

Chapman Client Alert

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Current Issues Relevant to Our Clients

U.S. Supreme Court Rejects Puerto Rico's Attempt at State-Level Restructuring Regime

The U.S. Supreme Court has placed the final nail in the coffin of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act (the "*Recovery Act*").¹ In its opinion, the U.S. Supreme Court found that the Commonwealth of Puerto Rico (the "*Commonwealth*" or "*Puerto Rico*") was not entitled to establish its own territory-level restructuring process because such a process is prohibited by the Bankruptcy Code. Specifically, on June 13, 2016, the Supreme Court affirmed that the Recovery Act is pre-empted by the U.S. Bankruptcy Code (the "*Bankruptcy Code*"), and thus was an impermissible act of the Commonwealth.

Widening its implications beyond Puerto Rico and to all of the states and Washington, D.C., this ruling solidifies that Chapter 9 of the Bankruptcy Code — the Bankruptcy Code's municipal bankruptcy provisions — is the only procedure by which a municipality may adjust its debts.

The Facts

As discussed in previous Chapman and Cutler LLP Client Alerts discussing the rulings of the lower courts, the facts are as follows.² In June 2014, with little warning, the Commonwealth legislature approved and the Puerto Rico governor signed the Recovery Act into law. The Recovery 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 Recovery 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 filed suit almost immediately to challenge the constitutionality of the Recovery Act. The U.S. District Court for the District of Puerto Rico agreed, and permanently enjoined the Recovery Act, stating that the law was preempted by the Bankruptcy Code and that it was "not a close case."³ The U.S. Court of Appeals for the First Circuit, in a decisive decision, upheld the District Court's decision, noting that it is Congress', and not Puerto Rico's, prerogative to pass legislation to address Puerto Rico's insolvency situation.⁴ Puerto Rico appealed to the U.S. Supreme Court.

The Supreme Court Decision

In a straightforward 5-2 decision, the Supreme Court applied standard principles of legislative interpretation to decide that the Recovery Act was pre-empted by the Bankruptcy Code. Three provisions of the Bankruptcy Code were implicated.

First, the Supreme Court analyzed the definition of "State" in the Bankruptcy Code. This definition has long included Puerto Rico and Washington D.C., but was amended in 1984 to exclude Puerto Rico and Washington D.C., "for the purpose of defining who may be a debtor under Chapter 9."⁵ As referred to by the Supreme Court as a "gateway provision", in order for a municipality to be eligible to file a Chapter 9 proceeding to adjust its debts, it must meet certain enumerated requirements of Section 109(c) of the Bankruptcy Code, including that it be specifically authorized by the "State" in which it sits to file a Chapter 9 petition.⁶ By excluding Puerto Rico from the definition of "State" for the purposes of who may be a Chapter 9 Debtor, Congress effectively prevented Puerto Rico from authorizing its municipalities to file a petition under Chapter 9.

The Supreme Court then discussed the applicability of Section 903 of the Bankruptcy Code to Puerto Rico. Section 903 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."⁷ The Supreme

Court refers to this provision as “Chapter 9’s pre-emption provision.”⁸ Widening the implications of its decision from Puerto Rico to all States, as the term “State” is defined in the Bankruptcy Code, the Supreme Court found that the pre-emption provision not only remains applicable to Puerto Rico, even though Congress has carved-out Puerto Rico from the gateway provision to Chapter 9, but also to all States even if such State’s laws does not permit its municipalities to file a Chapter 9 bankruptcy petition.

Importantly, the Supreme Court noted: “A State that chooses not to authorize its municipalities to seek Chapter 9 relief under the gateway provision is no less bound by that pre-emption provision. Here too, Puerto Rico is no less bound by the pre-emption provision even though Congress has removed its authority to provide authorization for its municipalities to file Chapter 9 petitions.”⁹

Thus, the Supreme Court, has ruled that the Recovery Act, and any other state-level restructuring provision that has been approved by any State, is pre-empted by the Bankruptcy Code leaving Chapter 9 as the only municipal-level restructuring mechanism available for the States.

Puerto Rico Moving Forward

The Supreme Court acknowledged that Puerto Rico is “in the midst of a financial crisis.”¹⁰ Puerto Rico’s debt levels are unsustainable and climbing, and the Commonwealth currently has no way to restructure its debt. The Supreme Court has effectively eliminated any state-level restructuring mechanism, and Congress has excluded Puerto Rico from the ambit of Chapter 9. In fact, currently before Congress is H.R. 5278 — the Puerto Rico Oversight, Management, and Economic Stability Act — a bill that, among other things, would establish a federal oversight board to assist Puerto Rico and its instrumentalities in restructuring their debts. This bill was approved by the U.S. House of Representatives on June 9, 2016, and currently awaits consideration by the U.S. Senate, where it has been referred to the Senate Committee on Energy

and Natural Resources. As currently drafted this bill would not amend the Bankruptcy Code, but rather would add an additional chapter to the provisions of the U.S. Code that apply to territories, such as Puerto Rico.

Conclusion

In its decision, the Supreme Court has clarified that the Bankruptcy Code precludes any state or territory-level municipal restructuring laws that purport to bind non-consenting creditors. Not only does the Supreme Court’s decision require Congressional intervention before Puerto Rico may restructure its debts, but the decision clarifies that States that currently do not permit municipalities to file Chapter 9 petition must pass legislation specifically permitting a municipal bankruptcy filing if consensual methods for restructuring debt have failed.

For More Information

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1 *Commonwealth of Puerto Rico v. Franklin California Tax-Free Trust*, Case No. 15-233 (S. Ct. June 13, 2016) (slip opinion) (hereinafter “*Slip Op.*”).

2 See *First Circuit Affirms Invalidity of Puerto Rico’s Public Corporations Debt Enforcement and Recovery Act* available at http://www.chapman.com/media/publication/538_Chapman_First_Circuit_Puerto_Rico_Recovery_Act_071415.pdf; see also *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.

3 See *Franklin Cal. Tax-Free Trust v. Puerto Rico*, 85 F. Supp. 3d 577 (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).

- 4 *Franklin Cal. Tax-Free Trust v. Puerto Rico*, 805 F.3d 322 (1st Cir. 2015).
- 5 See Slip Op. at 1 (discussing 11 U.S.C. § 101(52) (the definition of “State”).
- 6 *Id.* at 6.
- 7 *Id.* at 7.
- 8 *Id.* at 9.
- 9 *Id.* at 12.
- 10 *Id.* at 2.

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