court, and with the court, whose decisions regarding creditors' committee membership are not appealable.[170]

If Puerto Rico had filed under its own Recovery Act, the combination of judicial and creditor monitoring provided for by the law could have restricted the government's dangerous debt issuances. To the extent that the government did issue new debt, markets would have had the assurance of a stamp of approval from the judge and existing creditors. Greater monitoring would have increased the chance of optimal, efficient debt pricing.

7. *Executory Contracts*

The P.R. Recovery Act improves upon both Chapter 9 and Chapter 11 by statutorily defining which contracts the debtor may choose to reject after filing. Executory contracts are some of the most commonly litigated issues in federal bankruptcy.[171] For a large business or municipal debtor with many contractual

[167] Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749 (2011).
[168] P.R. Recovery Act § 318(c).
[169] §§ 318(h), 319(a), 333.
[170] § 318(g).
[171] Under § 365 of the Code, which applies in both Chapter 9 and Chapter 11 cases, a debtor may assume or reject executory contracts, subject to court approval, during the period between filing and plan confirmation. "Assumption" and "rejection" are bankruptcy law synonyms for "performance" and "breach." If the debtor chooses to assume an executory contract, the agreement continues uninterrupted, unless the debtor has already breached, in which case the code requires he compensate the other party in order to assume the contract. If the debtor rejects an executory contract during a bankruptcy proceeding, the event of rejection is effectively backdated and treated as a pre-petition breach. As such, the debtor will only need to pay a pro-rata portion of the claim. The effect is that, while executory contractual counterparties' "claims are calculated in full under state law . . . their actual relief, the payment of the claims, can be thought of as being in little tiny Bankruptcy Dollars, which may be worth only ten cents in U.S.

relationships, the executory contract determination is a matter of huge amounts of money. But the Code fails to define executory contracts.

Traditionally, courts have applied Professor Countryman's definition of an executory contract, *i.e.*, a contract where both parties have material obligations outstanding.[172] However, as many courts and commentators have pointed out, this definition is of limited use.[173] Once a contract ceases to be executory, it no longer exists. Additionally, the Countryman definition is difficult for courts to apply. Due to significant differences from one contract to another, judges struggle to determine whether there are material issues outstanding, driving up litigation costs and reducing predictability.[174]

Unsatisfied with the statutory language and Countryman interpretation thereof, some courts have implemented a functional definition of executory contracts that involves a business judgment test. The purpose of the functional test is to give effect to the Congressional intent behind § 365, which is to enhance the value of the estate. The functional test permits the debtor in possession or trustee to reject contracts that are net liabilities to the estate and assume contracts that are net assets to the estate. A functional executory contract provision maximizes the welfare of the collective, at least when limiting the universe to the parties directly involved in the bankruptcy. An enhanced estate increases payments to creditors, and thus sets the debtor closer to a fresh start.

In 1997, the National Bankruptcy Review Commission recommended that Congress eliminate the "executory" definition from § 365 and leave courts free to

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dollars." This provision gives the debtor a powerful tool; as Professor Jay Lawrence Westbrook explained, "these results suggest that the trustee somehow is not bound to the contract, yet can bind the Other Party, a consequence that seems almost magical to the legal mind." If a contract is not executory, a debtor's breach during the pendency of the case will not be backdated. Rather, the contractual counterparty will have a post-petition claim, which is not dischargeable in bankruptcy and which the debtor must hence pay in real dollars rather than tiny Bankruptcy dollars. Theoretically, then, determining whether a particular contract is executory or not could be very important to the debtor in possession or trustee as he tries to minimize liabilities for the estate. However, as Westbrook pointed out,

It is obvious that a contract must be executory to be assumed or rejected, if the term is used in its ordinary sense to mean merely that aspects of the contract were not fully performed or satisfied on Bankruptcy Day. But if executoriness had such a simple meaning, the requirement would be trivial. The trustee need not, and could not, assume or reject a contract fully performed a year before bankruptcy—nor would anyone dream of doing so. Speaking of a 'nonexecutory' contract in that sense is like discussing a sunset after dark.

The meaning of *executory* has spawned reams of litigation, and led to a labyrinth of case law such that the definition of executory is anything but intuitive. Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 253, 243 (1989).

[172] "[A] contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

[173] *In re* Jolly, 574 F.2d 349, 350 (6th Cir. 1978).

