Does the Bankruptcy Code Preclude Puerto Rico from Adopting a Local Insolvency Scheme for Restructuring the Debts of Its Public Utilities?

CASE AT A GLANCE

The Commonwealth of Puerto Rico is excluded from the scope of chapter 9 of the federal Bankruptcy Code, which permits a state's municipal entities, subject to the individual consent of each state, to file bankruptcy cases to adjust their debts. The City of Detroit recently emerged from the largest chapter 9 proceeding in history. Faced with the similar dilemma of a declining population, a dwindling tax base, and significant long-term debt, in June 2014, Puerto Rico enacted its own municipal restructuring regime (the Recovery Act), applicable only to its electric power, water and sanitation, and highway agencies. Absent an amendment to chapter 9 (which Puerto Rico is currently seeking through congressional action) or implementation of the Recovery Act, these agencies would lack access to an orderly debt adjustment regime. Certain investors holding bonds issued by the island's electric utility challenged the validity of the Recovery Act, principally on the grounds that it is preempted by chapter 9.

Puerto Rico v. Franklin CA Tax-Free Trust* and *Melba Acosta-Febo v. Franklin CA Tax-Free Trust
Docket Nos. 15-233 & 15-255

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From: The First Circuit

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INTRODUCTION

Puerto Rico's municipalities lack access to federal bankruptcy courts to restructure their debts under chapter 9 of the Bankruptcy Code. The Recovery Act was designed to create an alternative state law procedure that, in certain respects, emulated the chapter 9 process. Embedded within chapter 9, however, is a provision that bars any state law "prescribing a method of composition of indebtedness" that would bind creditors without their consent. The First Circuit held that this provision was not cabined within the framework of chapter 9 but reached beyond it to invalidate a law passed by an entity that is categorically ineligible to invoke chapter 9. As a result, Puerto Rico asserts it is stranded in a legal "'no man's land' where its public utilities cannot restructure their debts under *either* federal law *or* its own law."

ISSUE

Does chapter 9 of the federal Bankruptcy Code, which ceased to apply to Puerto Rico in 1984, still preempt a Puerto Rico statute creating an alternative mechanism for the island's public utilities to adjust their debts?

FACTS

The Commonwealth of Puerto Rico, its Government Development Bank (GDB), and its other agencies and instrumentalities have issued over $70 billion in long-term, tax-free municipal bond debt. Approximately $20 billion of this debt was issued by the island's public utilities, including the Puerto Rico Electric Power Authority (PREPA). The island has been struggling through a decade of severe recession, with a cumulative loss of over 250,000 jobs and a current unemployment rate hovering at almost 12 percent (more than twice the national average), coupled with the mass emigration of over 300,000 residents (all of whom are U.S. citizens). Due to aging infrastructure and the high cost of imported fuel, PREPA's electric power rates are well above mainland rates, further exacerbating the crisis. The government faces an unprecedented fiscal emergency, pitting the safety and welfare of its residents against the interests of its creditors.

Unlike a state, Puerto Rico cannot presently authorize its municipalities to file for relief under the Bankruptcy Code. In order to fill this perceived gap, in June 2014 the Commonwealth enacted the Recovery Act, an alternative restructuring statute aimed solely at its public utilities, permitting a controlled, collective restructuring process. The Recovery Act did not apply to the Commonwealth itself or its 78 municipalities, among many other excluded agencies and instrumentalities of the Commonwealth. The act contemplates two paths to a debt restructuring. Under the first path, the parties would attempt a consensual arrangement; if 75 percent of the affected creditors consented to the arrangement, it would then be approved by the GDB and a specialized local court. Under the second, the agency would initiate a court-supervised process to modify its debt obligations. Either path, however, would bind any dissenting or non-voting creditors to the debt modifications.

