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February 10, 2015

Puerto Rico Recovery Act Ruling Reaffirms Creditor Expectations

On February 6, 2015, the U.S. District Court for the District of Puerto Rico issued a decision holding Puerto Rico's Public Corporations Debt Enforcement and Recovery Act (the "Act") unconstitutional, noting that it was "not a close case."¹ The District Court's decision reaffirms the principle that States and Territories cannot enact laws that purport to provide "bankruptcy-like" relief for their municipalities. The ruling, although now subject to appellate court review, provides greater certainty to creditors of municipalities throughout the United States and casts doubt on the ability of States to enact laws in the future that permit a discharge of municipal obligations. However, it represents a setback for Puerto Rico public corporations attempting to restructure their debts, and may have further ramifications for the Commonwealth.

The Act was precipitated by Puerto Rico's decision to provide a means for its public corporations to restructure their outstanding debt. Although Chapter 9 of the U.S. Bankruptcy Code permits States to authorize their municipalities to file for bankruptcy, Congress has specifically excluded Puerto Rico municipalities from filing under federal law. Chapter 9 also includes certain creditor protections that were absent from the Act.

In response to the Act, entities holding almost \$2 billion of bonds issued by the Puerto Rico Electric Power Authority filed suit almost immediately, seeking to have the Act declared unconstitutional. These holders argued, among other things, that the Act was entirely preempted by Section 903 the U.S. Bankruptcy Code, which provides that a State may not enforce a law that prescribes a method for dealing with a municipality's indebtedness that binds non-consenting creditors.

After addressing several procedural issues, the District Court analyzed whether the Act was entirely preempted by Section 903 of the Bankruptcy Code, and therefore in violation of the Supremacy Clause of the U.S. Constitution. The Supremacy Clause establishes that the U.S. Constitution, and federal law generally, take precedence over state laws. In its 75 page decision, the District Court found, among other things, that it was evident from Section 903 that Congress intended to pre-empt all state laws that provide for the adjustment of municipal debt without creditor consent. The District Court concluded by issuing a permanent injunction against enforcement of the Act.²

While many practitioners previously viewed state-based municipal restructuring laws as constitutionally suspect, unless reversed on appeal, this ruling clarifies that States cannot enact laws that purport to adjust municipal debts without creditor consent. Chapman and Cutler will continue to monitor the progress of the case.

1 *Franklin Cal. Tax-Free Trust, et al. v. Commonwealth of Puerto Rico*, Case No. 14-1518, Dkt. No. 119 (D. P.R. Feb. 6, 2015) (Opinion and Order); *BlueMountain Capital Management LLC v. Alejandro J. Garcia-Padilla, et al.*, Case No. 14-1569, Dkt. No. 119 (D. P.R. Feb. 6, 2015) (Opinion and Order).

2 In support of its findings, the District Court cites a book published by Chapman and Cutler, LLP, entitled [Municipalities in Distress? How States and Investors Deal with Local Government Financial Emergencies](#). *Id.* at 39 n.16.

For More Information

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