[174] 3-365 COLLIER ON BANKRUPTCY P 365-02.

adopt the functional approach.[175] But the politicized bankruptcy reform bill inspired by the 1997 recommendations died by Clinton's veto. However, many courts today use the functional definition, which the 11th Circuit has affirmed on appeal. Others still use the Countryman test.[176]

Due to the murky Code language, the executory contract provision creates significant transaction costs in the U.S. A statutory definition would at least reduce the litigation costs that arise when parties puzzle over the meaning of executory. At this point, 80% of an effective executory provision would be just showing up in the Code.

The Puerto Rico Act codifies the functional test. § 326 of the P.R. Recovery Act provides that "a petitioner may reject any contract if the rejection is in the petitioner's best interests." The statutory test, then, mimics the business judgment test that the 11th Circuit and some other U.S. courts implement. The functional test does not only show up, but also goes an extra step towards effectiveness by placing economic efficiency at the center of the inquiry.

8. *Collective Bargaining Agreements*

Public employee contracts are another area where the P.R. Recovery Act provides a better solution that the U.S. federal approach simply by addressing the issue statutorily. Collective bargaining agreements are one of the largest outstanding questions in governmental bankruptcy, both monetarily and constitutionally. The Puerto Rico Act explicitly addresses collective bargaining agreements. As such, the Commonwealth's law promotes efficiency by anticipating and preventing ambiguity in federal law that elevates transaction costs. § 326(d) of the Act provide additional special protections for the opposite party to a contract in a collective bargaining agreement, retirement or post-employment benefit plan, mandating that:

> The Court shall not approve the rejection of a collective bargaining agreement or retirement or post-employment benefit plan unless the petitioner has demonstrated that:
>
> > (a) the equities balance in favor of the rejection of such agreement or plan . . .
> >
> > (b) absent rejection, the petitioner will likely be unable to perform public functions; and

[175] NAT'L BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (1997), http://govinfo.library.unt.edu/nbrc/report/01title.html.
[176] 3-365 COLLIER ON BANKRUPTCY P 365-02.

> (c) the petitioner shared with the representatives for employees and retirees, as applicable, the data underlying its request to reject the agreement or plan and conferred, at reasonable times, in good faith with the representative(s) to reach voluntary modifications to such agreements or plans, and such efforts did not succeed.

The U.S. Code, on the other hand, is unclear throughout, and especially in Chapter 9, on the treatment of collective bargaining and pension agreements. Federal law, generally, varies jurisdictionally as to the level of constitutional and contractual protection applicable to collective bargaining and pension agreements. In Chapter 11, it is more difficult for a debtor to reject a collective bargaining agreement than to reject other types of agreement. In the 1984 case Bildisco, the Supreme Court held that unexpired collective bargaining agreements are executory contracts under § 365, but rejection demands a higher level of inquiry by the court than the typical business judgment standard. Instead, the debtor must show that "(1) the collective bargaining agreement burdens the estate, (2) after careful scrutiny, the equities balance in favor of contract rejection and (3) reasonable efforts to negotiate a voluntary modification have been made, and are not likely to produce a prompt and satisfactory solution."[177]

Congress overturned Bildisco by enacting § 1113. However, § 1113 does not apply in Chapter 9 cases, introducing an additional level of uncertainty into labor contract decisions in the Chapter 9 context. For example, the standard for rejecting collective bargaining agreements in Chapter 9 cases was the subject of extensive litigation in In re Orange County.[178] The court there held that Bildisco rather than § 1113 applied, but that the debtor also needed to meet additional state law standards. More recently, the Vallejo court agreed with Orange County that Bildisco rather than the more stringent § 1113 standard applied in Chapter 9 cases, but disagreed that the debtor must also meet state law requirements.[179] Pension agreements bring up an additional set of issues, as courts disagree as to whether pensions are contracts at all, let alone executory versus non-executory, and then, what the appropriate standards for rejection are. The uncertainty under U.S. law, as well as public policy issues involved, makes the issue ripe for Congress to weigh in about whether collective bargaining agreements should be treated differently from ordinary contracts under bankruptcy law, as Puerto Rico's legislature wisely did. In the meantime, litigation costs will amass.

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[177] *See* COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 7 (discussing NLRB v. Bildisco & Bildisco, 465 U.S. 513, 526 (1986)).

[178] *In re* County of Orange, 179 B.R. 177 (Bankr. C.D. Cal. 1995).

[179] *In re* City of Vallejo, 403 B.R. 72 (Bankr. E.D. Cal. 2009).

