

Client Alert

Current Issues Relevant to Our Clients

July 14, 2015

First Circuit Affirms Invalidity of Puerto Rico's Public Corporations Debt Enforcement and Recovery Act

In a decisive opinion, the U.S. Court of Appeals for the First Circuit (the "First Circuit" or the "Court") affirmed a lower court ruling that the Puerto Rico Public Corporations Debt Enforcement and Recovery Act (the "Act") is preempted by the U.S. Bankruptcy Code (the "Bankruptcy Code") and therefore unconstitutional.¹ Given this ruling, in order to restructure the debt of its public corporations, absent a consensual agreement with unanimous support, Puerto Rico must now turn to Congress, and obtain an amendment to the Bankruptcy Code that would allow it to authorize its public corporations to file for protection under Chapter 9, the municipal bankruptcy provisions of the Bankruptcy Code.²

Looking forward, even if Congress amends the Bankruptcy Code, it is unclear whether Chapter 9 will provide a complete solution for the unprecedented problems faced by Puerto Rico and its public corporations. Under the Bankruptcy Code, the Commonwealth itself cannot adjust its debts using Chapter 9. Further, the debt of many of its public corporations may be subject to special protections available under Chapter 9 that were not included in the Act. Therefore, even if the Bankruptcy Code is altered to permit Chapter 9 filings for its public corporations, Puerto Rico is still likely to face a protracted period of uncertainty.

The District Court Case

In June 2014, with little warning, the Puerto Rico legislature approved and the Puerto Rico Governor signed the Act into law. This Act purported to create a Commonwealth-level, bankruptcy-like mechanism for restructuring the debts of many of Puerto Rico's public corporations without creditor consent. The Act, which had fewer creditor protections than those in Chapter 9, would have affected holders of bonds issued by many of Puerto Rico's public corporations.

Several creditors of the Puerto Rico Electric Power Authority ("PREPA"), however, filed suit almost immediately to challenge the constitutionality of the Act. The U.S. District Court for the District of Puerto Rico agreed, and permanently enjoined the Act, stating that the Act was preempted by the Bankruptcy Code and that it was "not a close case."³

The Appeal

Pursuant to the Supremacy Clause of the U.S. Constitution, federal law, including the Bankruptcy Code, is the "supreme Law of the Land," thus permitting Congress to preempt state law.⁴ Under this doctrine, any state law that contravenes federal law is "null and void."⁵ On appeal, the question before the First Circuit, therefore, was whether the Act was invalid, because it was expressly preempted by § 903(1) of the Bankruptcy Code – a federal law.

Section 903(1) of the Bankruptcy Code prohibits state municipal debt restructuring laws that purport to bind creditors without their consent, by providing that "a State law prescribing a method of composition of indebtedness of such municipality may not bind any creditor that does not consent to such composition."⁶ The First Circuit initially noted that by its plain language, § 903(1) bars state laws such as the Act.⁷ With respect to Puerto Rico, however, this was not the end of the inquiry, due to certain provisions inserted into the 1984 revisions of the Bankruptcy Code (the "1984 Amendments"), excepting Puerto Rico from the definition of "State" under the Bankruptcy Code solely for the purposes of determining what municipal entities may validly file a petition under Chapter 9.

Specifically, as a part of the 1984 Amendments, Congress defined "State" to include "the District of Columbia and Puerto Rico, *except for the purpose of defining who may be a debtor under chapter 9*"⁸ This definition, the Court explained, deprived Puerto Rico of the power to grant its municipalities the authorization required to file for Chapter 9 relief.⁹ The question then became whether the municipal debtor exception contained in the revised definition of "State" meant that the provisions of Chapter 9 — specifically § 903(1) — were inapplicable to Puerto Rico. The First Circuit found that although Puerto Rico is excluded from the definition of State for the purposes of its municipalities filing bankruptcy petitions, the general provisions of Chapter 9 apply to Puerto Rico. Because § 903(1) applies to all "States" as defined in the Bankruptcy

Code to include Puerto Rico, the Act was preempted by this provision.

The Court noted that the power to give Puerto Rico the ability to authorize its municipalities to file for bankruptcy protection lies with Congress, and none other, noting that “[i]f Congress had wanted to alter the applicability of § 903(1) to Puerto Rico, it ‘easily could have written’ § 101(52) to exclude Puerto Rico from the prohibition of § 903(1), just as it had excluded Puerto Rico from the definition of debtor under § 109(c).”¹⁰

The Court added that one reason for this exclusion is that “Congress may wish to adopt other – and possibly better – options to address the insolvency of Puerto Rico municipalities that are not available to it when addressing similar problems in the states.”¹¹ As such, it is Congress’, and not Puerto Rico’s, prerogative to pass legislation to address Puerto Rico’s insolvency issues. This could, of course, include removing the exclusion from Chapter 9, which would pave the way for Puerto Rico to authorize its municipalities to file for bankruptcy.