On June 28, 2014, the day the Recovery Act was adopted, certain mutual and investment funds holding about $2 billion of PREPA bonds filed actions for declaratory and injunctive relief to halt its implementation. In February 2015, the district court entered its summary judgment (meaning there were no material facts in dispute and no necessity for a trial) in favor of the bondholders (respondents) and enjoined the Commonwealth from enforcing the Recovery Act. The Court of Appeals for the First Circuit agreed with the decision of the district court in a lengthy opinion issued on July 6, 2015. Puerto Rico and the GDB (petitioners) each filed petitions for writs of certiorari, which the U.S. Supreme Court granted on December 4, 2015. PREPA, the issuer of the bond debt, has intervened as amicus curiae (among others) with the consent of the parties.

CASE ANALYSIS

One key aspect of chapter 9, crucial to its very constitutionality, is the requirement that each state must assent to the application of its provisions to that state's municipalities. The availability of chapter 9 relief, thus, is entirely voluntary—it is up to each state whether to accept the jurisdiction of federal courts over otherwise sovereign entities. The states, thus, retain full freedom to accept or reject the (albeit limited) federal authority over municipal affairs contemplated by the bankruptcy laws. Thus, if a state would prefer to internally manage its municipal affairs, through financial and political conditions that it deems in its best interest, that state can prohibit its municipalities from circumventing those conditions by seeking federal chapter 9 relief. Although many states currently permit chapter 9 cases, some with detailed preconditions or prior consent, almost half the states either prohibit or do not expressly permit the bankruptcy option. Unlike the states, however, Puerto Rico does *not* have the option to even consider the wisdom of a chapter 9 filing for its municipalities.

The core issue presented by this appeal, thus, is whether a federal law (the Bankruptcy Code), displaces a state law (the Recovery Act), even though the federal law is neither applicable nor available to the state. The First Circuit held that Puerto Rico's Recovery Act was expressly preempted by section 903(1) of the Bankruptcy Code. Section 903(1) declares 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." A "composition" generally refers to an agreement between a debtor and its creditors to discharge an obligation in exchange for a reduced payment. According to the First Circuit, the Recovery Act was plainly a binding composition law and was therefore preempted.

The statutory and legislative history of section 903(1) supported this outcome. The precursor to section 903(1) was enacted in 1946 in response to a 1942 Supreme Court decision (in *Faitoute Iron & Steel Co. v. City of Asbury Park,* 316 U.S. 502 (1942)), that arguably permitted state municipal bankruptcy laws that modified creditors' claims without their consent. *Faitoute* itself was considered somewhat of an anomaly because it appeared to conflict with the Contract Clause to the Constitution: no state shall pass any "law impairing the obligation of contracts." The 1946 amendment was expressly intended to override *Faitoute*. When the modern Bankruptcy Code was adopted in 1978, the 1946 prohibition was recodified at section 903(1). According to the accompanying legislative history, Congress kept section 903(1) intact because, absent such restriction, each state could enact its own version of chapter 9, "which would frustrate the constitutional mandate of uniform bankruptcy laws."

While the preemptive effect of section 903(1) is, thus, seemingly an unremarkable result given the language of the statute and its history, this outcome became somewhat muddled following legislative changes made to chapter 9 in 1984. As a result of these changes, Puerto Rico was no longer considered a state "for the purpose of defining who may be a debtor under chapter 9." Only a "municipality" qualifies as a debtor under chapter 9. A municipality, in turn, means a "political subdivision or public agency or instrumentality *of a State.*" Hence, none of Puerto Rico's political children is deemed a municipality since Puerto Rico is not deemed a state under this definitional paradigm.

This new paradigm was adopted in 1984 with no accompanying legislative history or indicative intent. Prior to that, Puerto Rico was considered a state for all purposes, including access to chapter 9. Moreover, before 1984, it was also accepted that the prohibition against state composition laws applied equally to Puerto Rico as well as the states and the other territories, each of which had enjoyed (ever since 1938) the ability to authorize their respective municipalities to obtain federal bankruptcy relief.

Thus, the question posed, in a nutshell, is whether the 1984 statutory change (that abruptly deprived Puerto Rico of the power to permit its municipalities to enter chapter 9) preserved or nullified the continued preemptive effect of a lone statutory provision embedded within chapter 9—section 903(1) of the Bankruptcy Code. Does section 903(1) apply if chapter 9 cannot be invoked?