9. Creditor Protection in Plan Confirmation

A major difference between Chapter 9 and Chapter 11 is § 1129(a)(7), which requires that the plan pay each creditor a value at least equaling the value he or she would have received in a Chapter 7 liquidation. This standard does not readily transfer to Chapter 9 because the municipality cannot be liquidated and so is not incorporated into municipal bankruptcy law.[180] Instead, Chapter 9 requires the plan to be "in the best interest of creditors," a vague standard that opens the door to litigation, reduces predictability, and, in its vagueness, does not necessarily offer creditors meaningful protection, as the level of protection depends on the individual judge's interpretation of "in the best interest of creditors."

The Puerto Rico Act solves this dilemma clearly and elegantly. § 315(d) of the Act mandates that "the plan provides for every affected creditor in each class of affected debt to receive payments and/or property having a present value of at least the amount the affected debt in the class would have received if all creditors holding claims against the petitioner had been allowed to enforce them on the date the petition was filed," and § 315(k) mandates that "each class of affected debt that will not be satisfied in full under the plan absent the additional consideration provided in this subsection shall be entitled to receive annually in arrears its pro rata share of 50% of the petitioner's positive free cash flow, if any, at the end of any fiscal year," after deducting for necessary payments, up to the amount necessary to pay the claim in full. These requirements apply to secured and unsecured creditors alike.[181] The P.R. Recovery Act thus offers more meaningful protection to creditors than Chapter 9 does, as well as more predictability *ex ante*, thereby reducing transaction costs.

At least in theory, the P.R. Recovery Act ambitiously strengthens both the debtor's and creditors' financial positions, granting each creditor not only "at

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[180] *See* Monograph1 COLLIER ON DEBT ADJUSTMENT FOR MUNICIPALITIES § 8.

[181] In addition to the §§ 315(d) and (k) creditor protections, which do not distinguish between secured and unsecured creditors, §§ 315(m) and (n) provide additional plan requirements that distinguish between secured and unsecured creditors. § 315(m) lifts § 1129(b)(2)'s protection for secured creditors. The P.R. Recovery Act plan must provide that secured creditors both retain their liens and receive cash payments totaling at least the value of the collateral, as determined "by the Court based on the plan's proposed disposition or use of the property." § 315(n) requires that payments to unsecured creditors be "in the best interest of creditors and shall maximize the amounts distributable to such creditors to the extent practicable." Additionally, the Puerto Rico Act imposes an absolute priority rule in a separate requirement: § 315(p) requires that "except to the extent agreed to by an affected creditor, the plan does not provide for a materially different and adverse treatment for such claim as compared to the treatment of claims in different classes under the plan having the same priority unless the petitioner demonstrates a rational basis to permit such disparate treatment." Presumably, §§ 315(m), (n) and (p) are additional requirements—albeit vague ones in the case of (n) and (p)—on top of § 315(d) and (k). Ideally, the Puerto Rican legislature would add language clarifying the relationship between these provisions.

least the amount . . . [they] would have received" if their claims were enforced on the date of filing, but also "50% of the petitioner's positive free cash flow." Thus, the P.R. Recovery Act would improve some creditors' positions.

Granted, the P.R. Recovery Act omits some creditor protections present in the Code. The P.R. Recovery Act does not specifically provide a safe harbor for derivative contracts or protect special revenue bondholders.[182] These are the type of amendments the legislature could easily add. In the meantime, the law is broad enough such that courts could read such protections into the law, given the general purpose of protecting creditors and incorporation of Chapter 9 and Chapter 11 case law as precedent.

C. Additional Proposed Chapter 9 Amendments

1. *Involuntary Filings*

As in Chapter 9, but in contrast with Chapter 7 and 11, under the P.R. Recovery Act, only the debtor may initiate filing. In federal bankruptcy language, a debtor-initiated proceeding is called "voluntary," and a creditor-initiated proceeding is "involuntary."[183] The P.R. Recovery Act does not explain in its text why it prohibits involuntary filings. But it is easy to see why empowering creditors to force the government into bankruptcy would strike terror into the hearts of legislators, who might imagine an endless onslaught of one involuntary petition after another, forever tying up the government's time and money in court.