The Concurrence

Interestingly, a concurring opinion affirming the Court’s analysis under § 903(1), questioned the constitutionality of the 1984 Amendments on the grounds that the exclusion of Puerto Rico as a “State” for the purposes of what entities may file a Chapter 9 petition violates (i) the requirement in the Bankruptcy Clause that the law be “uniform”; and (ii) the Territories Clause, because it treats Puerto Rico different from other states without a “rational basis” for doing so.¹² While a full analysis of the concurring opinion’s arguments is beyond the scope of this client alert, based on a roadmap set forth in the concurring opinion, Puerto Rico could attempt to challenge the constitutionality of § 101(52), and if it prevailed, its municipalities may be authorized to file under Chapter 9. However, such an approach likely would be met with strong resistance from its creditors.

Conclusion

As a result of the First Circuit’s holding, on July 8, 2015, the Puerto Rico District Court permanently enjoined the Commonwealth from enforcing the Act. Puerto Rico’s restructuring options are now greatly limited. Although, Puerto Rico may file a petition asking all of the judges of the First Circuit to review the three-judge panel’s decision, or petition the U.S. Supreme Court directly for reversal, both of these option may take a significant amount of time that may not be available to Puerto Rico in light of its current financial crisis. Therefore, to restructure the debt of its public corporations, absent further action from the courts or a consensual agreement with unanimous support, Puerto Rico must now turn to Congress and seek the ability for its municipalities to file for protection under Chapter 9.

- 2 Additionally, Puerto Rico may file a petition asking all of the judges of the First Circuit to review the three-judge panel’s decision, or petition the U.S. Supreme Court directly for reversal. As described below, a concurring opinion also suggests an alternate, but difficult path to Chapter 9 eligibility.
- 3 See *Franklin Cal. Tax-Free Trust v. Puerto Rico*, ___ F. Supp. 3d ___, Nos. 14-1518, 14-1569, 2015 WL 522183, at *1, *12-18, *29 (D.P.R. Feb. 6, 2015); *Franklin Cal. Tax-Free Trust v. Puerto Rico*, No. 14-1518, 2015 WL 574008, at *1 (D.P.R. Feb. 10, 2015). For a synopsis of the District Court’s decision, see *Puerto Rico Recovery Act Ruling Reaffirms Creditor Expectations*, available at http://www.chapman.com/media/publication/484_Chapman_Puerto_Rico_Recovery_Act_Ruling_Reaffirms_Creditor_Expectations_021015.pdf.
- 4 U.S. CONST. art. VI, cl. 2.
- 5 See, e.g., *Tobin v. Fed. Exp. Corp.*, 775 F.3d 448, 452 (1st Cir. 2014).
- 6 11 U.S.C. § 903(1) (emphasis added).
- 7 Slip op. at 30.
- 8 11 U.S.C. § 101(52) (emphasis added). This was necessary because when Congress approved the modern Bankruptcy Code in 1978, it erroneously omitted the definition of “State.” The definition of “State” existing from 1938 until the 1978 version of the Bankruptcy Code, however, included Puerto Rico in the definition of State, and included no carve-out with respect to who may be a debtor under the municipal bankruptcy provisions.
- 9 See 11 U.S.C. § 109(c) (defining who may be a Chapter 9 debtor). 11 U.S.C. § 101(52).
- 10 Slip op. at 30.
- 11 Slip op. at 31.
- 12 However, in a similar context involving the Uniformity Clause of the constitution, which requires that “all Duties, Imposts and Excises shall be uniform throughout the United States”, the Supreme Court ruled that Puerto Rico was not part of the United States for this purpose, and could be subject to non-uniform taxation. See, e.g., *Downes v. Bidwell*, 182 U.S. 244, 287 (1901). Laws providing for reorganizations in specifically defined regions have similarly been upheld. See, e.g., *Blanchette v. Connecticut General Ins. Corps.*, 419 U.S. 102 (1974) (upholding constitutionality of Regional Rail Reorganization Act even though it was restricted to a single statutorily defined region).

For More Information

For more information, please contact [Jim Heiser](mailto:Jim.Heiser@chapman.com) (312.845.3877), [Frank Top](mailto:Frank.Top@chapman.com) (312.845.3824), [Laura Appleby](mailto:Laura.Appleby@chapman.com) (212.655.2512), your primary Chapman attorney or visit us online at chapman.com.

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¹ *Franklin Cal. Tax-Free Trust v. Puerto Rico*, Case No. 15-1218 (Opinion July 6, 2015) (“Slip Op.”).