The Commonwealth argued at the First Circuit that the preemptive bar of section 903(1) was inextricably twinned with the opportunity to file under chapter 9; absent the latter, there was no basis for the former. But the First Circuit determined that the preemptive effect of section 903(1) remained unchanged. First, there was no evidence that Congress, by the 1984 amendment, intended to fundamentally alter the preexisting impact of section 903(1). If Congress had intended such a change, it could just as easily have amended the scope of section 903(1) as it had amended the eligibility test under chapter 9, concluded the First Circuit.

Indeed, despite the absence of congressional intent, the First Circuit thought it was equally plausible that Congress wanted to keep its powder dry to address the insolvency of Puerto Rico's municipalities, including options that might not be available to the states owing to the fact that Puerto Rico is a territory (acquired in 1898 after the Spanish-American War). Under the Territorial Clause to the Constitution, Congress retains plenary power to "make all needful rules and regulations" respecting the territories of the United States. Thus, it was not illogical for Congress to both deny Puerto Rico "the power to choose chapter 9 relief and to enact its own version thereof."

Second, the First Circuit found there was no structural anomaly created by the application to Puerto Rico of a selected provision within chapter 9 (section 903(1)), even though the entirety of chapter 9 was off-limits to Puerto Rico. Just as those states that

choose not to authorize their municipalities to file under chapter 9 remain subject to the proscription under section 903(1), entities like Puerto Rico that lack even the predicate power to choose are also bound. Although state bankruptcy laws applicable to banks and insurance companies are valid because banks and insurance companies are expressly excluded from the Bankruptcy Code, analogous state laws applicable to municipalities are invalid because of the failure of Puerto Rico to "qualify for the municipal bankruptcy protection that is available." Under this rationale, the terms of the Bankruptcy Code do not "*exclude* Puerto Rico municipalities from federal relief; rather, they *deny* to Puerto Rico the authority to decide when they might access it." Consequently, federal law was, and remained, the sole source of authority for municipal restructuring.

At the Supreme Court, the Commonwealth and the GDB, as the petitioners, urge that Puerto Rico retains the inherent, residual power to enact internal restructuring laws. According to the petitioners, applying federal preemption doctrine to block the Recovery Act would leave Puerto Rico handcuffed to address a crisis that is traditionally delegated to the exclusive control of the sovereign—the health, safety, and welfare of its residents. The respondent bondholders, on the other hand, claim that Congress acted purposefully to ensure uniformity in the field of municipal restructuring. Hence, chapter 9 of the Bankruptcy Code is the sole avenue for municipal debt adjustment, reserved *both* for those states that have chosen to opt out of chapter 9 and those entities (like Puerto Rico) that are barred from even considering the choice. According to the respondents, Puerto Rico's current effort to seek congressional eligibility under chapter 9 merely confirms that Congress has preserved to itself the power to legislate if, when, and how Puerto Rican municipalities can seek chapter 9 relief. As the First Circuit observed, "other solutions may be available" in Puerto Rico's unique case.

The petitioners make a two-part argument to the Supreme Court. First, they assert the Recovery Act is not displaced by the doctrine of field preemption. Field preemption applies where federal law (here, the Bankruptcy Clause to the Constitution and the Bankruptcy Code enacted thereunder) occupies the entire field otherwise addressed by state legislation (here, the field of municipal restructuring). Second, they assert that the Recovery Act is neither preempted by the explicit terms of section 903(1) nor does it stand as an obstacle to the accomplishment of the objectives of Congress.

On the question of field preemption, the petitioners point out that, although the Constitution contemplates a uniform, national bankruptcy law, Congress has acted only sporadically since the founding of the nation to adopt such laws, and usually only on a temporary basis (to be repealed once the financial downturn that triggered the legislation had abated). During that period, numerous states enacted their own competing bankruptcy legislation. Even after a national bankruptcy law became effective in 1898, states were still free to enact restructuring regimes applicable to their domestic banks and insurance companies (which remained ineligible to seek federal bankruptcy relief). Why then should Puerto Rico (barred from chapter 9), be denied the analogous opportunity to manage the fiscal affairs of its municipal household? For petitioners, local bankruptcy laws are only suspended to the extent of an *actual* conflict with an *actual* bankruptcy law passed by Congress—not by the implicit prospect for such a law under the Bankruptcy Clause to the Constitution.