However, allowing involuntary bankruptcy in the governmental debtor context would serve economic efficiency, preserving both dollars and debtor credibility in the specific instance and legitimizing government bankruptcy in the long run. First of all, involuntary bankruptcy would not significantly increase frivolous litigation. Creditors are already free to sue the government whenever they would like; permitting involuntary filings would make doing so more difficult, if anything, by introducing screenings such as the threshold number of creditors and dollar value of claims.

Secondly, involuntary filing would reduce the inefficient stigma costs that currently plague municipal bankruptcy law.

Expanding Chapter 9 would reduce inefficiencies that currently arise from the law's stigma effects. When Orange County filed for bankruptcy in 1994, the municipal bond market crashed under the weight of investors' fears. But Orange County's economy recovered rapidly, and today remains a standout in the region, with high job growth that currently drives the housing market recovery in

[182] McGowen, *supra* note 20.

[183] Chapter 7 and Chapter 11 allow involuntary filings, so long as there are at least three creditors filing with a minimum dollar value of claims. 11 U.S.C. § 303 (2010).

the area.[184] Like Orange County in 1994, after Puerto Rico enacted the P.R. Recovery Act, the three major credit ratings agencies downgraded the island's debt, citing the availability of municipality as their reason for doing so. However, as Orange County illustrated, investors' perception that bankruptcy reduces value may not be true. Credit restriction in Orange County's case had more to do with stigma than with real financial costs of bankruptcy.

An involuntary filing would signal that the creditors believed bankruptcy would serve their interests better than the alternatives and would thus counteract the stigma effects of bankruptcy. Stigma costs arise when creditors worry that debtors are filing opportunistically, to avoid their debt obligations because they do not want to pay, rather than because they are unable to pay. Involuntary filings would give creditors an effective tool to enforce their debt contracts in a coordinated, predictable way, and would thereby save costs for the municipality and creditors alike. Due to sovereign immunity, it is difficult and unpredictable for creditors to enforce obligations.

Empirical data also shows that, due to their concerns about stigma, debtors delay filing beyond the optimal time. Operating in a state of insolvency harms the debtor's economy and citizens, and further decreases creditors' chance of payment in the end. Prolonging the inevitable helps no one. Involuntary filings would counteract the debtor's tendency to drag its feet.[185]

2. *Reduce Exclusivity Periods*

Both Chapter 9 and the Puerto Rico Act impose indefinite exclusivity periods, which means that only the debtor and not creditors may propose reorganization plans. From an efficiency perspective, exclusivity is a toss-up. On the one hand, exclusivity reduces transaction costs. Only the debtor must incur the direct legal costs of forming and filing a plan, as well as the opportunity costs of diverting its attention towards plan formation and thus away from other activities. And the judge only needs to review a single plan. However, creditors still must approve the plan. The less involved creditors are in plan formation the less likely they will be to approve the plan, which will send the debtor back to the drawing board and cancel out any cost savings.

From a fairness perspective, exclusivity is a loser. Creditors will be more likely to find plan formation fair when their voices are part of the process. Though the P.R. Recovery Act imposes plan formation exclusivity, which, on

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[184] *See* James Flanigan, *In The Year Since Bankruptcy, Orange County's Economy Has Become Vibrant Again, Helping To Lead The Region On The Road To Recovery*, L.A. TIMES: BUS. (Nov. 29, 1995), http://articles.latimes.com/1995-11-29/business/fi-8294_1_orange-county (describing Orange County's recovery). *See also* Ricardo Lopez, *Orange County Economy Expected To Accelerate Through 2015*, L.A. TIMES: BUS. (Apr. 2, 2013), http://articles.latimes.com/ 2013/apr/02/business/la-fi-oc-forecast-20130402 (describing Orange County's continued economic success).

[185] For a similar argument regarding desirable provisions for an international sovereign bankruptcy regime, see Bolton & Skeel, *supra* note 30, at 786.

balance, does not necessarily improve efficiency and certainly does not improve the law's reputation in the eyes of creditors, the Puerto Rico Act mitigates these costs by including creditors in other ways. The Chapter Two procedure foresees negotiations between creditors and the debtor, ensuring creditor input into plan formation at the early, pre-confirmation stages of the process.

Chapter 9 theoretically requires early creditor input, as well. Under § 109(c)(5), the debtor must either present the creditors with a plan for debt adjustment and obtain the agreement of each impaired class, attempt in good faith but fail to present creditors with a plan and obtain agreement from the majority of each impaired class, or show that negotiating with creditors would be impracticable.