Turning to the facial applicability of section 903(1), the petitioners claim that, "as a matter of law and logic," there is no basis to apply its burdens to an entity that is barred from seeking the benefits of chapter 9. Thus, the context of section 903(1) within the overall bankruptcy scheme is critical to the interpretation of section 903(1). Since that section is not a stand-alone statute but is rather a *proviso* to a *provision* of a *chapter* of the United States Code that has no bearing on Puerto Rico, it would be "nonsensical" to apply it to nullify the Recovery Act. In the petitioners' view, "Congress required States to take the bitter with the sweet"—in exchange for the option of allowing federal relief, Congress limited the relief that states could provide under their own laws. But it would be "exceedingly strange" to bind Puerto Rico to a structure that would never apply to it, especially when that outcome would create a no-man's land "immune from regulation under *either* federal *or* state law."

The respondents, naturally, focus on the affirmance of the First Circuit's decision. They assert that the interpretation of section 903(1) is facially simple and straightforward—state laws that permit nonconsensual municipal compositions are prohibited. Congress acted repeatedly to keep this prohibition since it was first enacted in 1946, despite efforts to delete the provision while the modern Bankruptcy Code was being crafted in 1978. The statute applied to Puerto Rico since 1946, and the 1984 amendment did not change either the language of section 903 or the continuing vitality of the preemption bar. As emphasized by the respondents, "Congress will not be presumed to have made major changes to a statute unless it has clearly announced its intent to do so."

Moreover, according to respondents, the placement of section 903(1) within the overall structure of chapter 9 does not create any exceptions to the preemption bar. Indeed, as the First Circuit acknowledged, this argument would prove too much since it would imply that those states that did not choose to allow chapter 9 cases (almost half) nonetheless retained the ability to adopt a municipal composition law. Instead, chapter 9 still *applies* to those states that have chosen not to authorize chapter 9 relief just as it continues to *apply* to Puerto Rico (despite the impassable eligibility hurdle). In fact, the respondents flagged several standalone sections of the Bankruptcy Code that similarly apply whether or not a bankruptcy case is pending—section 528, for instance, regulates debt relief agencies and section 525 prohibits discrimination against former debtors. These provisions have independent vitality outside of a particular bankruptcy proceeding involving a particular debtor. Hence, it was not at all illogical to situate the preemption bar of section 903(1) in chapter 9.

Next, the respondents assert that the Recovery Act does not "fill a gap" that is otherwise ready to be filled. In other words, there is no traditional source of state municipal bankruptcy law that states can fall back on during times when a federal counterpart is either not in effect or is inapplicable. This is because the Contract Clause stands as a separate obstacle to the impairment of contracts by state legislation. Thus, only federal law can overcome the prohibition on

the impairment by states of the obligation of contracts or otherwise override contrary state law. U.S. Const., art. I, § 10, cl. 1 (Contract Clause); art. VI, cl. 2 (Supremacy Clause).

Even though the *Faitoute* decision seemed to imply that the Contract Clause was perhaps not as robust as imagined, Congress had never accepted the notion that states were free to enact their own laws providing for the nonconsensual restructuring of municipal debts. There is no gap, thus, into which the Recovery Act can comfortably, or constitutionally, fit. Nor does the fact that state regulatory schemes have been used to liquidate banks and insurance companies (excluded from the Bankruptcy Code) open the door for Puerto Rico (excluded from chapter 9) to adopt the Recovery Act. Those areas, the respondents note, have long been considered outside the scope of congressional authority, either because they do not involve interstate commerce or because the state's primary role predated the adoption of the Bankruptcy Code.

Last, the respondents point out that Puerto Rico is both in good company in its asserted regulatory "no-man's land," and that it enjoys other viable options to the Recovery Act. First, the states themselves, as well as the Commonwealth (with respect to their own debts, not the debts of their municipal creations), do not qualify for bankruptcy relief. Second, PREPA could employ a receivership remedy, or implement a consensual workout of bondholder claims (which, in fact, it was able to reach in early February 2016). Or, Congress could permit Puerto Rico to use chapter 9 or craft other creative solutions reflecting Puerto Rico's unique status as a territory of the United States. In short, Puerto Rico is neither presently nor permanently stranded without recourse or remedy. The respondents concluded by asking the Supreme Court to follow Congress's mandate prohibiting local municipal composition laws.

SIGNIFICANCE

On one level, the outcome of this case will almost certainly impact Puerto Rico's ongoing effort to seek congressional assistance in the form of legislation enabling access to chapter 9 for its municipalities, or even for the Commonwealth itself (a form of "super-chapter 9," since the states are not currently eligible to seek federal bankruptcy relief). If the Recovery Act is indeed preempted, and its implementation enjoined, Puerto Rico will likely need the federal bankruptcy advantage of a "breathing spell" to tackle its complex and interrelated debt obligations.

Although the bondholder respondents go to great lengths to downplay the severity of the island's crisis, and to highlight the availability of other avenues (short of a chapter 9 filing) for restructuring its bond debt, most observers see no bankruptcy policy reason for denying Puerto Rico the ability to take advantage of chapter 9 (as it had enjoyed for decades until 1984), particularly since the 1984 amendment did not evince *any* congressional justification for the change. By preempting the Recovery Act, however, Puerto Rico may lose some leverage in the ongoing debate over the appropriate nature of legislative reform for Puerto Rico.

It is possible, for example, that any legislation will be accompanied by some fiscal oversight or control mechanism to assure that the bankruptcy option, if offered to Puerto Rico, is used more sparingly, or subject to more stringent terms, than might otherwise apply to the states. This perhaps reflects a view that the relationship between a state and its municipalities is analogous to the relationship between the United States and its territories. In other words, while chapter 9 does not spell out how or under what conditions a state should authorize its municipalities to be a debtor (leaving that up to each state), Congress may determine that it should remain the gatekeeper of last resort if Puerto Rico is offered the bankruptcy option. Whether this gatekeeper role is viewed as undue interference or welcome assistance remains to be seen.

At another level, the case illuminates the continued quandary of Puerto Rico's political and legal relationship with the United States. On the one hand, Supreme Court precedent holds that Puerto Rico has the "degree of autonomy and independence normally associated with States of the Union." On the other hand, under the Territorial Clause to the Constitution, Puerto Rico derives its powers from Congress which, despite the passage of the Federal Relations Act in 1950 and the ensuing 1952 constitution for the island (which was approved by Congress), retains the ability to repeal all local laws and replace them with any "needful rules and regulations" of its choice.

Indeed, one of the arguments made by the respondent bondholders in favor of the continued preemptive bar of section 903(1) is that Congress is not constrained by Tenth Amendment federalism concerns when it comes to the territories and, thus, could paint a solution for Puerto Rico on a much different canvas than might apply to the states. This argument, however, raises the fundamental question whether Puerto Rico's attributes of sovereignty—its right to self-governance—is in fact similar to the states. A decision preempting the Recovery Act based on speculation that Congress has "something else" in store for Puerto Rico (aside from simply reversing the 1984 amendment), could renew a deeper discussion about the island's place in the federal system. Likewise, any reform legislation that subjects Puerto Rico's power to use chapter 9 to conditions and approvals not otherwise applicable to the states (despite the constitutional requirement of "uniform laws on the subject of bankruptcies"), could also trigger discussion about Puerto Rico's role in the federal political process.

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PREVIEW of United States Supreme Court Cases, pages 200–204.

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Tracking the Term*

52 – Number of oral arguments

18 – Number of cases (granted full review and oral argument) decided

12 – Days of oral argument remaining

82 – Number of cases granted to date

*As of March 16, 2016