However, the requirement of § 109(c)(5)(C) removes the teeth of the other three eligibility requirements. Any municipality can show that negotiating would be impracticable, especially those with multiple creditors and complex capital structures—in other words, those likely to desire debt adjustment in the first place. Puerto Rico would have no problem demonstrating that negotiating with its diverse bondholders and public employees would be time consuming, expensive, and distracting for its politicians.

VI. CONCLUSION

Puerto Rico's exclusion from the Code is costing its citizens, who live in a state of financial distress, investors, whose traditionally safe municipal bond holdings have transformed quickly into risky investments, and the federal government, which continues to bail the island out through tax credits. Additionally, the credit market is deprived of the chance to develop a predictable body of Chapter 9 law, which can only happen through quantity and quality of Chapter 9 filings.

On February 11, 2015, Pedro Pierluisi, the Commonwealth's nonvoting Congressional delegate, introduced the "Puerto Rico Chapter 9 Uniformity Act of 2015" in the House of Representatives. The bill suggests that Congress amend Chapter 9 of the Bankruptcy Code to include Puerto Rico.[186] The National Bankruptcy Conference, an influential group of experts, endorsed the bill.[187] Fitch Ratings Agency agreed and issued a press release entitled, "Chapter 9 Extension Would Be a Positive for Puerto Rico."[188] As of the time of this writing in March 2015, Congress is conducting hearings on the proposal.[189]

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[186] *Pierluisi Introduces Bill to Include Puerto Rico in Chapter 9 of the U.S. Bankruptcy Code*, U.S. CONGRESSMAN PEDRO PIERLUISI: PRESS RELEASES (July 31, 2014), http://pierluisi.house.gov/media-center/press-releases/pierluisi-introduces-bill-to-include-puerto-rico-in-chapter-9-of-the-us.

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

[188] *Chapter 9 Extension Would Be a Positive for Puerto Rico*, FITCH RATINGS (Aug. 6, 2014), https://www.fitchratings.com/site/pressrelease?id=845614&cm_sp=homepage--Featured_Content

A general policy by both Congress as well as judges to interpret Chapter 9 inclusively would serve efficiency goals. Approving Pierluisi's proposal would be a step in the direction towards a broader Chapter 9.

Cities and states play two roles. In one role, they are public goods that provide fundamental services to citizens. In the other, they are businesses that issue debt on the market, hire employees, and manage other people's resources as efficiently as possible.

In this way, they resemble banks. Banks also have a quasi-private, quasi-public function. They are private businesses that generate profits for shareholders, but they also play a crucial role in the money supply, and their failures create major negative externalities. For these reasons, the federal government both supports them through federal deposit insurance and also monitors their activity through regulatory regimes that have become even stronger over the past five years.

Cities and states also receive significant aid from the federal government, both in terms of direct dollars as well as federal income tax exclusion of municipal bonds. Like banks, they create public value when they prosper and effect the public negatively when they fail.[190] And yet, the federal government does not restrict their ability to lend. Municipal bankruptcy law presents an opportunity for federal monitoring of state lending in cases where the states are clearly mismanaging their resources. U.S. governmental agencies lend at subsidized rates, so the marketplace does not discipline them through increased interest rates.

Tenth Amendment principles are already undermined by the interconnectedness of state and federal governments when the federal government lends and subsidizes state budgets. It is inconsistent to interpret the Tenth Amendment strictly in the case of default, which is an inevitable corollary of lending, but permits lending on the front end. In the long run, this inconsistency will restrict governmental access to the capital markets, which will undermine their ability to invest in projects and provide public services.

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[189] *See* Aaron Kuriloff, *House Panel to Hear Proposal for Puerto Rico Bankruptcy Protections*, WALL ST. J. (Feb. 13, 2015, 5:30 PM), http://www.wsj.com/articles/house-panel-to-hear-proposal-for-puerto-rico-bankruptcy-protections-1423866611. *See also* Robert Slavin, *Three Puerto Rico House Members Call For Debt Restructuring*, THE BOND BUYER (Mar. 16, 2015, 12:41 PM), http://www.bondbuyer.com/news/regionalnews/three-puerto-rico-house-members-call-for-debt-restructuring-1071387-1.html.

[190] For a discussion of the unique characteristics of banks that make special regulation appropriate, see Schaake v. Dolley, 118 P. 80 (Kan. 1911). *See also* RICHARD SCOTT CARNELL, JONATHAN R. MACEY, & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 59–60 (5th ed. 2009).